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RLI Corp. NYSE:RLI

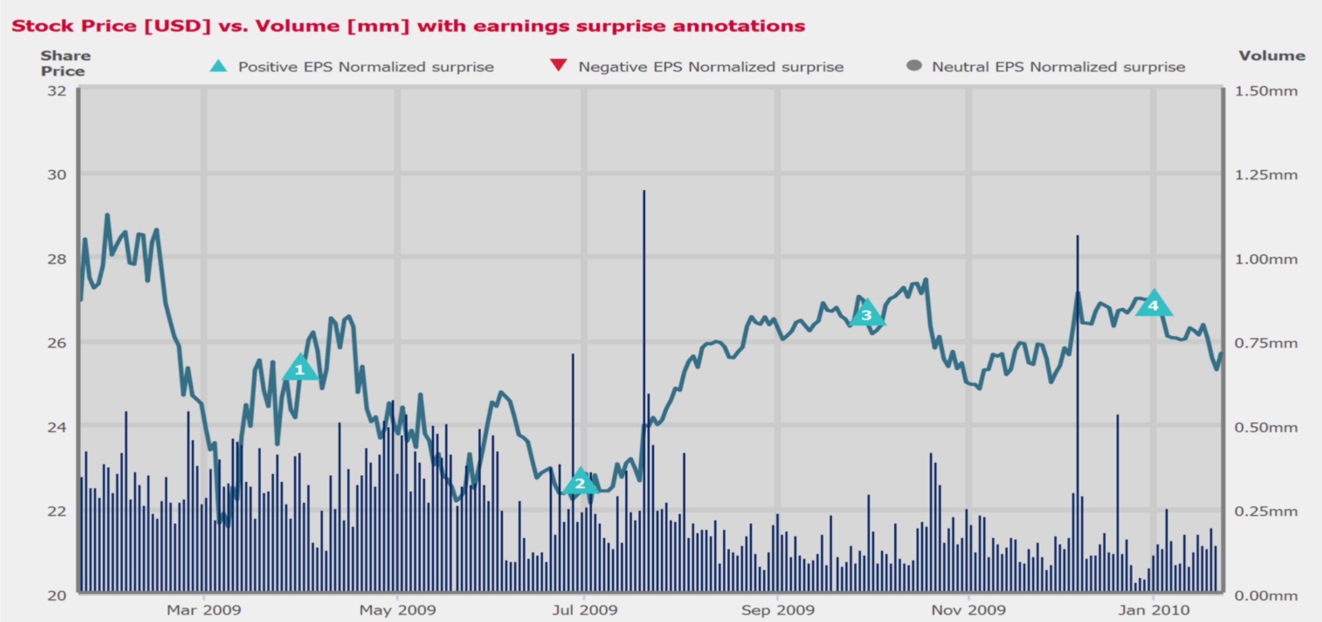
FQ1 2010 Earnings Call Transcripts

Tuesday, April 20, 2010 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2010-			-FQ2 2010-	-FY 2010-	-FY 2011-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.48	0.47	(2.08 %)	0.53	2.00	1.95
Revenue (mm)	133.96	139.33	4.01	134.04	544.52	566.39

Currency: USD
Consensus as of Apr-20-2010 1:57 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2009	0.51	0.52	1.96 %
FQ2 2009	0.52	0.66	26.92 %
FQ3 2009	0.47	0.59	25.53 %
FQ4 2009	0.48	0.58	22.92 %

Call Participants

EXECUTIVES

John E. Robison
Former Chief Investment Officer and Treasurer

Jonathan E. Michael
Chairman and Chief Executive Officer

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Michael J. Stone
Director

ANALYSTS

Caroline Steers
Macquarie Research

Doug Mewhirter
FBW

Joseph L. DeMarino

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Vincent M. DeAugustino

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. First Quarter Earnings Conference Call. At this time, I'd like to inform you that this conference is being recorded and that all participants are in a listen-only mode. At the request of the company, we will open the conference up for questions-and-answers after the presentation.

Before we get started, let me remind everyone that through the course of the teleconference, RLI management may make comments that reflect their intentions, beliefs and expectations for the future. As always, these forward-looking statements are subject to certain risk factors which could cause actual results to differ materially.

These risk factors are listed in the company's various SEC filings, including in the annual Form 10-K, which should be reviewed carefully. The company has filed a Form 8-K for the Securities and Exchange Commission that contains the press release announcing first quarter results.

RLI management may make reference during the call to operating earnings and earnings per share from operations, which are non-GAAP measures of financial results. RLI’s operating earnings and earnings per share from operations consist of net earnings after the elimination of after-tax realized investment gains or losses. RLI’s management believes this measure is useful in gauging core operating performance across reporting periods, but may not be comparable to other company definitions of operating earnings.

The Form 8-K contains reconciliation between operating earnings and net earnings. The Form 8-K and press release are available at the company’s website at www.rlicorp.com. At the request of the company, we will open the conference up for questions-and-answers following the presentation.

I will now turn the conference over to RLI's Treasurer and Chief Investment Officer, Mr. John Robinson. Please go ahead, sir.

John E. Robison
Former Chief Investment Officer and Treasurer

Thank you. Good morning to everyone. Welcome to the RLI earnings teleconference for the first quarter of 2010. Joining me for today's call are John Michael, President and CEO of RLI Corp.; Joe Dondanville, Senior Vice President and Chief Financial Officer; and Mike Stone, President and Chief Operating Officer of RLI Insurance Company.

The format for the call is as follows: I'll give a brief review of the financial highlights and discuss the investment portfolio, Mike Stone will talk about the quarter's operations, then we'll open the call to questions and John Michael will finish up with some closing comments.

Our first quarter operating earnings were $0.94 per share. Included in this quarter's earnings are $6.6 million in pretax favorable development in prior years' loss reserves. The favorable development came from our casualty and surety books of business. The combined ratio for the first quarter was 89.1. Gross written premiums were down 5% for the quarter. Given the economic slowdown and the continued soft rate environment, the decline in top line premium is expected. This discipline is ingrained in our culture and our compensation systems. We reward profits, not premiums.

Comprehensive earnings were $33.5 million for the quarter, resulting in book value per share growth of 3% to $40.28.

Turning to the investment portfolio. As of March 31, our overall allocation with 75% in fixed income, 15% in equities and 10% in short-term investments. During the last couple of weeks of the quarter, we had a number of maturities and calls and we have redeployed these short-term balances. The total return on our investment portfolio was 2.4% for the quarter. Equities were up 4.9%, while bonds posted a 1.9% gain. We expect the current economic recovery to continue at a positive, but sub-par pace.

Historically, recoveries have been led by the consumer spending and a robust housing sector, both of which remain fairly weak in this recovery. In addition, a high unemployment rate continues to put pressure on consumer spending and confidence. The next few quarters will mark a transition period for our economy, as government spending is scaled back and growth becomes dependent on the private sector.

While inflation remains in check, since the end of 2008, the 10-year treasury yields have increased over 160 basis points, but remained below 4%. While the government has increased its debt levels substantially, yields remain low as investors continue to seek the safety of treasuries. So what have we done? We have reduced our overall muni holdings over the last year by $100 million, as we believe these credits will continue to feel the impact of government deficits.

We have fully increased our equity allocation. While much of this increase is due to market, we have put some funds to work in the equity markets. We believe over the next three to five years, while the markets will remain volatile, equities will outpace bonds. We have reduced our overall bond portfolio duration from an average of five years throughout 2009 to 4.3 and remained asset liability match with a high-quality portfolio of AA.

Investment income declined 6.2% from the first quarter of 2009. Lower reinvestment rates, dividend declines and our exiting of the high-yield muni bond fund and preferred stocks during the first quarter of 2009 are the reasons for the decline. The tax equivalent book yield on our fixed income portfolio is approximately 5.1% and our book yield on our equity portfolio is 4.1%.

To summarize, we had a good first quarter of investment performance. We're proceeding in a cautious manner, making sure our portfolio remains high quality and is positioned well to support our objectives of protecting policyholders and enhancing shareholder value.

Turning to the share repurchase. During the quarter, we repurchased nearly 214,000 shares at an average cost of $52.79. Over the last three years, we have repurchased approximately 3.5 million shares at an average cost of $55.53. As we have said, many times, our first choice is to deploy the capital to create shareholder value. When we do not see opportunities to deploy our excess capital, we return it to shareholders. We have roughly $7 million remaining on our share buyback authorization. Once it is completed, we will re-evaluate our capital position, along with the market opportunities we see to effectively manage our capital.

For the operations highlight, I will now turn the call over to Mike Stone. Mike?

Michael J. Stone
Director

Thanks, John. Good morning, everybody. Another good underwriting quarter, 89 combined ratio, good by anyone standards. We continue to be disciplined in a tough market place and a difficult economy. In addition to generally weak pricing environment, the recession puts additional pressure on our exposure basis, premiums are heavily dependent on our customers revenues, miles traveled, values, new projects, etc.

In the surplus lines space continues under considerable pressure with standard lines companies, with broader terms and conditions and cheaper prices significantly cutting into our business and that of our wholesale distributors. This is consistent with prior cycles and seems to belie all the industry pundits assurances but this time it's different. Due to the better data, better management, better governance.

I would suspect that this cycle went badly for many, as it has in prior cycles. But we don't like shrink our premium and we work diligently to find new avenues, new products, for example, the crop premium that came in this quarter, we preferred to shrink than save the inevitable reserve whole others will face and none too soon as far as we're concerned.

Talk about casualties for a few minutes, the most competitive area. We're down 22% increase in gross written premium in our ENS [ph] (20:22) lines commercial umbrella and general liability, which also happens to be our largest line. Significant exposure in the construction arena and construction activity is down with the recession. And so measurably and it's off even more so in the major surplus lines space, for example, Florida and California. Rates are up about 7% in addition, as we continue to be disciplined by heart [ph] (20:51) for good renewals, but find it difficult to find new business opportunities.

Transportation up 14% gross written premium, very competitive trucking environment with the economy returning any growth there as well. However, we are starting to see some increased activity by our policyholders, a bit of a glimmer of hope in that sector.

Our top [ph] (21:12) product flat gross written premium. This is last subject to rate competition as it's an admitted product and volume was flat but very strong in this environment, very good story. Our design professionals, our newest casualty product was up some $2 million in gross written premium for the quarter year-over-year as it continues to gain traction and executes on its business plan.

Property. Gross written premium up 5%, pricing up a bit. Most of the premium growth comes from new products, the crop, and a small south Carolina companion facility that we have for a CAT business. Marine was down 9%, as we continue to re-underwrite the whole and ENI segment. We are through most of this underwriting. But we'll be cautious, as the quarters ahead and if the market continues to be difficult.

Our ENS business, the fire and wind that's up 5% and our DIC business is up about 20% gross written premium as we continue to effectively manage our exposures were down some 40% since 2006. We are achieving double-digit returns but remained very disciplined in this space.

Our property facultative reinsurance unit continues to perform well. Gross written premiums up 39%, about $1 million year-over-year in that area. Emission activity is up and the business is performing very nicely.

Fidelity and surety, gross written premium up 6% as the contract energy and commercial surety business is up 17% as additional underwriting capacity kicks in. Our Fidelity business struggles in a soft underwriting environment. We're adjusting our underwriting activity and expect to regain momentum in the coming quarters.

Our strategy remains to diversify our portfolio, both of the products that are less susceptible to cyclical pressures, for example, surety prop [ph] (23:13) and balance maintaining underwriting capacity with expense pressures. So all in all as a quarter, part of our underwriters and 89 combined ratio is good under any circumstances.

With that, I'll turn it back to John.

John E. Robison
Former Chief Investment Officer and Treasurer
Thanks, Mike. I'm ready to open the call up to questions.

Question and Answer

Operator

[Operator Instructions] We'll now take our first question from Joe DeMarino with Piper Jaffray.

Joseph L. DeMarino

My first question is on the pricing environment, can you give us an estimate of what pricing is like on renewals versus on new business, either within your business segments or across the board?

Michael J. Stone
Director

Yes, this is Mike Stone. Casualty pricing is up about 5%. The Property business is probably up a little bit north of 5%, 6% or 7%. And Surety is basically flat. So with continues depressure on the casualty arena and as I said earlier in the EMS space, where we're getting significant pressure from the standard lines companies. The Property business with a considerable component of that CAT where prices are not as much under pressure.

Joseph L. DeMarino

And is that for renewals or just in general?

Michael J. Stone
Director

That's basically for renewals. But we're not seeing any additional rate on the new business. In fact, the new business continues under, probably, even more pressure.

Joseph L. DeMarino

And then the acc [accident] in your loss ratio was higher year-over-year moderately or lower. Was there anything in last year's number that resulted in a higher accident year loss ratio?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

This is Joe Dondanville. We don't see it quite as you do. But we would think that the accident year loss ratio for 2010 would be higher than 2009, primarily driven by changes in pricing.

Joseph L. DeMarino

And then your cash balance seems to be higher also since year end and as well as year-over-year, is that because you feel you're not being rewarded for investing further out on the curve? Or are you hoarding cash because you're seeing some opportunities, in terms of...

John E. Robison
Former Chief Investment Officer and Treasurer

Towards the last two weeks of March, we had a number of calls and maturities, so it's more of a timing issue. Since then, we've put a lot of that back to work. We're buying shorter duration. We're not going out very far on the yield curve high quality.

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Let me follow-up with that loss ratio. If you're looking at the overall, the overall is down slightly because of fire, but if you look at the individual components, the Casualty and Surety are up slightly.

Joseph L. DeMarino

On an accident year basis?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Yes.

Operator

We'll go next to Doug Mewhirter with RBC Capital Markets.

Doug Mewhirter
FBW

Did you have any property losses due to the snow storms or are any appreciable amount?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

This is Joe Dondanville again. Yes, we did. It was roughly about $1 million, the Northeast storms.

Doug Mewhirter
FBW

Would you be willing to disclose how much you're pro-write premiums were this quarter? Or do you have that information?

Michael J. Stone
Director

Yes, we got.

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

It's a little over $5 million of written.

Doug Mewhirter
FBW

About $5 million written?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Yes and about $1 million of burn.

Doug Mewhirter
FBW

The expense ratio, I guess, has been kind of high. And I know that a lot of times that can be distorted by bonus accruals because you have favorable reserve development or so. But looking at -- I guess comparing the first quarter this year to first quarter last year were your favorable development was roughly the same in terms of combined ratio points. I noticed your expense ratio was several points higher, is that just because it's a lower earn premium base or you're still ramping up? Is it because of your new programs is normally [ph] (28:26), I guess, earned your underwriter salaries yet with the premium base, is it a mix?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Well, I would let John Robinson tell you why and it's the bonus attributes associated with the improvement in the investment side. That's what you see as any improvement or increase in expenses is related to that.

Just a follow-up on that, we did have an increase because of mix, as we're writing more Surety business. I think the increase in loss ratio points is about two points because of that -- expense ratio rather.

Doug Mewhirter
FBW

Yes, that makes because surety has, generally, a low loss ratio than a higher expense ratio.

Operator

[Operator Instructions] We'll move next to Vincent DeAugustino with Stifel Nicolaus.

Vincent M. DeAugustino

First off, on the Casualty segment, it looks like there's some occasional loss ratio about surety. But anything you can speak to about the higher term period combined ratio in the quarter, anything that we can look to for that?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

It's primarily driven by the expense ratio with the drop to premiums. We do look at our expenses, but we are trying to uphold on to the premium producers out in the field in order to keep our production plant in fact. And that's having a negative impact as premium volumes continue to drop.

Vincent M. DeAugustino

And then you talked a little bit on the -- putting some additional funds to working equity portfolio. Is there any particular sectors that you're that out to work in?

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, we tend to focus on higher dividend paying stocks, lower beta. So we would -- we'd steer clear of the higher beta, more volatile names, if we can. So we have a nice mixture of utilities and just the higher dividend payer.

Vincent M. DeAugustino

And then lastly, with the Maui Jim results, I think everything looks good there, especially considering the soft 1Q '09 comp. But taking a look at the increase there, is there anything you're seeing that would be indicative of a greater consumer propensity to make higher discretionary purchases in 2010? Are you foreseeing higher somewhat sales in 1Q '10 already?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

Well, we really can't say what impact Maui Jim is -- and what that leads the overall economy. But Maui Jim did see an increase in sales in the first quarter, not only in worldwide sales in which they've grown geographically. But they've also have seen an increase in sales in the United States.

Vincent M. DeAugustino

Is that any change in promotion or just a change in the consumer demand side?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

I believe it's the consumer demand side.

Operator

We'll move next to Michael Nannizzi with Oppenheimer.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

Mike, could you tell me a little bit about the habitational business in the Casualty segment, just kind of what sort of trends you're seeing there?

Michael J. Stone
Director

Yes, the habitational business on the deal side is picking up a bit on the loss ratio side. We've pulled back a bit in that area. We've written over the past four or five years during the hard market and continued for the last several years considerable amount of risk in the Northeast, as well as in the California and the Southeast. The Southeast is drying up. But we're pulling back in the Northeast, quite a bit of competition.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And then, I don't know if you've -- if I might have missed it out momentarily, but could you talk a little bit about personal umbrella and the trends that you've seen in that business over the past quarter [ph] (33:03), including August in the 1st quarter, but maybe fourth quarter, first quarter, just any trends materializing there?

Michael J. Stone
Director

No, I mean, we're about flat when it comes to premium. We're not growing, not like we have in the past because there's been a bit of additional competition. But from a loss standpoint, it's about the same. We're just continuing to perform well. We're like very careful in underwriting there and its continuing to form as it has in the recent past, and also back for a number of years. We have not seen any unfavorable trends, unlike some of our friends there.

Michael Steven Nannizzi
Oppenheimer & Co. Inc., Research Division

And then just maybe a question just on capital, I know you mentioned that you're revisiting the share repurchase authorization once exhausted. How do you think about capital and premium to surplus, I mean, let's say where we are we continue seeing the trends over the rest of 2010. Where do you anticipate that sort of capital, that risk of capital moving? I mean do you -- maybe at fault, you want to keep it above half? Do want to keep it below a certain number? I mean, is there a range that we should think about in terms of operating leverage?

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, it's John Michael. I think that premium to surplus ratio is probably more of the result of -- our capital is rather than where we want to keep that in any kind of a range. I know that would help you with your models. But we don't really view it that way. We look at our risk-adjusted capital, look at how the rating agencies view us and whether or not we have excess capital or not. So I guess I could -- it's a non-answer but I couldn't answer it because of the results of...

Operator

And we'll move next to Court Digman [ph] (35:22) with Sidoti.

Analyst

You mentioned broader in terms of conditions in the market, I think it was done -- the comment was made in conjunction with standard line carriers moving into this [ph] (35:40) market. I just wonder if you'd give a little bit more color on that? And maybe potentially compare it to history and whether you're seeing things like packaging, drawing, getting more traction, along those lines?

Michael J. Stone
Director

It's Mike Stone. Probably a big part of it is the packaging of either the property that was -- that chase the business into the surplus line space or the liability to chase in the surplus lines space, but we see it in container line companies packaging that business back up. And that business -- we don't lose the business to a typical competitor because it's not in the -- the wholesaler never even seen it, so we don't get it. When I talk about terms and conditions from that business, that's admitted business. So to the extent that we have special terms, exclusions, conditions on our policies, those would not obtain on a standard lines policy. So there would be broader as a result. That's what we're seeing. I think in the surplus lines that typical competitors that we have in that space -- for me the guys in the U.S. competitors, that's sort of more business as usual. We have -- some people are more competitive than others in various places but where we really see the competition. We're not not seeing the business is from the standard guys coming deeply into our territory.

Analyst

And then also, there looked to be a decline year-over-year in the casualty reserve release. And I'm just wondering if you could throw out a little bit more color in terms of whether you're seeing any changes on the margin frequency or severity trends by line or were there any specific action of yours are starting to stand-up?

Jonathan E. Michael
Chairman and Chief Executive Officer

John Michael again. I don't think there's any trend there. It is what it is. We calculate this every quarter and it doesn't appear to be any kind of a trend. Some lines are up one quarter, down the next. But we're not really seeing any trends there that we can tell you about.

Analyst

In terms of the overall yield for the fixed income portfolio and the equity portfolio, I'm just wondering what the new money yield was in the quarter?

Michael J. Stone
Director

I don't have that readily available. With the new money that we're putting to work in the fixed income side again, we're on the shorter end of the yield curve. And we're buying more defensive structures so the yield would start out a little lower than what you get at the 10-year level. So I'd say it'd be around 3%, 3½%, 4%.

Operator

[Operator Instructions] We'll move next to Caroline Steers with Macquarie.

Caroline Steers
Macquarie Research

As we entered a ProAg book, I know you commented on this on the fourth quarter call. But relating to the 2010 history [ph] (38:55), have your view changed at all in regards to how much that might affect you as a re-insurer?

Michael J. Stone
Director

It's Mike Stone. No, our view hasn't really changed. There's obviously going to be an impact. ProAg is not as -- it doesn't have as much penetration in United States, where it's going to be -- have a big -- much bigger impact. And they aren't on the highest end of the commissions, either so less impact, but there'll be an impact clearly. But not as much I think on that book of business and we would expect in some others.

Caroline Steers
Macquarie Research

And then just in terms of the casualty development, what lines or years is that development mainly coming from?

Joseph E. Dondanville
Former Chief Financial Officer, Senior Vice President and Principal Accounting Officer

This is Joe Dondanville again. It's primarily coming from 2005 to 2007, and it's coming out of personal umbrella and transportation.

Operator

And if there are no further questions, I will now turn the conference back to Mr. Jonathan Michael.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you all for your thoughtful questions and for listening in this quarter. We continue to deliver strong results in a difficult economy and insurance marketplace. Our business relies on the strength of the economy from the contractors we insure to the trucks that we underwrite. While our top line is down slightly, our profitable results remain our primary passion. We've been able to diversify our product offerings, which has helped offset premium losses in the more mature product lines like site [ph] (40:38) surety, fidelity crop, architecture engineers as some examples. Our balance sheet does remain strong and we're well positioned in the marketplace as we continue to seek new opportunities. To enhance our shoulders' value. As the capital markets have continued to strengthen in the first quarter, that helped to drive our strong comprehensive earnings in book value growth. ROE for the trailing four quarters was 15% and a little bit over 89 combined for the quarter, I think it's a very satisfying quarter. All in all, very good. Once again, thanks for attending and we look forward to talking to you next quarter. Thanks.

Operator
Ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 1-888-203-1112 with an ID number of 614-5991. This concludes our conference for today. Thank you all for participating and have a nice day. All parties may now disconnect.