S&P Capital IQ

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Mercury General Corporation NYSE:MCY

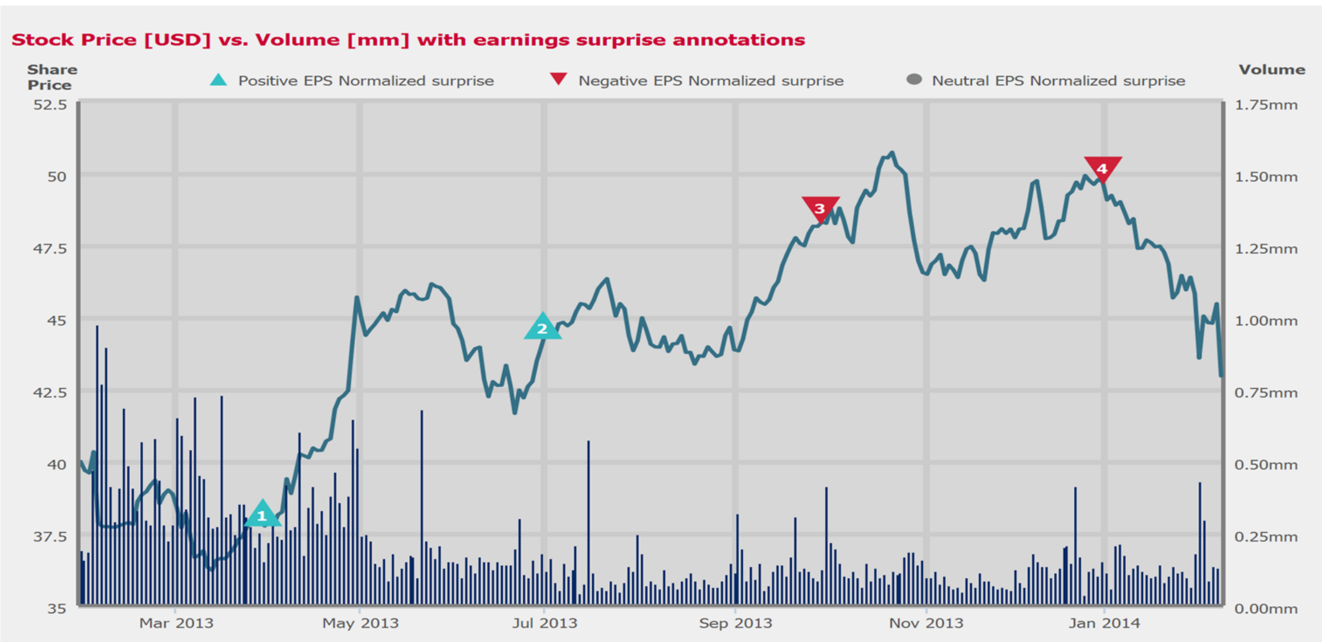
FQ1 2014 Earnings Call Transcripts

Monday, April 28, 2014 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2014-			-FQ2 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.61	0.77	26.23	0.62	2.35	2.50
Revenue (mm)	716.88	724.69	1.09	719.23	2883.22	2953.55

Currency: USD
Consensus as of Apr-14-2014 3:50 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2013	0.47	0.69	1 46.81 %
FQ2 2013	0.61	0.63	2 3.28 %
FQ3 2013	0.64	0.53	3 (17.19 %)
FQ4 2013	0.53	0.33	4 (37.74 %)

Call Participants

EXECUTIVES

Christopher Graves
Chief Investment Officer and Vice President

Gabriel Tirador
Chief Executive Officer, President and Director

Unknown Executive

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 Laurel, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General 2014 First Quarter Earnings 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'll now turn the call over to Gabriel Tirador, President and CEO. Please go ahead.

Gabriel Tirador
Chief Executive Officer, President and Director

I would like to welcome everyone to Mercury's first quarter conference call. I'm Gabe Tirador, President and CEO. In the room with me is Ted Stalick, Senior Vice President and CFO; 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.

Company-wide, we experienced our 13th consecutive quarter of positive premium growth. Premiums written grew 5% in the first quarter of 2014 and were driven primarily by higher average premiums from various rate increases in California. Premiums written outside of California declined 4.7% in the quarter. Our first quarter operating earnings were $0.77 per share compared to $0.69 per share in the first quarter of 2013. The improvement in operating earnings was primarily due to improved results in our California private passenger auto business and the absence of restructuring charges as compared to the prior year. The improvement in our California private passenger auto business was partially offset by worse results in our California homeowners business and in our operations outside of California. Excluding the impact of catastrophes, restructuring charges and the favorable reserve development, the combined ratio was 96.6% in the quarter compared to 96.7% in the first quarter of 2013.

Favorable loss frequency during the quarter contributed to the improvement in our California private passenger auto results. We believe the favorable frequency can be largely attributed to the general lack of rainfall during the quarter. In addition, higher average premiums aided the results this quarter.

In our nonstandard California company, a 6.9% rate increase that went into effect in July of 2013 is now being fully earned. In addition, a 6% rate increase in our preferred auto company went into effect in January 2014. However, the effect of this rate change had a minimal effect on earned premiums this quarter but will have a greater effect next quarter and will be fully effective in the third quarter of 2014.

Our California homeowners combined ratio was over 100% in the quarter. Both frequency and severity were up in the quarter. In addition, a 5.5% rate decrease mandated by an administrative law judge that went into effect in May of 2013 negatively impacted the results this quarter. However, as we previously reported, we implemented an 8.25% rate increase in our California homeowners business on January 25, 2014, which should improve results going forward.

Excluding catastrophes, our operations outside of California posted a combined ratio of slightly under 100% for the quarter. As we have previously reported, we have increased [ph] actions to improve our cost structure outside of California. These changes, coupled with our review of loss indications, allowed us to reduce private passenger auto rates in 5 of our markets in the first quarter of 2014. The rate reductions had an immediate positive impact on new business sales in all of these markets. Although we expect our new business sales outside of California to improve as a result of our rate reductions, we don't expect premiums written to grow in the near term as it will take some time for new business sales to impact premiums written and offset the lower average premiums from the rate reductions.

Our historical targeted combined ratio for private passenger auto is 95% and we generally price our private passenger auto product to that target. However, in states outside of California, we are pricing our product to expense targets that we have not yet achieved but expect to achieve over the next several years. This pricing strategy will allow us to be more competitive than we otherwise would be, but it means that our margins will be lower than our long-term target for the next few years. 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

Just to go back to last quarter, I wanted to try to make sure I understood some of the comments on auto frequency. So last quarter, there was a little bit of drag from increased driving in California. And then some of the VMP [ph] data we track might suggest that, that kind of played out again. But I just -- from a frequency standpoint, it seemed like maybe people were driving more, but because there was less dangerous conditions that even though that -- more mileage, there were fewer accidents and that's what drove your comment on the frequency in California being favorable?

Unknown Executive

Are you talking about the fourth quarter or the current quarter?

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

Trends in fourth quarter kind of carrying over into first quarter with increased driving, but then in first quarter maybe even though there was increased mileage. If say there wasn't wet roads and that kind of thing maybe more mileage here didn't translate into more accidents.

Gabriel Tirador
Chief Executive Officer, President and Director

That's what we attribute it to, Vincent, that's correct.

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

Okay, good. And then just to -- obviously, if you're on the East Coast, I don't get to experience the good weather in California, but it seems like maybe the weather was favorable, but then there was some drag on homeowners this quarter. And so I was just hoping to reconcile what may be any sort of impacts from non-cat weather would be if we thought about trying to look at it at an apples-to-apples comparison with homeowners clearly here being an issue -- or not an issue, but something to try to normalize.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we had the 5.5% rate reduction that we had to take in May of 2013, 1 year ago -- almost 1 year ago, and that impacted the -- obviously our average premiums, which impacted the combined ratio this quarter, more so. Although, as I mentioned earlier, we have an 8.25% rate increase that went into effect in January and these are annual policies, so it does take a little bit of time to be reflected in earned premiums. In addition to that, although we didn't have -- we had very little rainfall in the first quarter in California, although we did have about 5 inches of rain over, I don't know, a 3- or 4-day period in California over a weekend and we estimate that impacted our California results, I think, by a couple of million dollars. So those were the 2 major highlights for California. We also booked a little bit of adverse development in California.

Unknown Executive

For homeowners.

Gabriel Tirador
Chief Executive Officer, President and Director

For homeowners, I'm talking about homeowners, yes.

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

Okay. And then just on the outside-California growth as far as just the rate revisions and kind of pricing that to a longer-term pricing goal. As far as the next year or 2, would you have any ballpark figures on what we might expect from an impact to the margin?

Gabriel Tirador
Chief Executive Officer, President and Director

I think that outside of California, it'll vary by state. The larger states are probably closer -- are going to be closer to where we need to be because of the scale. But overall, I think it would be pushing closer to 100% combined ratio than the 95%.

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

And the 100% is outside of California?

Gabriel Tirador
Chief Executive Officer, President and Director

Outside. We're talking about outside of California, yes.

Operator

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

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

I was just wondering if you could talk a little bit about the expense ratio. It seems despite the restructuring charges and everything you've done, the overhead ratio doesn't look like it's coming down to too much. How are you thinking about that going forward?

Unknown Executive

We're expecting, Alison, that that's going to run at around 27%, hopefully, a little under 27% the rest of this year. We have a longer-term goal to get that down lower, but that's kind of what we're looking at it for the near term.

Operator

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

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

Just a few quick ones. Just following up on Alison's question on the expense ratio. Looking at the acquisition ratio, I would have -- I guess, I was a little surprised that year-over-year was up, and I just think with some of the changes you guys are putting in place on the cost structure outside of California that I maybe would have expected to see that being a little more stable. But with the nice loss ratio in California, I was just kind of curious if there might have been some performance commission impact there this quarter?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, one of the reasons is the mix is a little -- higher mix in California as compared to prior years. Our California business has grown, and outside of California has not grown. We tend to pay higher commissions here in California as compared to outside of California, as an example. We also have the impact of the fact that even though we've taken some cost reduction measures outside of California, I mentioned earlier that our premium volume is down outside of California. So you have some fixed cost that we have reduced, but you also have a situation where outside of California, our volume has declined somewhat. In addition to that, some of the expense measures that we're taking, including commissions, have not really taken effect in this first quarter, so you'll see some of those changes to commissions outside of California be more -- be effective probably starting in the second and the third quarter of this year. So those are 3, I would say, major reasons.

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

Okay. Good color. And then just looking at the balance sheet, looks like the debt maybe went up a little. I think in the 10-K, there was a mention of a $20 million draw on the credit facility, but so I just want to check in and see if it has gone up? And then second would just be if that's the case, just what would the plans for the proceeds be?

Unknown Executive

So we've increased our financial leverage by taking some draws on our credit facility. I think we're up to almost 13% debt to total capital. We wouldn't expect that to go much north of 15% if it does. And I'll let Chris talk to where we are investing the funds, but in general, we're looking at really favorable lending terms from the bank on our credit facilities and we've -- it's provided us with financial flexibility in our holding company and the opportunity to increase our level on investments, to enhance our investment income.

Christopher Graves
Chief Investment Officer and Vice President

Yes, this is Chris. And the objective with the proceeds there is to find income opportunities up in the holding company. We are also looking at total return for the capital appreciation. But it is somewhat, I guess, of an arbitrage opportunity from what the lending costs are versus what the market opportunities are currently available for us.

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

Okay, that's good. And just one quick one, and then I'll wrap up. Just going back to some of the pending -- or the pending issue before the ALJ, I was just kind of curious just thinking about that as far as the timeline. It's my understanding that we probably get an update from the ALJ sometime in June and then the commissioner would have until September or October to make a final decision and I guess does that timeline seem correct?

Gabriel Tirador
Chief Executive Officer, President and Director

Are you referring to the notice of -- 2004 notice of noncompliance issue?

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

Yes.

Gabriel Tirador
Chief Executive Officer, President and Director

The record has technically not closed, Vincent, although it's my understanding that it's ready to close. Administrative issues have been resolved by both sides and I think our record is about ready to close. So once that record is closed, I believe the judge has something between 60 and 90 days to make a decision and send that decision up to the commissioner which then he has, I believe, something in the same neighborhood, 30 to 60 days, for him to render his opinion.

Operator

There are no further questions at this time. I'll turn the call back to the presenters.

Gabriel Tirador
Chief Executive Officer, President and Director

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

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