S&P Capital IQ

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Selective Insurance Group, Inc. NasdaqGS:SIGI

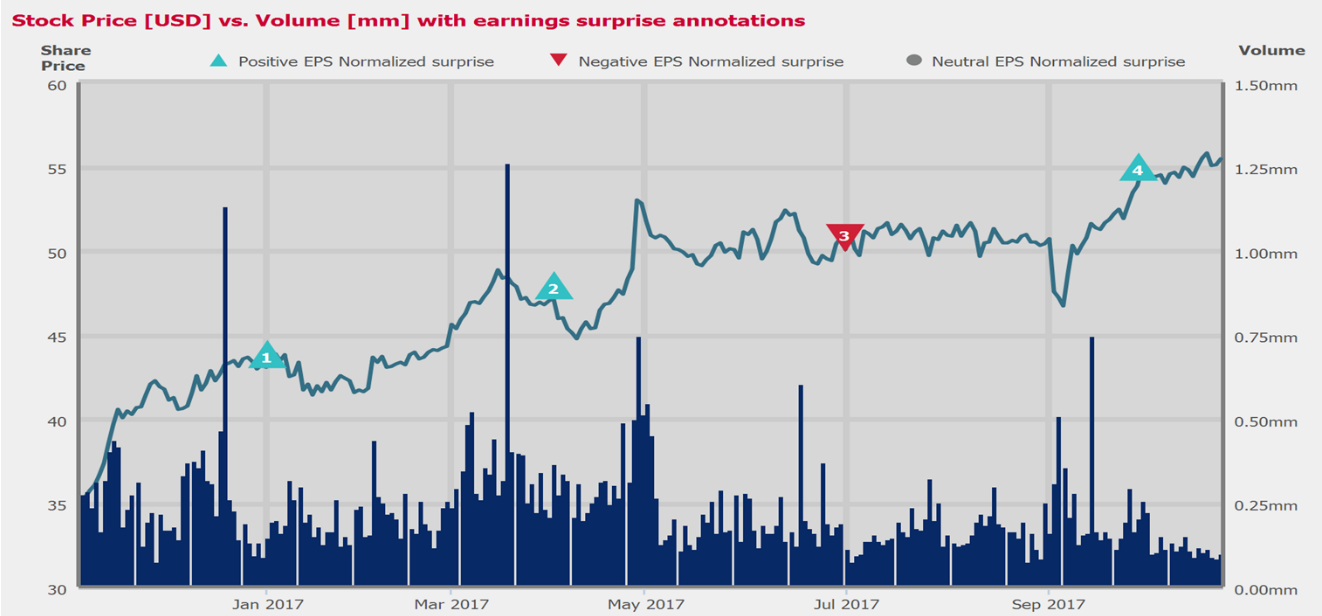
FQ4 2017 Earnings Call Transcripts

Friday, February 02, 2018 1:30 PM GMT

S&P Capital IQ Estimates

	-FQ4 2017-			-FQ1 2018-	-FY 2017-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.80	0.86	▲7.50	0.87	3.08	3.11
Revenue (mm)	632.30	633.70	▲0.22	645.30	2468.50	2470.00

Currency: USD
Consensus as of Feb-02-2018 11:40 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2016	0.68	0.75	▲10.29 %
FQ1 2017	0.68	0.86	▲26.47 %
FQ2 2017	0.73	0.68	▼(6.85 %)
FQ3 2017	0.65	0.72	▲10.77 %

Call Participants

EXECUTIVES

Gregory E. Murphy
Chairman and Chief Executive Officer

John J. Marchioni
President and Chief Operating Officer

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

Rohan Pai

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good day everyone, and welcome to Selective Insurance Group's fourth quarter 2017 earnings call. At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai.

Rohan Pai

Good morning, everyone, thank you for joining the call. This call is being simulcast on our website and the replay will be available through March 2, 2018. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call is available on the investors page of our website www.selective.com. Certain GAAP financial measures will be stated in the call that are also included in our previously filed annual report on Form 10-K and quarterly Form 10-Q reports.

To analyze trends in our operations, we use non-GAAP operating income, which is net income excluding the after-tax impact of net realized gains or losses on investments, the deferred tax asset charge that was recognized in 2017 in relation to tax reform and the result of discontinued operations, if any. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections made during this call are forward-looking statements, as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. We refer you to select this annual report on Form 10-K and any Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussions of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements. Joining today on the call are the following members of Selective's executive management team: Greg Murphy, Chief Executive Officer; John Marchioni, President and Chief Operating Officer; and Mark Wilcox, Chief Financial Officer. Now I will turn the call over to Greg.

Gregory E. Murphy
Chairman and Chief Executive Officer

Thank you, Rohan, and good morning. I'll first make some introductory remarks and then focus on some high-level themes for the full year 2017. Mark will then discuss our financial results, and John will review our insurance operations in more detail, providing additional color on key underwriting initiatives.

We are extremely proud of our financial results we generated for 2017. Our non-GAAP operating return on equity of 11.4% was in line with our long-term goal of achieving a return 300 basis points above our weighted-average cost of capital. An impressive result given the record level of expected industry-wide catastrophe losses, ongoing competitive commercial lines underwriting environment and sustained low new money interest rates.

Our 2017 statutory combined ratio was an excellent 92.4% and on an underlying basis or after adjusting for catastrophe losses and prior-year casualty reserve development was an extremely strong 91.6%. In addition, our after-tax net investment income was $119 million, up 20% over the last year. For 2017, we've seen estimates of global insured catastrophe losses at highs of $136 billion.

In the third quarter, the industry experienced hurricanes Harvey, Irma and Maria followed by devastating wildfires causing significant damage in portions of California in the fourth quarter. With the significant catastrophe loss activity this year and ongoing volatility of severe weather, we expect pressure on carriers to raise industry-wide pricing for property risk. For Selective, catastrophe losses accounted for 2.9 points on the 2017 combined ratio, and our 10-year average was 3.6 points, well below industry averages. We've been highlighting for several quarters that the industry needs to generate additional rate in order to produce adequate returns on capital. Remember, if you're not achieving overall renewal pure price increases then you will not keep pace with claim inflation. Higher rates must support industry catastrophe loss volatility, expecting claims inflation and continued low after-tax new money yields.

We continue to execute successfully on several difficult objectives that will set the table for ongoing sustained performance including: one, achieving a standard commercial lines written renewal pure price increase of 2.9%; two, improving renewal underwriting quality while maintaining strong and stable retention; three, targeted underwriting actions in our Excess and Surplus Lines segment to improve profitability; and four, excellent investor results with after-tax new money rates of 2.1% and strong operating cash flows that were 16% of net premiums written. All these achievements coupled with lower federal income tax for U.S. corporate taxpayers that reduced our estimated 2018 effective tax rate by approximately 10 points, establishes a strong base for future profitable growth.

Our geographic expansion efforts are on track, as in 2017 we opened 2 new commercial line states, Arizona and New Hampshire. In January 2018, we entered Colorado and we expect to add New Mexico and Utah later this year. This will bring our total number of commercial lines states to 27 by the end of 2018. The total amount of Commercial Lines premium represented by these 5 states is close to $12 billion and our long-term market share 3% implies an estimated $370 million additional premium opportunity.

We're always investing to make Selective the best. A truly unique company in the industry, which should position us for sustained financial outperformance and attract high-caliber distribution partners for appointments.

Some of the key competitive advantages of the company are as follows. First, our franchise model of Ivy League distribution partners, which is enabled by our empowered field underwriting model, a true differentiator in the marketplace. We have among the best relationships with the best agents in the industry and are focused entirely on providing our distribution partners with the tools, products and services and resources they need to be successful. We distribute our Commercial Lines product through 1,250 distribution partners, averaging about 50 per state. Our distribution partners are rated at 8.8 on a 10-point scale for overall satisfaction.

Second, we continue to build out sophisticated Commercial Lines underwriting tools and processes that allow our people to make better decisions faster while enhancing outcomes for our new and renewal business. This is best demonstrated by our market-leading written renewal pure price increases of 2.9%, coupled with an 83% retention.

Third, we're making significant investments focused on enhancing the overall customer experience in an omni-channel environment. Customer centricity is at the heart of Selective, and we recognize that our customers' expectations on how they engage with us are rapidly involving. We continue to strive towards providing best-in-class customer service in a 24-hour, 365-day environment. Our goals in this area are centered around leveraging technology to improve customer retention rates which should, over time, meet the higher new business volumes and enhance the quality of our business.

Our long-term growth plans include: one, increasing Ivy League distribution partner representation; two, higher share of wallet; and three, geographic expansion of our footprints. To date, we're in 25 states, which had a 3% market share, create a corporate Commercial Lines profile in excess of $4 billion of net premiums written.

In 2017, we had excellent performance in our investment portfolio as our overall after-tax yield was 2.1% on $3.32 of invested assets per dollar of stockholders' equity, contributing 7.3 percentage points to our non-GAAP operating ROE. Our portfolio managers generated significant output during the year without increasing credit or duration risk. The effective duration of our fixed income securities including short-term investments remains relatively low at 3.7 years.

Our achievements in 2017 could not have been accomplished without the hard work, focus and dedication of Selective's best-in-class employees, who strive each day to meet and exceed established targets. The investments we're making today to continually grow and improve while leveraging latest tools and technologies position us well for the future.

I also want to welcome our most recent hire to the executive managing team, Chip Dufala, as the Executive Vice President Insurance Operations. Chip has a long history of leadership roles in the industry and will be responsible for our Commercial and Personal Lines business segments.

As I've stated many times: one, hope is not a strategy and two, arithmetic has no mercy. When it comes down to improving performance in this industry, the following key drivers must be closely monitored: overall renewal pure price earned increases versus expected claims inflation and after-tax new money rates versus the effective fixed income duration.

Now I'll turn to our 2018 expectations, which are based on our current view of the marketplace and incorporates the following: one, a GAAP combined ratio excluding catastrophe losses of approximately 91%. This guidance assumes no prior-year casualty reserve developments; two, catastrophe losses of 3.5 points; three, after-tax net investment income of $144 million, which includes $10 million of after-tax investment income from our alternative investment portfolio; four, an effective tax rate of approximately 17% on investments inclusive of tax advantage municipal securities tax rate of 5.25% and approximately 25% for all other items; and five, weighted-average shares outstanding of 59.6 million shares on a diluted basis. A GAAP combined ratio of 95 -- 94.5% in 2018 inclusive of catastrophe losses of 3.5 points currently corresponds to a statutory combined ratio of 94%. Now I'll turn the call over to Mark to review the results for the quarter.

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

Good morning, and thank you, Greg. For the quarter, we reported $0.51 of fully diluted earnings per share and $0.86 of non-GAAP operating earnings per share, which is up 15% from 2016. Excluded from non-GAAP operating income in the fourth quarter were after-tax net realized investment losses of $700,000 and a reduction in the value of our net deferred tax asset of $20 million which is the result of the implementation of the Tax Cuts and Jobs Act of 2017, in which the net deferred tax assets will now be realized at a lower federal income tax rate. Despite the one-time charge, our expectation is for overall effective tax rate of approximately 18% going forward, a full 10 percentage points lower than our current effective tax rate. And the expected payback period for the one-time charge to book value per share or for it to be book value per share should be less than 12 months.

As Greg mentioned, we are assuming a 17% effective tax rate on investment income going forward, although this will move around a bit depending on our allocation to tax advantage municipal securities and approximately 21% on all other items.

In the fourth quarter, we generated an annualized non-GAAP operating ROE of 12%. For the full year, we generated non-GAAP operating income of $185 million, which is up 14% since 2016 and a non-GAAP operating ROE of 11.4%. The full year non-GAAP operating ROE is essentially in line with our financial target of 11.5% for 2017. Going into 2018, our estimated weighted-average cost of capital has increased from 8.5% to 9% and we have therefore increased our financial target to 12%. For the fourth quarter, after-tax underwriting income totaled $28 million and generated 6.5 points of ROE. The investment portfolio generated after-tax net investment income of $31 million, which coupled with our ratio of assets to equity of 3.32x, generated 7.3 percentage points of ROE. For the full year of 2017, underwriting income contributed 6.2 points of ROE while investment performance generated 7.3 points. It was a strong quarter of premium growth with consolidated net premiums written up 8% for the fourth quarter and 6% growth for the full year, driven by strong renewal fuel pricing, stable retention levels and good new business opportunities in our 24-state footprint, which includes premium from our 2 new states.

The consolidated combined ratio was 92.8% in the fourth quarter on a GAAP basis and 93.1% on a statutory basis. On an underlying basis or prior to catastrophe losses and prior-year casualty reserve development, our statutory combined ratio was somewhat elevated at 94.5% for the quarter, compared to 92.8% in the comparative quarter with the difference driven mainly by an additional 2.1 points of non-catastrophe property losses in the quarter.

For the full year, our underlying statutory combined ratio improved 60 basis points from 92.2% in 2016 to 91.6% in 2017, which is a record underwriting margin for us on an underlying basis. Of the improvement, the majority was driven by 70 basis point improvement in our expense ratio, which came in about 10 basis points better than our initial forecast for the year. Impacting margins were an elevated level of non-cap property losses in 2017 as well as deterioration of the current accident year for our commercial auto line of business.

Overall, we are very pleased to have delivered an all-in statutory combined ratio of 92.4% in 2017 or 89.5% excluding catastrophe losses. During the fourth quarter, we experienced $10 million of net favorable prior year casualty reserve development, which lowered the quarter's combined ratio by 1.7 percentage points, better-than-expected claims emergence in our Workers' Compensation line of business, resulted in $23 million of favorable development in the quarter, which is partially offset by $10 million of adverse development in our commercial order line of business and $3 million in personal order driven by unfavorable trends.

For the year, we experienced $49 million of net favorable prior year casualty reserve development. We are pleased with the performance of each of our operating segments during the quarter. Net premiums written growth was solid across Commercial and Personal Line segments where premium volume for E&S was impacted by our efforts to increase prices and implement targeted underwriting changes. Profitability was strong in each segment with Commercial Lines continuing to generate exceptional results.

Moving on to expenses. Please note that we've made a change to our reporting, which hopefully, makes it easier for you to analyze and project our expenses. More specifically, we have begun splitting our underwriting expenses between amortization of deferred policy acquisition cost, other insurance expenses and corporate expenses. The main change is that you can now calculate our expense ratio directly from the income statement. And corporate expenses now do not include any insurance-related expenses, which had been previously allocated to expense ratio and calculated in the segment results. All prior periods presented have been reclassified to reflect this change.

Our overall GAAP expense ratio including dividends was 35% for the fourth quarter, which is down 20 basis points for the comparative quarter. Included in the fourth quarter were over $5 million of after-tax expenses related to hiring, severance and several other items that elevated our other insurance expenses for the quarter. Overall, we continue to seek out areas of efficiency in cost savings, while continuing to invest in our employees and in key initiatives around geographic expansion, enhancing our underwriting tools and the overall customer experience. We are pleased with the progress we have made in reducing the expense ratio during 2017 but recognize there's still more work to be done.

For the full year 2017, the statutory expense ratio is down 70 basis points to 33.5% compared to 34.2% in 2016. We expect to continue to drive this ratio down to 33% over time. Corporate expenses, which are comprised of holding company costs and long-term stock compensation, were up $3 billion pretax relative to the comparative quarter and remain generally elevated relative to our longer term expectations. As stated on our recent calls, this is primarily due to the higher costs related to our long-term stock compensation program arising from the strong appreciation in our share price in 2017. As we highlighted last quarter, we expect expense savings in this line item due to changes in early 2017 that were made to our long-term stock compensation program. These savings will work their way through the corporate expense line item over time and should result in a lower level of volatility as well.

We successfully renewed our property catastrophe reinsurance program for 2018 with a very modest exposure adjusted price increase and an improvement to terms and conditions. We expanded our program to $735 million of limit from $685 million to take into account the low corporate tax rate and resulting tax shields for losses of sales of the distribution while we maintained our $40 billion at retention level. We also renewed our treaty to specific catastrophic events outside of our 22 states geographic footprint. This $35 billion in excess of $5 million per occurrence treaty reduces potential volatility to catastrophe events that would be specific to our E&S book and also includes our recent geo expansion states of Arizona, New Hampshire and Colorado. Overall, we are pleased with the outcome of the renewal process and believe it reflects our superior risk management, underwriting initiatives, the benefits of a loss-free account in a heavy cap year and our long-term partnership approach to managing our reinsurance relationships.

Turning to investments. For the quarter, after-tax net investment income totaled $31 million and was up 18% from a year ago. Fixed income securities, which represent 40 -- 92% of our portfolio, experienced an increase in after-tax net investment income, resulting mostly from a higher book yield. Our fixed income portfolio is highly rated with an average credit rating of AA- and a 3.7-year effective duration including short-term investments. The after-tax yield on the fixed income portfolio averaged 2.2% during the quarter compared to 2% a year ago. The new money after-tax yield on the fixed income portfolio during the fourth quarter was 2.1%. The total return on the overall portfolio was a very solid 4.5% for the year. Alternative investments, which report on a one quarter lag, reported a strong pretax gain of $3 million for the quarter. The results were driven by solid performance in our private equity portfolio.

Risk assets which principally include high-yield fixed income securities, public equities in our alternative portfolio, are up modestly to 7.9% of total investment assets at year-end from 7.1% a year ago. We've been gradually diversifying our investment portfolio and will likely continue to modestly increase our asset allocation over time depending on market conditions and opportunities. Our balance sheet remains strong with $1.7 billion of cap equity. Book value per share was up 11% for the year benefiting from strong earnings and net unrealized investment gains, offset in part by $0.66 of dividends per share for the year.

We are adequately capitalized to support our expected growth and continued to target a premium to surplus ratio of approximately 1.4x, which is about twice the industry average. Our sustainable growth rate, which we calculate at 75% of our operating ROE is around 9%. We continue to adopt a conservative stance with respect to managing our underwriting risk appetite, investment portfolio, reserving processes, reinsurance plan and catastrophe risk management. This allows us to maintain higher operating leverage than the industry as a whole with each combined ratio point now equating to 110 basis points of operating ROE posttax reform. This model positions us well to generate superior returns in today's low interest rate environment.

Turning to our forecast for 2018, as Greg mentioned, our underlying GAAP combined ratio forecast for 2018 is 91%. This compares to our 2017 underlying GAAP combined ratio of 92.5%. The 150 basis points of margin improvement is relatively evenly split between improvements in the expense ratio and loss ratio. The loss ratio improvement is driven by a mixed earned rate, underwriting mixed improvements, claims improvements and offset in part by expected claim inflation. Before I conclude, I want to mention that going forward, we'll move from a statutory accounting focus to a GAAP focus. In conjunction with this change, we'll focus our consolidated segment level and line of business disclosures and discussions on a GAAP basis and we plan to eliminate the majority of the corresponding statutory accounting numbers and ratios from our commentary and disclosures. With that, I'll turn the call over to John, to discuss our insurance operations.

John J. Marchioni
President and Chief Operating Officer

Thanks, Mark, and good morning. As we move into 2018, our focus remains to capitalize on opportunities for profitable growth. We looked to execute our strategy by leveraging our competitive strengths, namely our franchise agency relationships enabled by our unique field underwriting model, our sophisticated underwriting tools, which allow us to segment and price risk on a granular basis and the superior customer experience we and our agents provide customers. All this is in the context of a disciplined underwriting culture that is focused on generating adequate returns for our shareholders on a risk-adjusted basis.

We've often talked about our long-term growth plans, to achieve a 3% market share with our footprint states for Commercial Lines. We seek to appoint new agents in our current markets to represent 25% of available Commercial Lines premium and growing to a 12% share of wallet with our appointed distribution partners. During 2017, we appointed 102 new distribution partners in our footprint states excluding New Hampshire and Arizona. Our current agency market share stands at approximately 18% and our share of wallet is approximately 8% in our legacy states.

In July of last year, we launched our Commercial Lines product in Arizona and New Hampshire. We're extremely pleased with the receptivity and early performance with both exceeding our expectations for the year at $9 million of premium volume in just 6 months of operation. Our regional office in Arizona serves as the underwriting hub for our ongoing Southwest expansion. On January 1, we opened Colorado for Commercial Lines business and are on track to open New Mexico and Utah by the end of this year. We also plan to open Arizona and Utah for Personal Lines business. Strong receptivity from agents, who are actively seeking to do business with Selective in these new markets, validates our value proposition and the strength of our reputation.

In addition, as we increase our geographic footprint, we are better positioned to increase our share of wallet in our existing states as we are able to compete for multistate accounts previously unavailable to us. Also integral to our overall strategy is the development and deployment of leading underwriting tools to enhance risk selection. The ability to segment the business on a granular basis allows us to present the right price for a given account.

In 2017, we deployed our underwriting insights tool to new business underwriters. In addition to provide a model-driven guidance that they've long had, it provides real-time insights into how each piece of new business compares with similar accounts already in the portfolio. We believe the tool positions us to better grow the business regardless of overall market dynamics.

Finally, we continue to make rapid strides on the customer experience front. We challenge ourselves as an organization to develop a customer experience model that rivals what customers experience across all goods and services they purchase, not just insurance. Our investments remain focused around providing customers with multiple avenues for accessing information and initiating transactions and ensuring the level of customer experience is consistent across all of them. We're working closely with our distribution partners to ensure we present our customers with a seamless experience.

Turning to operations, our Standard Commercial Lines segment, which represented 78% of total 2017 net premiums written, again produced extremely strong results. Solid net premiums written growth for the quarter of 8% was driven by stable retention of 84% and renewal pure price increases averaging 2.9%. For the full year 2017, net premiums written increased 6%. The GAAP combined ratio for the Commercial Lines segment was 92% for the fourth quarter and 91.6% for the full year. We constantly monitor our renewal pricing on a granular level based on profitability expectations using our Dynamic Portfolio Manager underwriting tool. For the highest-quality Standard Commercial Lines accounts, which represented 49% of our premium in the quarter, we achieved renewal pure rate of 1.3% and point of renewal retention of 90.6%. On the lower-quality accounts, which represented 10% of premium, we achieved pure rate of 6.6% while retaining 79.8%. This granular approach to administering our renewal pricing strategy allows us to achieve additional loss ratio improvement through mix of business changes while continuing to deliver pure rate increases that equal expected claims inflation.

Drilling down to the results by line for Commercial Lines, our largest line of business, General Liability, did not experience any reserve development during the quarter. For the full year of 2017, we experienced favorable reserve development totaling $48 million relating primarily to lower-than-anticipated claim frequencies and severities for accident years 2016 and prior. We achieved renewal pure price increases of approximately 1% for this line in 2017. Our Workers' Comp line experienced $23 million of favorable prior year casualty reserve development for the quarter, as a result of lower-than-expected severities for accident years 2016 and prior. For the full year 2017, favorable reserve development for the line totaled $52 million. Workers' Compensation pricing was flat for the full year and loss cost filings by NCCI and other individual state bureaus have been trending negative overall.

Commercial Auto remains an area of focus, as we take steps to improve the overall financial results. For the fourth quarter, Commercial Auto experienced $10 million of unfavorable prior-year casualty reserve development, primarily relating to higher severities for the 2013 to 2015 accident years. In addition, we strengthened current accident-year reserves with this line by $6 million, reflecting higher-than-expected frequencies for the recent quarters. For the year, prior year casualty reserve development was unfavorable by $36 million and the current accident year was strengthened by $13 million. To address profitability of this line, we've been actively implementing price increases, which averaged approximately 7% in 2017. Loss trends remain elevated and should support additional rate in 2018.

In addition to price increases, we've also been actively managing the new and renewal books in targeted industry segments reducing exposures and increasing price on higher hazard classes. Our Commercial Property Line has experienced profitable results over the past several years despite an extremely competitive pricing environment and generated an 89.7% statutory combined ratio for 2017. While results have benefited from generally benign catastrophe loss activity in our geographic footprint, we have seen an increase in non-catastrophe property loss activity in the book, which has put pressure on underlying results. As the industry takes stock of the severe catastrophe losses incurred in 2017 and the generally anemic returns offered in this line, we believe pricing will strengthen.

Our Personal Lines segment, which represented 13% of total 2017 net premiums written, generated 17% of premiums growth in the fourth quarter and 5% growth for the full year 2017. Underwriting margins overall were profitable with a 95.2% GAAP combined ratio for the fourth quarter and 96.2% for the year. The Homeowners Line experienced strong profitability with a 77% GAAP combined ratio for the fourth quarter and 88.2% GAAP combined ratio for the full year. We continue to target a 90% combined ratio in a normal catastrophe year or one that has approximately 14 points of catastrophe losses. Renewal pure price increases across our homeowners book averaged 2% in 2017.

In Personal Auto, we continue to see improved growth driven by new business volume following years of flat or declining premiums. Renewal pure price increases on our book averaged 4% for Personal Auto liability and physical damage during 2017. However, we experienced $3 million of unfavorable prior-year casualty reserve development for the quarter and $7 million for the full year primarily driven by accident year of 2016. Profitability for this line should improve with benefits of greater scale and efficiencies along with generating earned rate in excess of expected claim inflation. Our plans for 2018 incorporate rate filings averaging approximately 7.4%.

Our E&S segment which represented 9% of total year-to-date net premiums written generated a GAAP combined ratio of 96.5% for the quarter and 103% for the full year. We've been taking deliberate steps to obtain price increases where appropriate and let go

of business that does not meet our profit targets. Overall price increases averaged 5% in 2017 with significantly higher rate increases in the casualty lines of business. We remain comfortable with the rate adequacy of our new business and are continuing to address the pockets of underperforming segments in our renewal inventory. Our strategy has been to drive profit improvement and let the top line float down if the market does not support our pricing stance.
And in 2018, we remain focused on implementing our strategy of generating consistent profitable growth. We continue to invest in strengthening our franchise agency relationships, enhancing our sophisticated underwriting tools and building out our customer experience capabilities, which together underwire our high-tech, high-touch operating model. With that, we will open the call up for questions. Operator?

Question and Answer

Operator

[Operator Instructions] And the first question is from Arash Soleimani with KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

So first question I have is, looking at Standard Commercial, you guys had, I think, quite a bit of an uptick in the non-cap property loss ratio. So if I back the uptick in that ratio out, looks like you actually had about 50 basis points of improvement in the core loss ratio. So I was just wondering what drove that 50 basis points of improvement, especially in light of the strengthening you were mentioning within Commercial Auto in terms of your higher initial loss picks?

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

This is Mark Wilcox. Why don't I start and then Greg and John can jump in as well. I think what you're referring to is the quarterly underlying combined ratio for the Standard Commercial Lines backing out the increase in non-cap property losses. And if you do that, I'm pretty close to a number of about a 40 basis point improvement in the underlying combined ratio, which is really driven by the loss ratio. And I think what you're seeing there is the current accident year development. So in the current accident year, for '17, in the fourth quarter, we did have an uptick in our loss picks, but in the fourth quarter of 2016, we had a higher uptick. The real difference is, we -- in both quarters, on a comparative basis, we raised the loss picks for Commercial Auto, but in the fourth quarter '17, we've continued to see the Workers' Comp book of business perform better than expected and we had a slight reduction in the current accident year loss pick for Workers' Comp, which drove the difference on a comparative basis.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

That makes sense. And is that -- in terms of Workers' Comp, and is that something where going forward the initial loss picks are continue to be lower year-over-year?

Gregory E. Murphy
Chairman and Chief Executive Officer

Yes. Let me just start and others can add in. I'll tell you, this is a line that as an organization we are concerned about, you're seeing a lot of highly competitive conditions in terms of commission rates that we're seeing in the market place. It's a line that we're just very mindful of, I mean, this is the line that has the biggest inflationary tale. This is a line that can turn quickly. And so I don't think you can expect systematic drops in the ratio because you're starting to see rates, this is the line that we got the least amount of rate in, so when John talked to you about the 2.9 that we got and when you look at comp overall, you would see that for the year, it was 0. So you can't put out a 0 rate, and you got to remember, we always talk about overall rate. So overall, we got 2.9 in rate for the year. And when you get 0 on a line and you look at expected claim inflation and the fact that the same drivers that you saw in auto at some point relative to employment rates and other matters can start to affect frequency in this line of business. So I would say, if anything, that the comps kind of, I would say, bottomed out and if anything you should see, ratios actually start to pick up industry wide.

John J. Marchioni
President and Chief Operating Officer

And Arash, this is John. Let me just add a couple of additional points that really reinforce everything that Greg said, which I think is exactly right. The competition on this line has really intensified. Commission rates have been increased in certain cases dramatically, especially for smaller lower hazard workers' comp at a time where pricing has flattened and gone negative. And this is a line where it's harder for us or any other company to really manage pricing like we do on other lines because you are constrained by the underlying loss cost filings that are made by the various state bureaus. And those have been flat to negative and are continuing to move in that direction. We do anticipate normal medical cost inflation driving the line going forward and it's hard for anybody to anticipate that frequency that vary trends, which have been negative for quite a few years, will continue and build those into your forward expectations. So when we take that altogether, we're happy with our book of business. Our performance has been very good. We've been focused on writing on an account basis, a lower hazard style of business. We continue to drive improvements and outcomes to our claims operation. But we're just very mindful of some indicators have suggested this line my start to deteriorate because of what the fundamentals are moving towards.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And just -- while we're on the topic of the loss ratio, just wanted to touch on the guidance again. I know there is 150 basis points of improvement on a GAAP basis in the core combined ratio. And I think you may have mentioned this in your prepared remarks, but did you say that the 150 basis points was evenly -- will be evenly split between the expense ratio and the loss ratio?

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

Arash, this is Mark, again. That is exactly right. So if you look at our combined ratio on a GAAP basis for 2017, we came in at 93.3%. If you back out CATs and favorable development, the underlying was 92.5%. The guidance for the -- guidance for 2018 is 91.0% so it's 150 basis points of margin improvement. And it's about equally split on a GAAP basis between the expense ratio improvement, which we continue to expect to drive down in 2018 as well as the loss ratio improvement. So I think --

Gregory E. Murphy
Chairman and Chief Executive Officer

If I could just add a little bit more comment. So when you think about -- and again, yes, I know you guys heard me say this many times, that you have to look at the effect of rate just on the combined ratio, which you just don't get 4 -- 3 points of rate and that goes right to the bottom line. You've got to get the fact that you've got variable cost of 20%. And even in your nonvariable, you have inflation, you have -- general wage inflation, you have other matters because the biggest part of insurance company's nonvariable cost is labor and labor is going higher. But just to get to your core question and this is something that we are very dialed in, you see this on our waterfall charts and basically, for Selective, when you just look at trend versus -- loss -- loss trend versus earned premium rate, I'm not saying they're neutral, but they're pretty much right -- sitting right on top of others -- of each other. So when you look at our numbers, going from 2017 into '18, what we're getting in rate, pretty much offsets trend and then the rest of the improvements are coming from claim and underwriting. And then, as Mark articulated, the things that are happening on expense basis, which obviously GAAP, you're getting into expense lag, that's actually a little bit more improvement that you're seeing on a GAAP basis than you would see normally on a statutory basis. But when you really think down to it, that's where we're really dialed in on and that's what's going to drive performance. And that's why I think, from your standpoint, earned pure rate is what you need to focus on in 2018, earned pure rate. Nothing else matters in this business.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And when I look at the split between, I guess, in terms of the 3 segments, would that 150 basis points be kind of more E&S driven? Or just -- how would you think about it across the 3 segments?

Gregory E. Murphy
Chairman and Chief Executive Officer

I think you'll see E&S a little bit higher, because of rate expectation is higher. And then in Personal Lines, our auto is tracking up, but our home is more a thing. So I'd say, more -- somewhat you get proportionally maybe a little bit higher in E&S than you would get in the Commercial Lines. So if I were ranking them, I would probably put E&S on the top, I'd put Personal Lines next and Commercial Lines underneath -- slightly underneath that. But there is a huge calibration. I don't want you to think that there's some epic calibration between -- among those 3 different segmentations. I'm just ranking them in the order that you want to understand them and that's what I'm trying to do.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And that 2.9% rate increase you had in the fourth quarter within Standard Commercial, does that look like it's moving up year-to-date so far? I mean -- I know, we've only been a month into the year, but does that look like it's headed upwards?

John J. Marchioni
President and Chief Operating Officer

Yes, look, Arash, this is John. So you -- what you saw in the quarter was -- in the fourth quarter, '17 was a pretty consistent trend relative to pricing. We have not reported a January price number at this point. But throughout the prepared comments, I think you saw a couple of references on a by-line basis. Pricing on Commercial Property has been one of the underperforming lines for the industry. And for us, it was just under 2% for the year and about the same for the quarter. And with all of the activity on both the CAT and the non-CAT basis and all of the industry commentary, we would anticipate that line starting to get a little bit more pricing power going forward. Whereas auto -- I'm sorry, comp has been in the flat to slightly down. I think the other line of note, and we also highlighted this in our prepared comments, is auto -- Commercial Auto has had a couple of years now of strong rate and you saw our rate level, we disclosed for the quarter at just under 7%. And commentary that we believe that based on what's happening with regard to frequency severity trends for the entire industry, we would expect that to continue to be the case. So we haven't put a number out for January yet, but based on what you saw in the fourth quarter and our commentary relative to market outlook, you could draw your own conclusions on that.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And I had mentioned the non-CAT property losses before and I thought that that was up the ratio across each of your 3 segments. So I'm just curious what was driving...

John J. Marchioni
President and Chief Operating Officer

Actually just one clarification. For the year, we saw non-CAT property in the E&S actually below budget, below expectations, but for Standard Personal and Standard Commercial, it was above. There is certainly normal volatility in that line and fire losses continue to be the biggest driver. Large fire losses continue to be the biggest driver. But again, there is normal volatility and if you look at our performance over a long period of time, probably seeing a little bit of noise in '17, we look at our underlying -- the underlying quality of our core Commercial Lines book and feel good about it, but think that the line needs rate overall and that's our focus. So because of that volatility and a little bit of a tick up in larger losses, we expect to drive some rate in that line and that's what the industry is talking about on both the CAT and a non-CAT basis.

Gregory E. Murphy
Chairman and Chief Executive Officer

So when you sit there and you listened to what John has said and what Mark said earlier and you think about '18 versus '17, you can tell by what we've done, you really underrated the fact that we've left this elevated non-CAT expectation stay in 2018 and have not dialed that back. So we're looking at rate changes, we're constantly monitoring the book, trying to find ways to increase the safety management of the properties that we have and are systematically driving more rate through the book.

Arash Soleimani

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

And my last question is on tax reform. How do you guys -- how are you guys thinking about that? Is that something where you think, even looking a bit -- looking over the long-term, is that something that you think will fall to your bottom line or do you see increased competition coming from tax reform that will kind of make the benefits go away? Just what -- how are you guys looking at that?

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

Yes, Arash. Why don't I start and then John or Greg can jump in and comment as well. I think, just overall big picture, obviously tax reform is great for U.S. domestic insurance companies. When you look at what the package was that was approved compared to what it looked like a year ago, you go down the list of the benefits and almost without exception, they all benefit, whereas a year ago, some of the items in the tax package could have been a little bit on the negative side. So just big picture, from an overall perspective, we think it's good for the economy, we think it's good for our customer base and we think that increases exposure and it increases overall industry premiums. So we're pretty excited about that. From a Selective perspective, we talk about our effective tax rate coming down from about 28% to 18%. So 10 -- a whole 10 percentage points of additional profitability that we would expect to drop to the bottom line. Over the long term, I think there is some -- and we can only speculate, we don't have solid data as to how it will turn out. But our expectation is when you go into 2018 and you look at the overall industry, expecting to trend about at 7% ROE, that's well below the cost of capital for the industry as a whole. So there isn't an amount of sort of excess profits that could be returned back to customers. We believe that most of our competitors probably have expected returns lot less than their required returns and therefore the majority of the benefit should accrue to the shareholders. But I think over time, that perhaps could get watered down a little bit and there will be a mix between what goes to shareholders, employees and customers. But time will tell.

John J. Marchioni
President and Chief Operating Officer

And I would say, it's a little different. I mean, look, we start with the core basic of 300 of our weighted-average cost of capital. Taxes is one ingredient in the cake. There's all kinds of other ingredients in the cake, it's what's happening to after-tax yields, there's -- where's your duration on the portfolio, it's what's happening to your cost of goods sold. There are so many pieces. And I will tell you for Selective, the pieces doesn't change. The starting point is 300 over, taxes impact that and our goal is to generate over the long term, a target -- hit our target, not every year, but to beat 300 overall weighted-average cost of capital. So from our -- our cost of capital went higher just because of our market stock price and other things. So there are things that push and pull at that performance. And our overall goal to generate to return to shareholders doesn't really change. And this is just a different ingredient in the cake that's a little bit for us, as Mark said earlier, very favorable from Selective's standpoint. This tax reform is very positive from our standpoint. It levels the playing field and it lessens our tax load, and it gives our investment department more product opportunities to look at and to invest in because of the taxable equivalency, actually came down from 145 now to 120. So we look at product in the marketplace. This actually increases the bandwidth of opportunities that we can invest in. And our managers were on that trade earlier in the year. So they've been on that trade once this whole thing got crystalized.

Operator

[Operator Instructions] And the next question comes from Mr. Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I would like to talk about a couple of slightly different areas than what we've just been covering. I'm thinking about your expansion into the new territories, both the ones that you've already started and the ones that are under way or soon will be under way. I guess, the main question I have there, first, assume these are all Commercial Line expansions. And then secondly, you gave the kind of size of the markets that you're addressing, what do you normally think of? And I know there is no singular answer. What do you normally think of as, say, the number of months or years that it takes to get to maybe a 1% market share. Just how you're thinking about it broadly? Obviously, tax and circumstances will tell.

John J. Marchioni
President and Chief Operating Officer

Mark, this is John. I'll start on that. Just a -- let me answer a couple of more direct questions out of the gate and I'll take the more complicated question last. So our expansion to this point in Arizona, New Hampshire and now Colorado and then soon to be Utah and New Mexico by the end of year, are Standard Commercial states. But I also mentioned, we're in the process of investing in some Personal Lines expansion, specifically in the states of Utah and Arizona. We haven't committed to anything beyond those 2 states at this point, but are looking for some states to add to our footprint that give us some diversification from a catastrophe loss perspective and also present some higher economic growth in some of our existing footprint states and that's also the logic that drove our Commercial Lines expansion and the choices we made around which states to enter into. In terms of our pact to a 1% or ultimately a 3% share, if you look at our approach to open in these states versus how we open the Midwestern states in the early- to mid-'90s, you've heard us talk about our goal of getting to about 25% agency share of the markets that we're in overtime and our current or legacy footprint is only at 18% at this point, which varies from one state to another, but 18% overall. For the most part, we've opened up these new states in and around that 20% to 25% range, which would indicate that we at least have access to available premium that will allow us to ramp-up our market share more quickly than we have in other expansions in our other legacy states. But that said, we focus our company on underwriting and pricing discipline. And I realize that's a little bit of a statement that may lead you to the question, "Hey, are we going to commit to a time frame?" and generally, we don't put new business targets out for any of our employees that don't include a profitability component to that. We're pleased with what we've seen so far in Arizona and New Hampshire, and our premium per field underwriter, specifically in the state of Arizona, very early, is as good as we've seen in a lot of our existing footprint states which indicates that the agency partners we picked were the right ones and the access to quality new business opportunities at our pricing levels were abundant. And we expect that to continue. So I'm not going to put a data out there. You saw the volume we've gotten to this point and we're going to be disciplined about it, but if the market continues to be disciplined in those geographies, I think you're going to see good solid growth and certainly growth in excess of our overall Commercial Lines growth rate that you've seen over the last couple of years.

Gregory E. Murphy
Chairman and Chief Executive Officer

And let me just say that, actually, if you think about Arizona, let's round it to a $4 billion Commercial Lines market, it's like $3.8 billion, but $4 billion for the sake of this conversation. So $4 billion market and 3 shares, $120 million -- I'm just trying to round -- and so 3 shares, $120 million operation and as John went through, we did $7 million in 6 months. I don't want you to just straight line and extrapolate that. But I just want to make sure that the point being made that we're doing this greenfield, we've got 3 of the best field underwriters in the market place. We're absolutely, 100% comfortable with the Ivy League agents that we've got in that geo location. So we really feel good about the infrastructure that we've got, what we've built. The fact that we are -- we haven't gone out and bought another company, that now has brought on a whole different culture, a whole different level of systems and the integration is clear and the line of sight is clear. And our people, at the highest level, are the ones that are managing that operation relative to -- they are existing Selective people at the regional level and running the office. So when you think about how you want to grow, how you want to do it systematically, how you want to do it rationally, as John is telling you, we want to do, we've got -- this demonstrates to us that we can take our style of operation and do it in other states, but more importantly, the agencies there clearly value the unique business proposition that Selective brings to the table.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

That's helpful color. I appreciate that. Let me give you a quick easy one. Any -- you are seeing any particular uptick in claims activity from the various winter weather that we've had so far in the first month-ish of the year?

Mark A. Wilcox
Chief Financial Officer and Executive Vice President

Mark, this is Mark here. January will be a pretty heavy CAT loss month for us. It's just one month in the quarter, so we don't really want to comment on the overall level of CAT activity with too much specificity. But PCS 1811, which was the big winter storm in the NorthEast has created a fair number of property losses within our book of business. So we're keeping an eye on that. The claims activity has dropped off at this point. The claims team is on it, but January will be a pretty heavy month for us. But it's just 1 month in a 3-month quarter.

Gregory E. Murphy
Chairman and Chief Executive Officer

And Mark, one thing I'd just like to point out to you is, we pretty much hold our CAT budget at 3.5 points of NTE. And when you're really starting to sit down and disaggregate our NTE in terms of our liability and our rate increases. And so -- when you start to think about the pure absolute dollars that get put into that pot every year, that actually is getting larger every year, probably faster than other companies who may keep the ratio the same, but their earned premium isn't going as high as ours is. So I'm not saying that that's anything you should hang your hat on, but I just want to make sure that, that point gets made. Our 3.5 points is stronger in '18 than it was in '17 or '16 or '15 or '14.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And then last question is just, again, this is kind of a broad market question, but as you approach customers for the 3% average rate increases that you're getting, how are you -- just some feedback on customer reaction. Are they sort of accepting, they kind of get it, people changing their limits or their retentions? How's the customer responding to the 3% pure rate?

John J. Marchioni
President and Chief Operating Officer

Yes, Mark, this is John. First thing, I'll take the last part of your question first. Our small and middle market customers generally don't negotiate term and condition changes from one policy period to the next. There are occasional additions of coverage in certain areas like Cyber or Employment Practices Liability and those sorts of things. But you don't see a lot of retention increases in order to manage premium increases. It's just not our style of business. With regard to how the customers are handling it, I think the most direct way to think about it is to look at what's happening with retentions and what's happening with retentions more specifically, by pricing cohort, which we see as very strong. And -- but I think it depends also on the customers' experience from a loss perspective. We've certainly gotten a lot more sophisticated as a number of our other competitors, where price change in the upcoming term, isn't just driven by that individual's account, what the account's loss experience in the last 1 or 3 years. And we think that's appropriate to better predict future loss experience. But unfortunately, a customer who is loss free, on occasion the agent representing that customer who's been loss free, I think that should generate a rate reduction and then customer who had the loss, even though that loss may not be indicative of an issue with the account or profitability channels going forward, it's easier for that agent to sell an increase to an account that's had a loss. That's where it becomes a little bit of a struggle. But we pointed to our granular approach, which builds in a number of factors beyond just the loss experience of the account. And our ability to work on a portfolio basis, 60 to 90 days ahead with our agents. And then our agents cause customer connection and their ability to articulate the reason why policy is renewing flat, down or up. And we do have a number of policies, even with a 3% overall rate, that are getting decreases, because they've earned the decrease and others who are getting increases because they've earned the increase. So retention suggests the message is resonating, but it's a constant struggle and it's an account by account conversation between agent and customer.

Gregory E. Murphy
Chairman and Chief Executive Officer

And let me just add, so when you think about what John just went through, Mark, think about it this way. 50% of our book got on average of 1% increase. So you can't think about, hey, how are you delivering a 3% increase to a customer, half of our book got a little over 100 basis point increase and that was even done on an extremely granular level. So when you're insight underwriters have the ability to have portfolio management conversation with agents that are at the level of specificity that we have, is why we're able to achieve the high retention in that. If you're socializing this rate, which, when I mean socializing, you're doing 3% across the board, you'd have an absolutely different result than what we have. So it's the insightful data that we have, it's the people that we have that can interpret that data and be very agile in terms of what's happening in the market conditions to make sure they're focused around retention on the best end. And where they have to flex in terms of, hey, I'm going to stay hard on this rate increase on this cohort, that's on the worst end so that you've got to be firm on that pricing.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Appreciate the answer, that's a great color.

Operator

And at this time, there are no further questions. I would like to hand the call back to Greg Murphy for any closing remarks.

Gregory E. Murphy
Chairman and Chief Executive Officer

Great. Thank you very much for your participation. If you have any follow ups, Rohan and Mark are clearly available to answer any follow-up questions, and thank you very much for your participation this morning. Thank you

Operator
Thank you. And that concludes Selective Insurance Group's fourth quarter 2017 earnings call. Thank you for participating. You may now disconnect.