S&P Capital IQ

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RLI Corp. NYSE:RLI

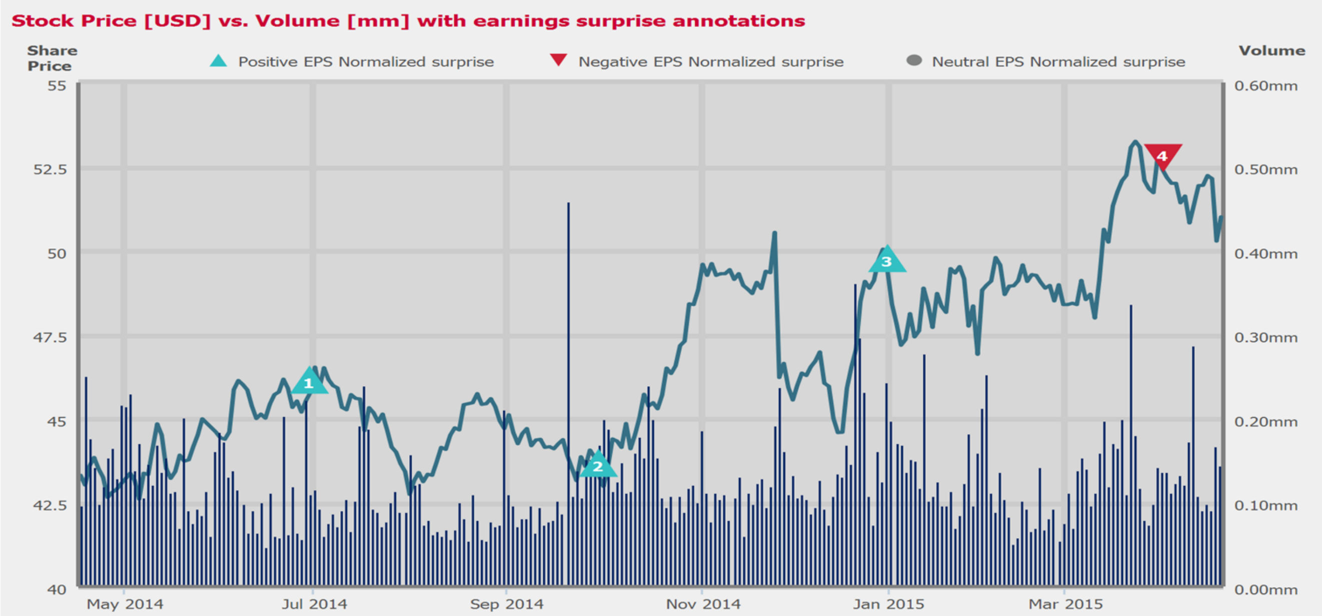
FQ2 2015 Earnings Call Transcripts

Tuesday, July 21, 2015 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2015-			-FQ3 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.54	0.77	▲42.59	0.52	2.28	2.22
Revenue (mm)	187.41	190.57	▲1.69	186.59	753.48	749.32

Currency: USD
Consensus as of Jul-21-2015 2:00 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ2 2014	0.60	0.66	▲1 10.00 %
FQ3 2014	0.60	0.68	▲2 13.33 %
FQ4 2014	0.60	0.71	▲3 18.33 %
FQ1 2015	0.52	0.50	▼4 (3.85 %)

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Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Craig William Kliethermes
President and Chief Operating Officer

Jonathan E. Michael
Chairman and Chief Executive Officer

Michael J. Stone
Director

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

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Compass Point Research & Trading, LLC, Research Division

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

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

Randolph Binner
FBR Capital Markets & Co., Research Division

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Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. second quarter earnings teleconference. At this time, I'd like to inform you that this conference is being recorded. [Operator Instructions]

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 with the Securities and Exchange Commission that contains the press release announcing second 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 companies' definitions of operating earning. 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.

I would now like to turn the conference over to RLI's Vice President, Corporate Development, Mr. Aaron Jacoby. Please go ahead, sir.

Aaron H. Jacoby
Vice President of Corporate Development

Thank you. Good morning, everyone. Welcome to the RLI Earnings Call for the Second Quarter of 2015. Joining me on today's call are Jon Michael, Chairman and CEO; Mike Stone, President and Chief Operating Officer; Tom Brown, Vice President and Chief Financial Officer; and Craig Kliethermes, Executive Vice President, Operations.

I'm going to turn the call over to Tom first to give some brief opening comments on the quarter's financial results. Then, Mike and Craig will talk about operations and market conditions. Next, we'll open the call to questions, and Jon will finish up with some closing comments. Tom?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Thanks, Aaron. Good morning, everyone. We are pleased to announce an excellent second quarter. Starting with our key metric, we achieved a 79.8 combined ratio in the quarter, which brings our first half in at just under an 85 combined ratio. Profits were strong across each of our 3 segments. Casualty, our largest segment, achieved an 81 combined ratio; property, an 88; and surety came in at an impressive 63.

Included in these results was $30 million of net favorable reserve development, offset by $6 million of storm loss activity during the quarter.

While underwriting margins were excellent, on the premium side, growth actually accelerated a bit from the first quarter. You'll recall that for several quarters now, we have discussed our exit from the crop reinsurance business.

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Although this impact first showed up in the prior quarter, the seasonal impact in the second quarter was significant. Quarter-over-quarter, the decline in crop gross premium was $31 million, however, the impact on earnings was nominal.

This drove the headline gross premium for the quarter to a negative 6%, but without this impact, premium actually advanced 7%.

Growth was driven by both our casualty and surety segments, up 14% and 7%, respectively, and was generally spread across a number of our products. While our property segment declined 9%, exclusive of crop, as we continue to fight headwinds in the E&S property market brought on by the inflow of alternative capital.

Mike and Craig will go into more detail on these product and pricing trends in a minute.

Turning to investments. Investment income remains a challenge as we reinvest maturities and cash flows below the average yield on existing positions. As a result, investment income was down nearly 4% in the quarter. With the portfolio's total return flat on the year and slightly negative during the second quarter, our underwriting results played a significant role in driving book value per share growth, which was up 4.2% year-to-date inclusive of dividends paid.

Maui Jim, our minority investment, continued to post growth in earnings, up 5%, as did our other minority investment, Prime insurance, this quarter compared to the second quarter of 2014. We are pleased with the performance of both these investments. In total, we achieved diluted operating earnings per share of $0.77, up 17% from last year.

And with that, I'll turn the call over to Mike Stone. Mike?

Michael J. Stone
Director

Thanks, Tom. Good morning, everybody. An outstanding underwriting quarter by anyone's definition. We brand ourselves as an underwriting company and we are true to our brand, even as the market continues to be more difficult. As Tom indicated, combined ratio of 79, all 3 segments under a 90 combined ratio, while gross written premium, ex-crop, up -- that is with an O by the way -- up 7%.

Now just a little bit of insurance commentary -- insurance market commentary. Our casualty segment still holding up flat to up slightly rate wise. Craig will provide a little more color here. We were able to grow premium by 14% in the quarter, led by transportation, up some 31%; commercial umbrella, up 24%; our architects and engineers professional liability, up 18%.

Transportation is illustrative of our discipline and focus on underwriting while providing superior customer service. While many carriers exited transportation over the past couple of years, throughout, we maintained our discipline, reduced our writings. Now that opportunities present themselves at adequate rates and appropriate terms and conditions, we're there to meet our customer needs.

A number of customers left for lower prices and they are now back in the fold, properly rated and welcoming of our service capabilities. That's our value proposition: better service, better outcomes equates to better deals for our customers over time.

In addition, our commercial umbrella and our personal umbrella of products continue to grow, up 24% and 4%, respectively, and producing underwriting profits in both spaces. Our general liability business -- primary liability business, our largest business over the past decade, continues to perform well with gross written premiums up some 9%, as we continue to reduce our exposure to habitational business. I'm not sure how anyone writes E&S, excess and surplus lines, habitational business profitably in the current rate environment.

So overall, casualty continues to be a solid growing segment in an increasingly competitive market.

Property. You've already heard about the loss of the crop premium, which by the way was really not very profitable for us. Our E&S property is also very competitive with rates down -- Craig will again speak

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to that in more detail -- as alternate capital attacks this space aggressively. I won't say their behavior is profligate, but returns on this business shrunk over the past several years. We continue to maintain our discipline looking to outservice our competition and find opportunities to enable us to maintain our capabilities.

We're working on a number of opportunities that will enable us to better exploit our talents, that is, our underwriting expertise. In addition, I'd say, we'll see what happens to all the new capital when a major U.S. CAT strikes.

In our marine business, it continues its return with a profitable quarter. My kudos to them and their hard work.

Surety. Gross written premium up 7% and all our segments are performing well. We continue to develop our systems capabilities to allow us to capture more of the profitable miscellaneous business by being even easier to do business with.

There also continues to be considerable competition in this segment. I think I mentioned in the last several quarters a number of new entrants. All I can say to the many new entrants, it's not that easy. We have superior underwriters, significant underwriting knowledge and experience and superior technology capability, which will enable us to outperform over time.

Overall, a terrific quarter. My congratulations to all our underwriters, claim and support staff for all their efforts this quarter. Thank you. Craig?

Craig William Kliethermes
President and Chief Operating Officer

Thank you, Mike, and good morning, everyone. I'm going to talk a little bit about the reinsurance placements for the quarter and the general pricing environment. Our reinsurance placements, our observation for 7/1 is the market was still soft. We feel we're getting more for our reinsurance dollar than ever before: higher expected ceded loss ratios, broader coverage and better security and more diversified panel. I believe this is a testament to our great underwriting track record, our aligned interest in a pretty soft reinsurance market.

In the quarter, we placed a marine, D&O and property CAT proportional treaty. We continue to see about 10% to 15% risk-adjusted rate improvement in terms and conditions. These better terms and rates allow us to continue to see net retained premium growth outpace the gross top line and also increases our pricing flexibility on the best accounts, allowing us to maintain underwriting margins.

On the price level in our markets, overall, it has been pretty stable, as Mike said, with most of our products seeing rate changes for the quarter and year-to-date in the plus to minus 3% range. Property CAT continues to be the exception with rates down about 15%. Wind down a little more, earthquake down a little less. On an undiversified basis, we believe the market is pricing this business below double-digit returns. Our exposures have shrunk about 5% to 10% this year as a result, but we will continue to select our spots in this business. We're also seeing a little more rate give back in our E&S casualty business, particularly for physicians professional liability. On a more positive note, D&O rate seemed to have flattened a bit, and we continue to get rate in excess of trend on most of our auto, marine and recreational vehicle business.

The market is in a position where underwriting selection and discipline really do differentiate. We are fortunate to be in an enviable position where we have an outstanding and consistent selectors of risk and exceptional arbiters of claims. Our people, our relationships and our service matter, and we will continue to use these advantages to grow where the opportunities arise.

Jonathan E. Michael
Chairman and Chief Executive Officer
Great. Thanks, Craig. We can now turn the call over for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from Randy Binner.

Randolph Binner
FBR Capital Markets & Co., Research Division

I have a question on the favorable reserve activity in the quarter, which is significant. Hoping to get a little bit more color and in particularly, not so much on kind of specific business lines beyond just generically casualty, but on the accident years and whether or not you're seeing more contribution from kind of the more recent accident years, I'll call them kind of '12 and later, where there was a mini hard market, the economy was pretty good versus more legacy years. So is there any way to provide color on kind of how much of the contribution or how the trend is developing in those more recent accident years as far as what's coming through in the redundancy?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

It's Tom Brown. I'll start and perhaps Craig will chime in with a few other thoughts. I think to the first part of your question, it really is across the board, casualty being the largest driver, approximately about $23 million, really spread over amongst all the lines in the more recent accident years from 2010 to about 2014. Property, some favorable development on marine, again, in the 2010 to 2014, with about half of it being in the most recent accident year 2014. And then surety was pretty much across all lines, commercial contracts, miscellaneous and oil and gas in the more recent 2 accident years, 2013 and 2014. And it compares fairly consistent with a year ago. The $30 million, $31 million this year compared to about $23 million last year. Craig, do you want to?

Craig William Kliethermes
President and Chief Operating Officer

I think the only thing I would add is what you said about consistency. I mean, if you go back and look at last year, it's usually those 3 previous accident years that drive most of the -- we don't have really long-duration products, so those 3 previous accident years are usually responsible for the bulk of the reserve release, '12 to '14.

Randolph Binner
FBR Capital Markets & Co., Research Division

Yes, okay. Right. Understood. That's helpful. And then on -- just on Mike's opening comments, I missed some of the numbers. You said transportation, I think, was up 30%. Commercial umbrella was up 18%. What was that last one that had the -- kind of the higher growth?

Michael J. Stone
Director

The 3 of them were transportation, commercial umbrella and architect and engineers professional liability.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And that was up kind of high teens?

Michael J. Stone
Director

Yes, I forget exactly what the number was.

Thomas L. Brown

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Chief Financial Officer and Senior Vice President

16. 15.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay, and then -- and so that's -- those are obviously the big drivers of the casualty's top line. And then, I guess, just one more and I'll drop back in. But just jumping over to the -- I think that you've had comments on this for at least a couple of quarters, that the alternative capital was coming in and we see that a lot. This is for Property and E&S. So is there areas in particular they're focused on? Or are there -- could new conduits they're using, is your view that it might be foreign capital from places where a double-digit return sounds pretty darn good? I mean, any clarity on what you're seeing there because it would be I think helpful for us to see how sustainable it is. Because for some Japanese folks, for instance, low double-digits might be real good for them on wind and quake.

Michael J. Stone
Director

Well, this is Mike Stone, again. So it's coming from all kinds of places, right? It's coming from pension funds. It's coming from hedge funds. I'm sure some of it's foreign capital. And certainly, at least everything we hear and also everything our underwriters are seeing is that they are acceptable of returns somewhat less than we have been in the past. So is that sustainable over time? Is that sustainable as interest rates go up? Is that sustainable following a major U.S. CAT event? I think those are questions that have yet to be answered. But certainly, in a benign loss period, which we have been through, it certainly looks like these returns are pretty nice. So I guess we'll see. Frankly, over time, you need to make a decent return and capital is capital. So we'll see what happens.

Operator

Our next question will come from Mark Dwelle.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I actually planned to ask about this topic before you guys reported really strong results on it, but I wanted to drill down into the transportation line a little bit. The overall growth in the quarter was very strong, and I was wondering if you could characterize, first, kind of some of the splits between how much of that was rate, how much might be new business in general and how much might be the byproduct of more economic activity, unit count exposure, et cetera?

Craig William Kliethermes
President and Chief Operating Officer

I'll try and Mike can jump in. This is Craig, Mark. I'd say the rate is about plus 3% or 4% across most of our auto businesses, particularly in that transportation business. I think Mike alluded to this earlier, we had a lot -- quite a few accounts come back to us that had been previous customers. We do deal typically with larger customers, so the premium could be a little lumpy in that business. But quite frequently, we'll have customers leave us, realize that there was some value there or additional value worthy of paying an additional price, particularly our claim service. We value greatly and differentiate ourselves, I think, in claim service and underwriting knowledge in that space. So I think some of those folks came back to us in recognition of that, realized that decrease in price wasn't worth it when they had somebody who didn't know how to handle their claims. And then there were some exposure increase, obviously, with those customers coming back, but it is very lumpy with some larger accounts.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

But it's probably fair to characterize the majority of the premium growth is really being new business wins as compared to being any kind of material rate driven increases?

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Craig William Kliethermes
President and Chief Operating Officer

That's correct.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And then the second question in that is you guys have obviously done reasonably well in this line for some time. But a lot of companies have fairly abysmal results, particularly just in terms of large losses and so forth. Is there something that you're seeing or something that you're aware of that seems to be driving that trend? Surely, their results are not simply just all inadequate pricing. There does seem to be something happening on the actual loss side that seems to be contributing?

Michael J. Stone
Director

This is Mike Stone. Well, first off, I'd say that a number of the carriers that experienced abysmal -- that's your word, probably not inaccurate, by the way -- results were writing through a number of MGAs and in many instances were allowing MGAs, TPAs or selected TPAs to handle their claims. And so they were getting inadequate rates and they probably weren't handling the claims up to what we would think would be appropriate claim handling. So what we have done is, I think, as Jon Michael likes to say, we underwrite all our own business. So we underwrite this business. And as our lead product guy says, I know I'm going to have losses. I've got a rate for those losses and I've got to make sure that I get in adequate deductibles and I got to make sure that my claim staff is up to snuff. So I think it's a combination of those things. And we'll let business walk away. It's much harder for an MGA to let business walk away.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. Last question I have related to transportation. I'm sorry for drilling down into this one so deeply, but it's kind of an interesting line. More and more transportation providers of all sizes and all vehicle classes are using different monitoring technology on their drivers and even speed regulation, et cetera. Is that something that you take account in -- of in the underwriting process? I assume it's something that's viewed favorably to the extent that people have it, but is that actually a driver of underwriting at this point?

Craig William Kliethermes
President and Chief Operating Officer

Mark, this is Craig. Yes, I mean, we do factor that in. It's not a specific rating variable at this point in time, but it's qualitatively factored into the price so they do give schedule credits and debits based on quality of management, and part of under quality of management is how they monitor their drivers. And you are correct that a lot of these organizations have become even more professional in the way they monitor their drivers, not just the hours they're driving, but also how they're driving, the speed they're driving. They have -- the more sophisticated people in this business that are in the transportation business themselves, they're doing even more around the logistics side in capturing data.

Operator

And our next question will come from Meyer Shields.

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

When you -- you mentioned before the return of some transportation clients. Is there -- I know that it's lumpy because they're large accounts. But is there any seasonality to that in terms of maybe agents recommending that clients take another look into their -- buying insurance from?

Michael J. Stone

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Director

I'm sorry, on transportation, Meyer?

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

Yes.

Michael J. Stone
Director

I don't think so. I don't think there's any seasonality to speak of. I mean, it depends on when their renewal is and -- but I don't think there's -- I think there's probably more losses in the summertime when they're out driving faster, et cetera, but I don't think there is any on opportunities.

Operator

Our next question will come from Ken Billingsley.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Just 2 questions here. One of them, on the reinsurance side, we've seen the retention ratio move up, and I believe a lot of that has to do with -- that your reinsurance costs have gone down. Are you -- is there a mix where you're actually retaining some more business? Or is it almost all cheaper reinsurance?

Jonathan E. Michael
Chairman and Chief Executive Officer

This is Jon Michael. Mainly, mix determines that.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Mix from a reinsurance standpoint or whether you're increasing your retention?

Craig William Kliethermes
President and Chief Operating Officer

If you look at the retention, like the overall retention for our company, I think it's gone from 80% to 85% if you look at our net written premium to gross written premium. That's -- a big part of that is driven by crop this year. A combination of crop and rate reductions is the real driver this year. Yes, in the past, I'll say back in 2013, we did restructure our reinsurance. So that had an impact back then. But this year, we really didn't take any bigger net retentions, none that were worthy of speaking of. We have bought more limit in some spots where the pricing was reasonable. So that mostly comes to the combination of crop. As Jon said, the loss of crop had about probably a 3 point impact so from the 80% to 85% and the other 2 points was mostly from price reduction, reinsurance cost reduction.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

And the 7/1 renewals that's -- I'm assuming that might move that needle a little bit more.

Craig William Kliethermes
President and Chief Operating Officer

We continue to see rate reduction and the retentions did not change for any of those treaties. So they are maintaining the same, particularly the CAT and the marine treaty we saw rate reductions. The D&O treaty was a little closer to flat.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

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And then just on the Prime Holdings Service. I know it's a very small piece here, but can you just talk maybe a little bit about what -- maybe what was going on with their specialty businesses? Was there any particular items, lines? And what kind of conversation do you have with them if there's any overlap with business that you may have some more experience in?

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, it's Jon Michael. Ken, we do not have conversations with them in terms of overlap. That would be -- that's a no, no. They write their business, we write our business. So we're an investor in Prime only.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Okay, so you wouldn't have any...

Jonathan E. Michael
Chairman and Chief Executive Officer

And the reinsurer too. Reinsurer, obviously, too.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Okay, so it would probably be another quarter before you have that information to review anyway, is that correct?

Jonathan E. Michael
Chairman and Chief Executive Officer

No, no. We're competitors. I mean, potential competitors, but -- so we really can't talk to them about any particular account or any rates or anything like that. That would be a true no-no in our business to do that. We know what kind of business they're writing. They know what kind of business we're writing. And that's about it. So I don't know. Anybody else?

Michael J. Stone
Director

I'd say, by and large, they're not really in the same space that we're in, but they are in the surplus lines of business, but they tend to be in truly surplus lines of business. And we think we're a little surplus lines-lite, but doesn't mean that on an account-by-account basis we couldn't very well be competitors. So we're not talking about individual accounts with them, or markets or anything like that. So we believe they're good underwriters and have a good track record, and we've enjoyed the relationship so far.

Kenneth G. Billingsley
Compass Point Research & Trading, LLC, Research Division

Last question and I apologize if you may have talked about this already. I believe in the past, you've talked about earthquake as a line at least you've been shrinking. Can you talk about the plans there? Are you -- is it still too competitive that you're continuing to shrink your earthquake exposure? Or is it starting to get more attractive with reinsurance costs, pricing where it is? Or do you not play that game that you're not going to utilize cheaper reinsurance that might only be temporary?

Craig William Kliethermes
President and Chief Operating Officer

This is Craig. We have used reinsurance. That's allowed us to compete in spots, although we still find that market increasingly competitive. So at the same time, I mean, we have given up some primary rate. We've also received some benefit of reinsurance reductions, which has allowed us to compete on some accounts on the margins, but we have shrunk our overall earthquake exposures over the last couple of

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years because of the market. So we still think it's a good business for us as part of a diversified portfolio, but it wouldn't be one we're particularly looking to grow in, in this space or at this time, I should say.

Michael J. Stone
Director

Ken, I'd also say that our reinsurance panel has remained basically the same. So we're not reducing the security and taking rate reductions from less secure reinsurers.

Operator

[Operator Instructions] And if there are no further questions, I would now like to turn the conference back to Mr. Jonathan Michael.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you, all, for attending another good quarter. Just south of 80 combined ratio for the quarter, premiums were up 7%, except for our canceled property insurance business. Disciplined underwriting is our strongest core value as a company. And I think all the speakers today talked about our disciplined underwriting, good claims handling and the like, and that certainly is a hallmark of RLI. Thanks, again, and we'll talk to you next quarter.

Operator
Thank you. 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 of 7585792. This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.

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