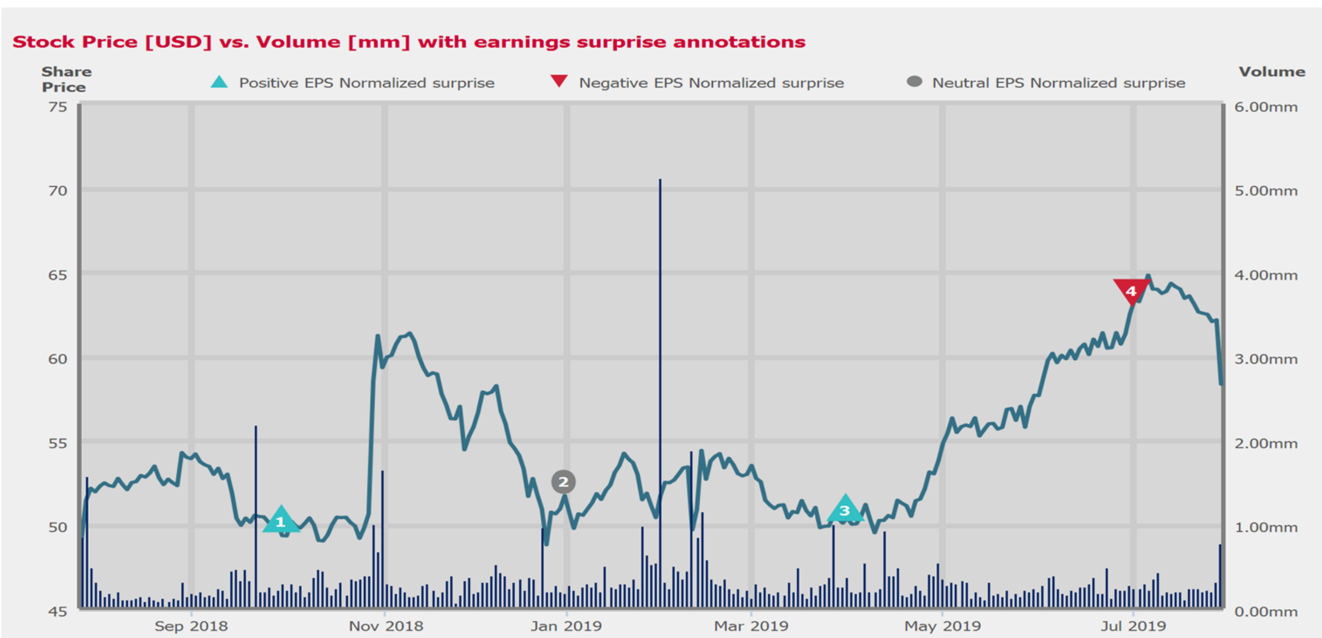
S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY
FQ2 2019 Earnings Call Transcripts
Monday, July 29, 2019 5:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ2 2019-			-FQ3 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.03	0.74	(28.16 %)	1.12	3.58	4.10
Revenue (mm)	922.34	936.08	1.49	941.55	3664.97	3899.47

Currency: USD
Consensus as of Jul-11-2019 9:12 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2018	0.71	1.11	56.34 %
FQ4 2018	0.46	(0.26)	NM
FQ1 2019	0.77	0.87	12.99 %
FQ2 2019	1.03	0.74	(28.16 %)

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Call Participants

EXECUTIVES

Christopher Wadewitz Graves
VP & Chief Investment Officer

Gabriel Tirador
President, CEO & Director

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Presentation

Operator

Good day. My name is Ian, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General second quarter 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 would now like to turn the call over to Mr. Gabriel Tirador. Sir, please go ahead.

Gabriel Tirador
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's second quarter conference call. I'm Gabe Tirador, President and CEO. In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; and Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter.

Our second quarter operating earnings were $0.74 per share compared to $0.88 per share in the second quarter of 2018. The deterioration in operating earnings was primarily due to an increase in the combined ratio. The combined ratio was 98.3% in the second quarter of 2019 compared to 96.9% in the second quarter of 2018.

The combined ratio in the quarter was negatively impacted by $9 million of unfavorable reserve development, $9 million of catastrophe losses primarily from Midwestern storms, and a $3.4 million increase in accrued expenses as a result of an adverse appeals court ruling related to a California Department of Insurance noncompliance matter. The $9 million of unfavorable reserve development in the quarter was primarily due to an increase in our loss adjustment expense estimates for defense and cost containment expenses and our auto California lines of business and also includes $3 million of unfavorable reserve development from prior year's catastrophe losses.

Excluding the impact of unfavorable prior year reserve development, catastrophe losses exceeded reinstatement premiums earned and increased accrued expenses related to the adverse appeals court ruling, the adjusted combined ratio was 95.5% in the second quarter of 2019 compared to 93.6% in the second quarter of 2018.

For states outside of California, the combined ratio deteriorated, which contributed to the increase in a company-wide combined ratio for the quarter. For all lines of business outside of California, we posted a combined ratio of approximately 108% in the second quarter of 2019 compared to 92% in the second quarter of 2018.

Earned premium for both periods was approximately $130 million for states outside of California.

Our homeowners combined ratio was 102% in the second quarter of 2019 compared to 95.3% in the second quarter of 2018 and contributed to the company-wide deterioration in the combined ratio.

The California homeowners combined ratio was negatively impacted by an increase in loss estimates related to the significant California rainstorms that occurred during the first quarter of 2019.

Our year-to-date accident year combined ratio for California personal auto is approximately 95%. For California personal auto, we recorded a low single-digit reduction in frequency trend and a mid-single-digit increase in the severity trend.

In California, a 6.9% personal auto rate increase in California Automobile Insurance Company was implemented in March 2019 and a 6.9% personal auto rate increase for Mercury Insurance Company was implemented in May of 2019. Collectively, these represent 2/3 of company-wide direct premiums earned. Approximately 32% of the California Automobile Insurance Company rate increase was earned during the quarter and only 10% of the Mercury Insurance Company rate increase was earned during the quarter.

In addition, a 6.9% rate increase in our California homeowners' line was approved by the California Department of Insurance with an implementation date of August 2019. We also recently filed for another 6.9% rate increase in our California homeowners' line of business.

The California homeowners' premiums represent about 12% of direct company-wide premiums earned.

The expense ratio was 24.4% in the second quarter compared to 24.3% in the second quarter of 2018. The slightly higher expense ratio was primarily due to the $3.4 million increase in accrued expense related to the adverse appeals court ruling, partially offset by a decrease in acquisition cost, primarily from lower average commissions and cost efficiency savings.

Premiums written grew 6.6% in the quarter primarily due to higher average premiums per policy and an increase in homeowners' policies written.

We recently completed our catastrophe reinsurance treaty renewal effective July 1, 2019. The total reinsurance limit purchase increased from $205 million in the prior period to $589 million for the July 2019 through June 2020 period.

Our retention increased from $10 million to $40 million. Total annual premiums on a new reinsurance program are approximately $38 million. For the prior reinsurance treaty, total premiums were $40 million, including $18 million of reinstatement premiums.

More details of the catastrophe reinsurance treaty renewal will be included in our second quarter 10-Q filing.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Our first question is from the line of Greg Peters from Raymond James.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I had a couple of questions for you. First around the reserve development. I was going through my record of your results over the last 20 years, and it seems like if we narrow it down to last 10 years, you've had unfavorable development in 8 of the last 10 years, and with all the rate increases and all the changes, that sort of stands out because most companies tend to report favorable development. So can you give us some perspective of -- obviously, you talked about severity issues, but can you give us some perspective of how that might change in the future?

Gabriel Tirador
President, CEO & Director

Well, I think we've said before that we feel, especially in the bodily injury line that there has been a changing environment. And how that might change in the future is we're being more conservative with respect to selecting more recent factors as opposed to averaging factors for a longer period of time. So that should help with any adverse reserve development going forward. I will say that for California PPA, the loss reserve development this quarter was pretty much nonexistent, and it was really under defense and cost containment line or expenses where we're seeing increased litigation and we decided to increase our reserves for defending bodily injury claims.

Theodore Robert Stalick
Senior VP & CFO

One -- this is Ted. One of the biggest issues we have had in the past has been with the California bodily injury coverages as far as the development goes. And I'll just say for the first half of this year, our actual versus expected incurred loss development was -- has essentially been in line. So it's developed pretty much how we expected it to when we set reserves at year-end. And I know it's just 2 quarters, but this is something that we haven't experienced in the last couple of years where the actual has been higher than the expected. And so it does give us some indication that the increasing loss development factors that we've seen over the years have now sort of stable -- become more stable, and we're going to see better stability in those reserves.

Gabriel Tirador
President, CEO & Director

Having said all that, Greg, we're obviously not happy with the reserve development that we have had 8 out of the last 10 years, but the rationale is what we just gave you.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

I certainly appreciate that things around litigation are a moving target and so -- I just was -- it just stands out as unique because most of your peers tend -- have a tendency to go through shorter periods of adverse development and then they find neutrality or favorable development. But, hey, in your opening comments, you called out the $9 million of what you called out -- pardon me, you called out the unfavorable reserve development. And what I was trying to understand is, did that include the piece that you mentioned for catastrophe losses from prior years?

Gabriel Tirador
President, CEO & Director

Yes. So the $9 million had -- within, it had $3 million from catastrophe losses from prior years, which was primarily from the Woolsey Fire. The partial losses have developed more than we expected. The one thing I'll point out is the Woolsey event, the losses were -- we had exhausted our reinsurance limit within that layer. And so any development on the Woolsey was not covered. With the traditional $3 million, we're now into the next layer and if there is any future development on prior year cats, those will be fully covered by reinsurance.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Thank you for the clarification. Can I pivot for another line of questioning around your -- the disclosure around your new catastrophe, your property cap program? And I think in your comments, on your limit -- total limit is up, what, substantially, like twice as much as what you purchased before. So I'm just curious, what -- obviously your experience last year colored your perspective there. But that -- this is all going to come at a cost too. And then the quarterly retention is moving from $10 million to $40 million. So you've -- if we were to replay the quarterly results last year, how many quarters would we hit that $40 million retention?

Theodore Robert Stalick
Senior VP & CFO

We would replay...

Gabriel Tirador
President, CEO & Director

The Camp Fire, obviously, was well in excess of $100 million. So about what it hit that. And the Woolsey Fire is in the low 40s. So a piece of that would've hit it. The Carr Fire was about $20 million.

Theodore Robert Stalick
Senior VP & CFO

Yes, Greg, we just felt that the pricing for the $10 million to $40 million was just too high. It just -- it did not make economic sense from our standpoint to purchase that layer.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

It -- yes, I totally understand what you're saying. So it seems like going forward, the exposure on a net basis to cat losses will go up. And if I am to read through your comments, the cost of the reinsurance, the new program relative to last year is only up modestly? Or is it -- is there a different perspective on cost?

Gabriel Tirador
President, CEO & Director

Well, it's up modestly, if you consider the reinstatement premiums, but the reality is that the cost -- the rate increase -- there is sizable rate increases in each layer, pretty sizable rate increases in each layer. But when you compare what we actually ended up paying, in the last 3 period, it was -- is about $40 million, and I think the new treaty is about $38 million.

Theodore Robert Stalick
Senior VP & CFO

And that $40 million from last year includes $18 million of reinstated limit.

Gabriel Tirador
President, CEO & Director

Right.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

The $18 million of what?

Theodore Robert Stalick
Senior VP & CFO

Reinstated limits. So without that, it's $38 million compared to $22 million.

Gabriel Tirador
President, CEO & Director

That's hard to analyze, though, because of the retention change and we obviously bought a lot more limit on the higher end.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Right. And you mentioned in your comments that you'll have more detail around this in your 10-Q. So we'll be able to pull out the cost, et cetera, that will be easy for us to identify?

Gabriel Tirador
President, CEO & Director

Well, the total cost will be in there.

Theodore Robert Stalick
Senior VP & CFO

Yes. I think the more detail is going to be around how the layers work and the exclusions within those layers.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Okay. Well, I don't want to hog up your conference call time, but it'd be great to have a follow-on conversation off-line on this topic...

Theodore Robert Stalick
Senior VP & CFO

Sure.

Charles Gregory Peters
Raymond James & Associates, Inc., Research Division

Just to make sure I have everything set up right. Can -- the last line of questions, I realize there's other analysts that probably want to ask questions. So the -- it seems like the California business is doing well, but the non-California business is not. Is there anything -- is your perspective changing on business outside of California now? Or do you still have the same strategy going forward?

Gabriel Tirador
President, CEO & Director

We have the same strategy going forward. Outside of California, current year-to-date results have been disappointing. In the quarter, we had quite a few large losses in the quarter that contributed to the results. We had increased severity, we had some Midwestern storms. On an accident year basis through June of this year, the 2018 accident year is running 97 but the '19 is running at like 102.5. So a lot of that is being driven right now by Florida and Georgia. We're continuing to analyze what's going on there from a severity standpoint. We also have some changes that we're going to be implementing in Florida and Georgia, I think, Florida in September and in November for Georgia that -- from a segmentation standpoint that we think will help both on the gross side and also on the profitability side. But last year, we had a really good year outside of California. I think we -- for PPA, I think we recorded a calendar year combined in the 93, 94 range, if I am not -- if my recollection is right in an accident year, as I mentioned, for '18 is about

97. So we have some work to do, though, outside of California and especially in some of these estates to improve the results.

Operator

And our next question is from the line of Christopher Campbell from KBW.

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

First question is on the core loss ratios. It sounds like that you're having some issues in like Florida and Georgia and some of the other states. But if you look at the core loss ratio, that was up 200 bps year-over-year. So I mean, how much of that -- was any of that like a one-time event? Or is that more attritional? How should we think about that? How should we think about modeling that going forward?

Gabriel Tirador
President, CEO & Director

Well, I mean, I think from my perspective at least for PPA outside of California, like I mentioned earlier, we think we're running at about 102 right now. We have some changes, and there's a lot of volatility outside of California sometime from quarter-to-quarter. I will say that. I think in California PPA, we think we're running at about a 95% on a year-to-date basis. We have a lot of the 6.9% that we haven't earned, most of that has not been earned. We see frequency going down a couple of points and severity going up mid-single digits. So there should be some margin expansion in our California PPA line going forward, absent any kind of reserve development. So that's how I would view it.

Theodore Robert Stalick
Senior VP & CFO

I would say the onetime -- so as Gabe mentioned, there was $3.5 million expense charge that was the result of this appellate court ruling, so that's clearly not going to happen every quarter. And then the homeowners -- California homeowners was elevated in the first quarter. It's -- in California, we had a significant amount of stormy weather. And there was about $4 million of additional reserves from the first quarter that we put up in the second quarter just related to that kind of stormy weather events. So that's now pretty much -- those have pretty much closed out. So you can probably figure there is a little bit there, too.

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

Okay. That is very helpful. And then just looking at California lines. So I think you had said -- Gabe, you had said in the script low single digit -- low single-digit increases in frequency and then mid-single digit increases in severity. Is that right?

Gabriel Tirador
President, CEO & Director

Yes. Reduction in frequency, reduction. I think you said the increased reduction and mid-single-digit increase in severity.

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

Okay. Perfect. So all in -- so should we be thinking like low- to mid-single-digit loss cost inflation in that line?

Gabriel Tirador
President, CEO & Director

That's what we're thinking.

Christopher Campbell

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

Okay. And then you have the 6.9%, basically, you said only 10% of that earned in the second quarter? So we have like 90% of that to come?

Gabriel Tirador
President, CEO & Director

Yes. For Mercury Insurance Company, which is our biggest, and then Cal Auto had about 32% of it earned.

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

Okay. Got it. And then are you guys planning on taking any more auto increases in California? Or you guys think you're done for the time being?

Gabriel Tirador
President, CEO & Director

I think we're done for the time being.

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

But you are taking another 6.9%. You just filed for another 6.9% in California homeowners, correct?

Gabriel Tirador
President, CEO & Director

Yes, yes. And the 6.9% goes into effect in August, and we filed for another 6.9% in California homeowners, yes.

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

Okay. Great. And then just pivoting to net investment income. I mean pretax net investment income growth was a little bit weaker than I expected. So it was like only off like 70 bps versus kind of that mid- to high single digit premium we've seen over the last year. So I guess just why was the growth so soft this quarter? And then how should we think about projecting the net investment income going forward, especially as rates are starting to come down?

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes, Chris, it's Chris Graves. I thought the growth was actually pretty good, especially year-over-year. But we've seen -- in the last year, we have -- we positioned ourselves to be much more sensitive and actually in the prior year as well, to be much more sensitive to the rising low interest rates from the Fed, and that really boost investment income, and of course, that's come to an end. The curve has flattened on us, it's inverted in parts, leaving us with very few real interesting fixed income opportunities. So -- and in light of the structure of the yield curve, I've brought in our duration quite a lot. I think there's considerable more risk out on the yield curve. So going forward, it's going to be a tough environment, and I think it's going to last well through the rest of this year and a good part of 2020 as well. So I don't know if we've -- I mean, the company is growing, the underlying growth is good. I'm seeing growth in the investment portfolio, that's going to continue to push investment income higher if everything else stays the same. But it's hard for me to tell you exactly where we're headed now.

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

Okay. Got it. That's very helpful. Thanks, Chris. And then maybe one for Ted. Operating tax rate was a little bit lower than we had expected. Any color on anything special that was happening? And what -- how should we be thinking about modeling this going forward?

Theodore Robert Stalick
Senior VP & CFO

Well, I think it was lower because underwriting income was lower than you modeled. And so underwriting income is taxed at roughly 21%, and investment income is taxed at roughly 10% or 11%. And so when the mix of those changes, it changes the overall effective tax rate.

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

Got it. Best of luck for the second half of '19.

Gabriel Tirador
President, CEO & Director

Thanks, Chris.

Theodore Robert Stalick
Senior VP & CFO

Thanks, Chris.

Operator

[Operator Instructions] Our next question is from the line of Jay Cohen from Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes. Just a couple of questions. During the call, you had suggested a more conservative loss pick. I think it was for Auto BI. Is that something you've already put in place or something you have to contemplate going forward? Or maybe I misheard it.

Gabriel Tirador
President, CEO & Director

No. What I was referring to is, when we select linked ratio factors, generally we would select maybe an average of going back 4 quarters, 8 quarters as an example, but we're waiting more -- the more recent linked ratio factors, which produces a higher amount. So that's what I was referring to, Jay.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

And I guess, looking forward over the next 4 quarters, that by itself, all else being equal, puts a little bit of upward pressure on the loss ratio?

Gabriel Tirador
President, CEO & Director

Well, I'm not -- I don't, I mean, we've already done that, so I'm not sure why it would put upward -- unless it's worse than we picked.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Well, I guess because you've had some of those adverse developments that's why I thought, but I guess it came from some other areas so it's not such a big factor. I guess, the other question, with the price increases, how are you finding the reaction in the market? It feels as if you're being a bit more aggressive than others in raising price. And is there some competitive blowback because of these increases?

Gabriel Tirador
President, CEO & Director

Yes, yes. I would say that our new business applications are down quite a bit actually in California for the quarter, they were down about 20%. But what's happening, too, is the quoting volume is down quite a bit. Our quote volume is down about 16% year-over-year for the quarter. So as a result, our new business is down as a result of both the 6.9% increase that we took and the quoting volume. Now if you take away the quoting volume, our forecast was pretty much in line -- a little bit better than in line with respect to what I -- what we thought the new business and our retention would end up at. But the quote volume has really had an impact.

Operator

And at this time, I'm showing that we have no further questions on the line. I'd like to turn the call back to the presenters for any closing remarks.

Gabriel Tirador
President, CEO & Director

I'd like to thank you all for joining us this quarter, and we look forward to speaking with all of you next quarter. Thank you very much.

Operator
Ladies and gentlemen, this does conclude today's conference call. We thank you greatly for your participation. You may now disconnect.