

# Selective Insurance Group, Inc.

## NasdaqGS:SIGI

### FQ2 2018 Earnings Call Transcripts

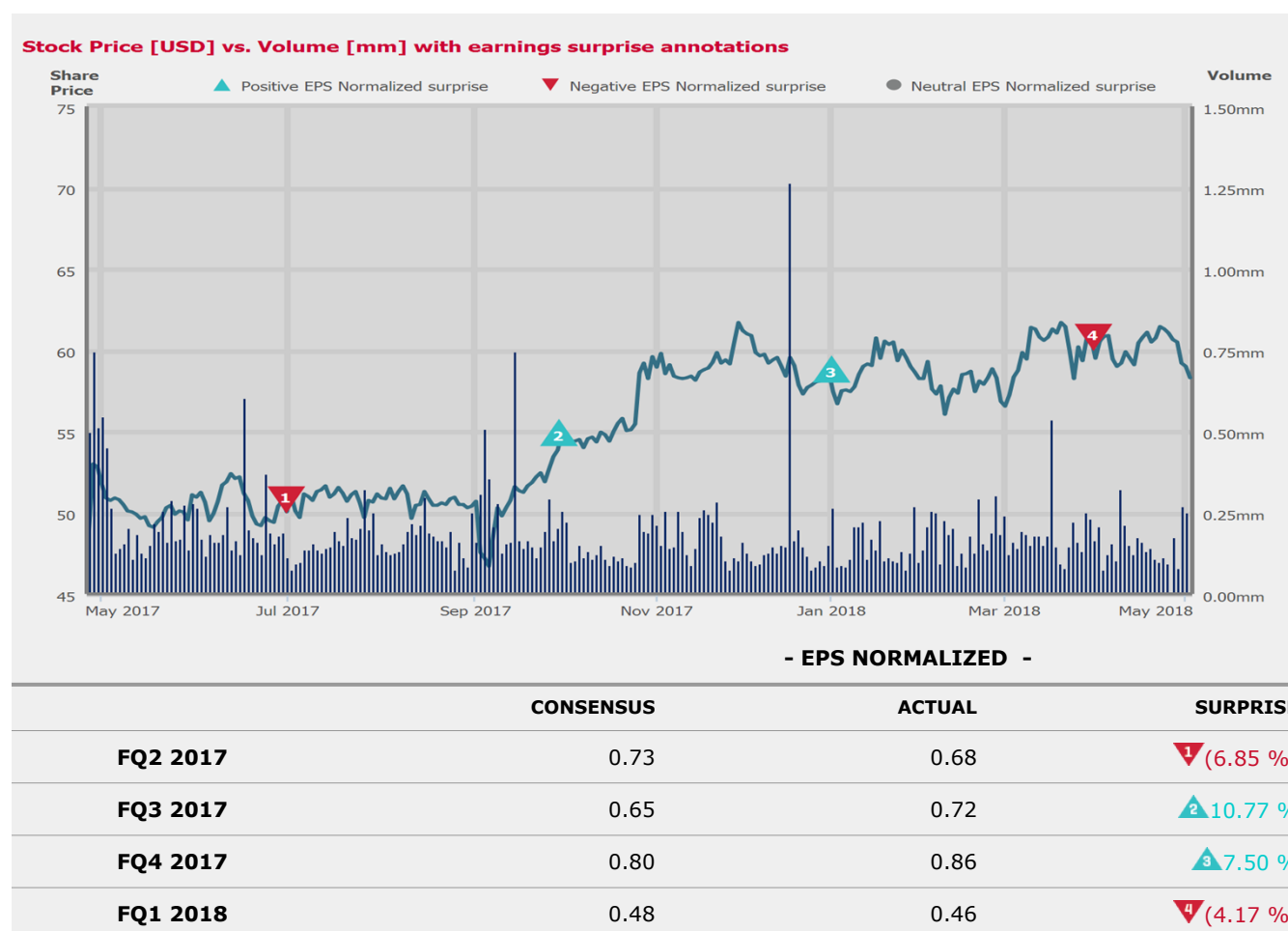
Thursday, August 02, 2018 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
<b>EPS Normalized</b>	0.88	1.01	▲14.77	0.98	3.44	4.10
<b>Revenue (mm)</b>	650.38	651.90	▲0.23	665.10	2616.70	2772.90

Currency: USD

Consensus as of Aug-02-2018 1:50 PM GMT



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# Call Participants

## EXECUTIVES

**Gregory Edward Murphy**  
*Chairman & CEO*

**John Joseph Marchioni**  
*President & COO*

**Mark Alexander Wilcox**  
*Executive VP & CFO*

**Rohan Pai**  
*Senior VP of Investor Relations &  
Treasurer*

## ANALYSTS

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

**Michael David Zaremski**  
*Crédit Suisse AG, Research  
Division*

# Presentation

## Operator

Good day, everyone, and welcome to Selective Insurance Group's Second Quarter 2018 Earnings Call. [Operator Instructions] Now for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai. Please go ahead.

## Rohan Pai

*Senior VP of Investor Relations & Treasurer*

Good morning, everyone. And welcome to Selective Insurance Group's Second Quarter 2018 Conference Call. This call is being simulcast on our website and the replay will be available through September 3, 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](http://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 and unrealized gains or losses on equity securities.

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 risk and uncertainties. We refer you to Selective's annual report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties.

Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining on the call today are the following members of Selective's executive management team: Greg Murphy, Chief Executive Officer; John Marchioni, President Chief Operating Officer; and Mark Wilcox, Chief Financial Officer.

With that, I'll turn the call over to Greg.

## Gregory Edward Murphy

*Chairman & CEO*

Thank you, Rohan, and good morning. I'll first make some introductory remarks and then focus on some high-level themes that continue to drive our strategy for profitable growth. 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're extremely pleased with the solid results we've generated in the second quarter, benefiting from robust growth and profitability in our Standard Commercial Lines and Commercial Lines segment.

The 14% non-GAAP operating ROE we reported for the quarter was well above our 2018 target ROE of 12%. We established a very high bar for our non-GAAP ROE target of 300 basis points above our weighted average cost of capital. We will establish a new target ROE for 2019 and develop a comprehensive plan around both investment and underwriting ROE contributions. We do not make exclusions or adjustments when assessing our annual performance relative to these targets.

Our interests, thus, are aligned with those of our shareholders to generate an adequate return on capital. Consolidated net premium written of 7% in the second quarter was robust, driven by renewal pure price

momentum that outpaced expected claims inflation and strong retention rates in our standard lines, partially offset by a decline in our E&S segment.

We achieved overall renewal pure price increases of 3.5% in our Standard Commercial Lines segment for the quarter, which was up from 3.2% in the first quarter and 2.9% for the full year 2017.

In terms of pricing trajectory for the remaining of the year, we expect our pricing to edge higher, particularly in light of the ongoing industry pressures in the commercial automobile and property lines.

For the month of July 2018, our renewal pure pricing was 3.6%. Our ability to obtain market-leading Commercial Lines renewal pure pricing while maintaining extremely strong retention and growth rates is a testament to our strong relationships with our Ivy League distribution partners and our sophisticated underwriting tools that enable granular risk segmentation and can be deployed on an account basis for an agent's portfolio.

You've heard me say arithmetic has no mercy, and for this industry, where your cost for goods sold, i.e. loss cost or pure premium, have inherent volatility.

Overall, renewal pure rate is the only true indicator of future levels of profitability for this industry. From both an industry and company perspective, as commercial auto frequencies continue to edge higher and property results remain volatile, we would expect the industry to focus on trying to achieve overall renewal pure price increases that exceed their expected claim inflation.

Through the year-end of July 2018 -- or for the period ending, excuse me, we are about 62% through our renewal inventory with an overall renewal pure price increase of 3.4% that will impact our 2019 results.

So far, we're pleased with how 2019 should line up relative to our expected target return on equity. The GAAP combined ratio for the second quarter was 93.7% and was very solid, and the underwriting combined -- and the underlying combined ratio or -- after adjusting for catastrophe losses in prior year casualty development was 91.3%. Excellent profitability in our Standard Commercial Lines and Personal Lines segments was slightly offset by weakness in our E&S segment.

For the first half of the year, we reported a consolidated combined ratio of 96.4%, which is slightly above our full year target of 95.5%. We generated excellent investment income in the quarter with after-tax investment income up 24% from a year ago to \$38 million.

While a lower tax rate accounted for about half the increase, we've made a number of tactical moves to optimize after-tax investment and income and take advantage of higher interest rates, while maintaining a conservative AA- rated fixed income portfolio and a relatively low duration of 3.9 years. Our investment portfolio at \$3.34 per dollar of stockholders equity generated an after-tax yield of \$2.65, which contributed 9 points to our annualized ROE in the quarter. We are a great execution company and we're focused on: one, achieving overall Standard Commercial Lines renewal pure prices in excess of expected claim inflation; two, driving underwriting quality improvements through retention and providing better customer experience and added -- value-added services; and three, improving profitability in our excess and surplus and automobile lines; and four, pursuing growth and diversification through geographic expansion.

We strive to achieve these objectives by leveraging our high-tech, high-touch operating model, which is based around our strong distribution partner relationships, field-based underwriting model, enabled by our sophisticated tools and technology, and superior omni-channel experience that we offer to our agents and shared customers.

Improving the business mix while maintaining and increasing retention is a key factor in generating better underwriting results. We have invested heavily in providing our frontline and inside underwriters with the tools they require to understand the price and risk dynamics on each piece of business at a very granular level.

This allows us to continue to retain the very best business while driving profitability higher for lower performing cohorts of business. We have a number of initiatives in place to leverage technology to

increase switching costs, including our digital self-service platform, proactive messaging and providing clients with value-added services such as sensor devices to increase customer loyalty.

We expect these initiatives to drive our current Standard Commercial Lines retention of 84% higher in the coming years while also increasing new business hit ratios. We are aggressively working to address profitability issues for Commercial Auto and our E&S segment. In Commercial Auto, we've been implementing meaningful price increases while lowering our exposure to higher hazard risks. However, we continue to experience elevated loss frequencies that have exceeded our expectation.

While our E&S segment result have not met our expectations, we continue to implement targeted price increases while improving the mix of business and enhancing claim service -- claim processes. As I've said before, our strategy in this segment is to strive towards target margins while allowing the top line to float up or down based on market conditions. Our geographic expansion efforts remain on track. Arizona and New Hampshire, the 2 Commercial Lines states we opened in 2017, continue to perform ahead of our expectations so far. We entered Colorado earlier this year and we're on track to add New Mexico and Utah later this year.

After our second quarter results, we have confirmed full year guidance as follows: one, a GAAP combined ratio, excluding catastrophes, of 92%, this assumes no additional prior year casualty development; two, catastrophe losses of 3.5 points; three, after-tax net investment income of \$150 million, which includes \$8 million of after-tax net investment income from our alternative investments; four, an overall effective tax rate of 18%, which includes an effective tax rate of 17% for net investment income, reflecting a tax rate of 5.25% for tax-advantaged municipal bonds and a tax rate of 21% for all other investments; and five, weighted average shares of 59.6 million.

Now I'll turn the call over to Mark to review the results for the quarter.

**Mark Alexander Wilcox**

*Executive VP & CFO*

Thank you, Greg, and good morning. For the quarter, we reported fully diluted earnings per share of \$0.99 and non-GAAP operating earnings per share of \$1.01. Both the diluted EPS and non-GAAP operating EPS for the quarter were a record for Selective and resulted in a very strong 14.3% annualized non-GAAP operating ROE. Our results were driven by after-tax underwriting income of \$30 million, which generated 7.2 points of ROE and after-tax net investment income of \$38 million, which generated 9 points of ROE. We also benefited from lower corporate expenses. As a result of our very strong second quarter results, our year-to-date annualized non-GAAP operating ROE has improved to 10.2%, which positions us well to move towards our target return for the year 2018.

For the quarter, we saw a good growth with consolidated net premiums written increasing 7%, driven by 8% growth in our Standard Commercial Lines segment, 7% growth in Personal Lines and partially offset by a 1% premium decline for the E&S segment.

The growth in Standard Lines was driven by excellent pure renewal price increases, high retention rates and good new business opportunities, including those within our 3 new Standard Commercial Lines states, which are providing us additional runway for growth.

The consolidated combined ratio was a solid 93.7% in the second quarter. On an underlying basis or prior to catastrophe losses and prior year casualty reserve development, our combined ratio was 91.3% compared to 92% of the comparative quarter in 2017, with the improvement largely driven by a reduction to the expense ratio.

For the first 6 months of the year, the consolidated combined ratio was 96.4% and the underlying combined ratio was 93.7%.

Results in the first half were adversely impacted by the first quarter non-CAT property losses, which we discussed last quarter. Our ex-CAT combined ratio was 90.6% for the second quarter and is 92.7% for the year-to-date.

As Greg mentioned, our ex-CAT combined ratio forecast for the full year 2018 remains at 92% and we're still forecasting 3.5 points of CAT losses for 2018. Although, as always, there's considerable variability in these forecasts.

For the quarter, catastrophe losses were 3.1 percentage points on the combined ratio, down 2.1 points from the comparable period, while the 3.7 points impact for the first six months was in line with the year-ago period.

Non-catastrophe property losses in the second quarter equated to 13.7 points on the combined ratio, which was slightly above our expectation for the second quarter. Year-to-date, our non-catastrophe property losses have impacted the combined ratio by 15.8 percentage points, which is 3 percentage points higher than the comparative period in 2017, with the negative variance principally driven by the heavy non-GAAP profit losses we experienced in the first quarter.

During the second quarter, we experienced \$4 million of net favorable prior year casualty reserve development, which lowered the quarter's combined ratio by 0.7 percentage points.

Better than expected claims [ emergence ] in our Worker's Compensation line totaling \$17 million was partially offset by \$7 million of adverse development in our Commercial [indiscernible] line of business and \$6 million of adverse prior year casualty reserve development for our E&S segment.

We also had some pressure on the current accident year and raised our loss specs modestly for commercial auto as well as for our E&S casualty business. Our GAAP expense ratio was 32.9% for the second quarter, which is down 1.3 percentage points compared with 34.2% in the comparative quarter a year ago, mainly due to ongoing expense reduction we have highlighted in the past, coupled with a modest decline in profit-based incentives included in Employee Incentive Compensation.

For the first half of the year, the GAAP expense ratio was 33.3%, which is down 1.1 points from the comparative period in 2017.

We remain focused on seeking out areas of efficiency in cost savings while continuing to invest in our employees and key initiatives around geographic expansion, enhancing our underwriting tools, technology and the overall customer experience.

Corporate expenses, which are principally comprised of holding company costs and long-term stock compensation were down \$5.2 million on a pretax basis relative to the comparative quarter.

The primary reason for the reduction in the quarter was a lower amount of stock compensation expense resulting from a decline in the share price during the quarter.

While we expect there to be volatility in this line item based on fluctuations in the share price, we made structural changes to our long-term share-based compensation program in early 2017 that should lead to lower costs over time.

Year-to-date, corporate expenses are down about \$6 million.

Turning to investments. For the quarter, after-tax net investment income totaled \$37.6 million and was up 24% from a year ago. The year-over-year increase primarily reflects the lower tax rate on investments following the implementation of tax reform as well as the higher book yield for our core fixed income securities portfolio. We continue to actively manage the investment portfolio, tactically seeking opportunities to increase the after tax book yield, while maintaining high credit quality and managing duration risk.

Our average credit rating remains AA- and the effective duration of our fixed-income and short-term investments portfolio is relatively unchanged at 3.9 years.

As we highlighted last quarter, we have made some allocation shifts in the portfolio this year, whereby we -- which we sold a number of tax-advantaged securities and reinvested in corporates and structured bonds, due to the relative value on an after tax basis and post tax reform.

In addition, approximately 17% of the fixed-income portfolio is invested in floating-rate securities, which primarily reset based on 90-day LIBOR. As a result, we continue to benefit from the relatively rapid rise in 90-day LIBOR, which was up 64 basis points this year through June 30.

Many of these floating-rate securities reset in April, which helped drive a 12-basis point increase in our pretax book yields during the quarter for our core fixed income securities portfolio and brought our year-to-date pretax book yield increase to 29 basis points.

Overall, the after-tax yield on the fixed-income portfolio was 2.79% during the quarter compared with 2.2% a year ago. The new money pretax yield on the fix fixed income portfolio during the second quarter was 3.76% and 3% after-tax.

Risk assets, which principally include high yield securities and our public equities and our alternate portfolio, accounted for 7.6% of total invested assets as of the end of the second quarter, and is down slightly from the first quarter as we made a modest reduction to our high yield allocation.

We have been gradually diversifying our portfolio of risk assets and will likely modestly increase our allocation over time, depending on market conditions and opportunities.

Alternative investments, which primarily represent limited partnerships and private equity investments that are reported on a 1-quarter lag, generated a pretax gain of \$2 million for the quarter.

Turning to capital. Our balance sheet remains strong with \$1.7 billion of GAAP equity and we are adequately capitalized to support our expected growth. We continue to adopt a conservative stance with respect to managing our underwriting risk appetite, investment portfolio, reserving processes, reinsurance buying and catastrophe risk management.

Our debt-to-capital ratio of 20.6% at the end of the second quarter is trending below our longer term target of approximately 25%, and allows us to opportunistically increase financial leverage if we choose to.

With our 1.4x premium to surplus ratio, it means that each point of underwriting margin points to approximately 110 basis points of ROE. In addition, with our 3.34x investment leverage, every 100 basis points of pretax book yield from our investment portfolio results in 275 basis points of ROE.

This unique differentiated business model, combined with our ability to generate pure renewal rate increases positions us very well for the future.

During the quarter, we renewed our property excess of loss and casualty excess of loss reinsurance agreements.

These reinsurance agreements cap our net losses on large individual property and casualty losses at \$2 million.

This is a part of our underwriting strategy to reduce the volatility of our underwriting results from large losses in our overall book of business.

With that, I'll turn the call over to John to discuss our insurance operation.

**John Joseph Marchioni**  
*President & COO*

Thanks, Mark. I'll begin with an overview of some of our strategic initiatives and then focus on the results of our operations by segment.

We continue to move forward with various initiatives to drive our profitable growth strategy and position the company for sustained outperformance.

Our distribution partner relationships represent the Ivy League of independent agents, and our franchise approach to the business is a true differentiator for us. It means we have an average of approximately 50 agents per footprint state, with each partnership representing a meaningful relationship.



The principal drivers of our growth plans are new agency appointments in our current markets, increased share of wallet with our existing agents and geographic expansion into new states.

Our longer-term Commercial Lines targets are to build distribution partner relationships representing 25% of their markets and seeking a 12% share of wallet within each agency.

This translates to a goal of a 3% market share in Commercial Lines or an additional premium opportunity in excess of \$2 billion.

We appointed 109 distribution partners in 2017 and an additional 66 so far this year, bringing the total to approximately 1,300 agency partners and close to 2,130 storefronts.

Our current agency market share stands at approximately 19% and our share of wallet is approximately 7% in our legacy states.

We remain focused on driving both these metrics higher in the coming years. In addition, we are successfully executing on our geographical expansion plans. We opened Arizona and New Hampshire in July 2017 for Commercial Lines business and opened Colorado for Commercial Lines in January with 10 agency partners.

Together, these 3 states have generated approximately \$21 million of premium volume since inception, which is above our expectation when we developed our plans.

Our 3 new states represent an additional \$290 million of premium opportunity if we achieve our goal of a 3% Commercial Lines market share over time.

By the end of 2018, we expect to open New Mexico and Utah for Commercial Lines business and to open Arizona and Utah for Personal Lines. Our empowered field-based underwriting and servicing model is a key element in the execution of our franchise distribution strategy. We are investing heavily in providing our underwriters with the tools they need to make better decisions faster at the point-of-sale.

A very granular approach to underwriting and pricing enhances outcomes for our new and renewal books by allowing us to drive business mix improvements while obtaining the appropriate price. This is best demonstrated by our ability to consistently obtain renewal pure rate that exceeds market averages, while, at the same time, maintaining strong retention and growth rates. We continue to invest in technologies that help us enhance the overall customer experience with a goal towards increasing retention rates over time. We strive to deliver a superior omni-channel experience, enabling our customers to interact with us in a 24/7 environment in the manner of their choosing.

Policyholders who prefer a fully-digital experience now have that option available to them.

We have also built out master data management capabilities, whereby we have a 360-degree view of our customers, enabling us to provide the most effective solutions to our distribution partners and policyholders.

We are executing on this path in concert with our agency partners who are critical to the success of this initiative.

Another area in which we are leveraging technology is to find ways to add value for our clients beyond just providing insurance, with a goal towards further increasing switching costs. Examples of these include: a, the ongoing rollout of sensor devices to our commercial auto clients as part of our Selective Drive program to help them manage their businesses better through fleet management and telematics; b, providing software-based solutions to our clients to help them track the licensure status of their employees; c, increasing take-up rates for our digital self-service platform, which currently stands at 32% of our Commercial Lines book; and d, proactive, outgoing digital communications to our policyholders with relevant information such as product recalls and account status updates.

We are testing several other technologies that we expect to roll out in the coming years, benefiting our clients by making them more efficient.

We expect these initiatives to, over time, help increase hit ratios and retention rates.

Turning to our underwriting operations. Our Standard Commercial Lines segment generated net premiums written growth for the quarter of 8%, driven by stable retention of 84% and overall renewal pure price increases of 3.5%.

We are encouraged by the strong renewal rates as we strive towards price adequacy in each of our lines of business. The Commercial Lines segment generated a GAAP combined ratio of 91.4% on a reported and underlying basis. For the first half of the year, we generated a 94.9% combined ratio on a reported basis and 93.6% on an underlying basis.

For the highest quality Standard Commercial Lines accounts, based on future profitability expectations, we achieved renewal pure rate of 2.1% for the first half of the year and point-of-renewal retention of 91%. This cohort represented 49% of our Commercial Lines premium in the quarter.

On the lower quality accounts, which represented 11% of premium, we achieved renewal pure rate of 7.7% while retaining 78% at point of renewal. 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 exceed expected claims inflation.

Going down to the results by line for Commercial Lines. Our largest line of business, general liability, generated a 90.2 combined ratio for the first 6 months of the year. We achieved year-to-date renewal pure price increases of approximately 2.5% for this line. Decreasing frequency trends had led to meaningful favorable reserve development over the past several years, but we have not experienced any development in the first half of 2018.

Our workers top line experienced \$17 million of favorable prior year reserve development for the quarter as a result of lower-than-expected severities for accident years 2016 and prior.

The worker's comp combined ratio was 72.8% in the second quarter and 75.9% for the first half of the year. On a year-to-date basis, we achieved 0.1% renewal pure price, as we have attempted to hold the line in the context of significant industry-wide pressure.

Loss cost filings by NCCI and other individual state bureaus have been trending negative overall. While reported profitability remained strong due to favorable emergence on prior year reserves, current accident-year margins do not support negative rate levels.

Commercial auto remains an area of focus for us, as loss trends have remained elevated. In the case of our book, elevated loss experience has mainly been the result of higher liability frequencies. Second quarter commercial auto combined ratio was 108.8% and included \$7 million of unfavorable prior year casualty reserve development due to higher claim frequencies and, to some extent, severities in accident years 2015 through 2017.

The combined ratio for the first half of the year was 110% and included \$15 million of adverse prior year reserve development. To address profitability in this line, we've been actively implementing price increases that averaged 7.4% so far this year.

This was in line with the level of price increases implemented for the full year 2017. We believe that the elevated loss trends should support additional rate moving forward.

In addition to price increases, we've also been actively managing our new and renewal books in targeted industry segments and reducing exposures to higher hazard classes.

Our initiatives around the Selective Drive-centered technology program should also help with loss mitigation by improving driving habits.

Commercial property remains highly competitive despite elevated levels of catastrophe and non-catastrophe probable losses for the industry in recent quarters. While we have seen an uptick in pricing so far this year, more rate is needed to achieve the profitability level commensurate with the embedded volatility in this line.

Renewal pure price increases for our commercial property business averaged 4.2% in the quarter as pricing has climbed since the start of the year.

Our Personal Lines segment, which represented 13% of second quarter premiums generated 7% growth, driven by new business in personal auto. This segment produced a profitable GAAP combined ratio of 93.7% on a reported basis or 86% on an underlying basis. Generally benign weather in our footprint helped the profitability of this segment. In addition to the strong loss ratio, we have lowered the expense ratio for this segment, which was 28.6% in the second quarter, a 310 basis point improvement from a year ago.

Lower data costs, reduced expenses for technology development and benefits from increased scale have all helped drive the expense ratio down.

The homeowners line generated a GAAP combined ratio 94.4% during the second quarter, including 17.6 points of catastrophe losses. Net premiums written were approximately flat compared with the prior year, due to a competitive pricing environment and efforts we have been taken to limit catastrophe exposure.

Our plans for 2018 incorporate rate filings averaging 3.7% for this line. In personal auto, net premiums written increased a solid 13%, driven by higher pricing and strong new business growth opportunities.

Renewal pure price increases on our book averaged approximately 6% during the quarter. The combined ratio for personal auto was 101.5% in the second quarter and 104% for the first half of the year.

Profitability for this line should improve with the benefits of greater scale and efficiencies, along with generating rate in excess of expected claim inflation.

Our plans for 2018 incorporate rate filings averaging approximately 8%. Our E&S segment, which represented 8% of total second quarter net premiums written generated a 1% decline compared with the year-ago period. The GAAP combined ratio of 114.7% for the quarter included \$6 million of adverse prior year casualty reserve development and \$2.5 million of reserve additions for the current accident year.

We were disappointed by the results and have been taking aggressive steps to fix the profitability issues in this book. Overall price increases in E&S casualty lines averaged 5.9% in the second quarter. Premium volume has been under pressure in recent quarters, resulting from a reduction in new business as we have pushed towards target pricing levels and approved underwriting standards in targeted classes.

Our strategy has been to improve profitability while allowing the top line to flex depending on market conditions.

As we look to the remainder of 2018, we remain focused on executing our strategy of generating consistent profitable growth. The investments we are making today in our franchise distribution model, sophisticated underwriting tools and technology and enhancing the overall customer experience in an omni-channel environment remain differentiating factors and position us well for continued strong performance.

With that, we will open the call up for questions. Operator?

# Question and Answer

## Operator

[Operator Instructions] And our first question comes from Arash Soleimani from KBW.

### Arash Soleimani

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

First question, I just wanted to get some more color on E&S. I guess I was just a bit surprised there because you I know you guys had done a pretty thorough reserve review in the third quarter of last year, so I just wanted to get just a bit more color on what happened there this quarter.

### John Joseph Marchioni

*President & COO*

Arash, this is John, I'll start. And just as reminder, we do our full reserve review every quarter for all of our lines of business. And you certainly saw the impact of that most recent review come through in the current quarter. First, I just wanted to make sure we continue to put this in context, which is, as we said in the prepared comments, on a year-to-date basis, this is about 9% of our premium and, in a quarter, about 8% of our premium, and it's always been viewed as a complementary business. Now that said, we still are focused on making sure we achieve profitability in this segment and are focused on the profitability side before we look to grow the operation.

A couple of points I'll make, when you look at the context of the performance we reported for the quarter. Number one, pricing on the in-force book is strong, and we've said that for the last several quarters. It remains strong and our new business is coming in at or above our target pricing levels. And our renewal inventory, while overall is close to our target, we've got a handful of pockets of business in the renewal inventory by segment that are being more aggressively addressed because they're below target from a pricing perspective. In addition to that, and this will really start to take effect in the third quarter when we see our pricing come through, we just fully implemented an entirely new property-rating structure of that is much more granular by protection class, by construction type, by hazard of the exposures in the property, which we think will also -- although, our property book is a smaller percentage, about 25% of the inventory, we think that'll help profitability as well, so that's number one. Number two, there are a handful of small non-core segments that, when we looked at our performance, have driven the performance in a negative way and have added to the volatility that we will be exiting. And our philosophy around this business is understand what you could do well and focus on that business. We've got some noncore segments that we plan on exiting, which will put some top line pressure going forward. These weren't overly sizable segments, but, we think, certainly were contributors to the uneven performance. And then the final point I would make and you've heard us say this over and over again and we stand by it, which is we've made a number of claims changes. We moved our claims handling into our overall claims organization, and we do believe that is resulting in better outcomes and better expense in terms of managing the claims inventory, which will ultimately result in stronger case reserves and better litigation management, better expense management relative to litigation, but we haven't seen that come through the reserve inventory for the older accident years at this point.

So this is a business we still think we could be successful in. It's going to continue to be a business we think about as complementary and in that 10% kind of range of overall volume. But as I think we've demonstrated in our core commercial and personal lines businesses, we understand what our profitability drivers are, and when we lay out a plan to fix them, we execute on that plan.

### Gregory Edward Murphy

*Chairman & CEO*

And I would only add to that. I mean, this is the lightest class -- the lightest risk class in the E&S sector. It's much like our small business. So what we do in small business really isn't all that different than the types of classes you're seeing in the E&S sector. And as we continue to refine our small business strategy,

our belief is that this is going to fit well into that structure. And as we migrate this more to a class-type structure, I think it'll continue to add more discipline into the pricing and how we manage our new and renewal inventory. So again, did it disappoint us? Yes, but let's not -- 114% combined ratio on a relatively small premium base, these are not huge reserve inventory movements but unfortunately, they -- I agree that we've have -- we hit it last year, we hit it again this year, and our goal is to get this segment where we need to have it.

**Arash Soleimani**

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

And just my next question is on the general corporate expenses. Obviously, that approved a lot this quarter. I know part of that was related to the stock price. So looking ahead to the rest of the year, I'm assuming we should expect that to still be down year-over-year, but by a much smaller magnitude, is that the right way to [ think ] of it?

**Gregory Edward Murphy**

*Chairman & CEO*

Are we talking just corporate expenses at the [indiscernible] level or overall? I just want to make sure our response to you is targeted. Which one are you referring to?

**Arash Soleimani**

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

Just the corporate expenses that are not reflected in the expense ratio.

**Mark Alexander Wilcox**

*Executive VP & CFO*

Yes, Arash, it's Mark. In the quarter, corporate expenses were down as you mentioned. I mentioned it in my prepared comments, we were down \$5.2 million on a comparative basis. And year-to-date, we're down about \$6 million. Most of that, if not all of that, is driven by the long-term incentive stock compensation plan and a big piece of the reduction in the expense year-on-year in the quarter was driven by a reduction in the stock price. So we started the quarter with a \$60 share price, we finished at \$55, it's a 9.6% reduction. And with some of the liability of mark-to-market accounting for a portion of that long-term incentive compensation plan, that did drive the expense down and was actually -- came through as a contra expense in the quarter. There was also an element to an adjustment to a key group factor for 1 of the 3 years that rolls the expense then.

I would say those are kind of one-offs in the quarter, so call it nonrecurring. It was a benefit that came through. We wouldn't expect that to continue into future periods. But overall, over the last couple of years, we've been running \$35 million, \$36 million a year in corporate expenses. And as we've talked about in the past, we fully expect to achieve about a \$10 million benefit on a run-rate basis once the full effect of the restructuring of the long-term incentive compensation plan takes effect, which won't be until -- fully effective until the end of 2019. But we'd expect to achieve some cost savings in that line item for the full year '18.

**Arash Soleimani**

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

And just one other question on non-CAT property losses. I know, last quarter, those were obviously up a lot. But in general, it looks like they've been up 4 of the last 6 quarters overall and 5 of the last 6 quarters within Standard Commercial. So I just wanted to see if I could get some more detail there. What's been driving that?

**John Joseph Marchioni**

*President & COO*

I would say -- Arash, this is John. I would say we've looked at this closely and looked at the underwriting portfolio to ensure there wasn't a significant shift in the size or complexity or hazard grade level of our

property inventory, and we haven't seen any meaningful shift there. So we would view this as normal volatility. You have seen more competitors in the industry talk about a little bit of the same thing relative to higher non-CAT property losses, but we view this as normal embedded volatility in line -- which is why we're focused on making sure that rate level in this line continues to go higher. We told you that our rate on commercial property was 4.2% in the quarter, which is up over the first quarter pretty significantly. And we think this is aligned because of that embedded volatility that needs more rate level. And that's an industry dynamic as well, but we haven't seen any significant change in our core underwriting portfolio relative to the commercial property book.

**Gregory Edward Murphy**

*Chairman & CEO*

And I would just add to that. For the quarter, they were pretty much on budget. So on the volatility -- let's make sure we get -- so the volatility that we experienced in quarter 1 was principally in the month of January. There was a little bit above budget that happened in February and March, but not substantially that much out of line with budget. And then for the entire quarter of this year -- for the second quarter, they were pretty much on budget or just slightly elevated. So I don't think it's any different than what you're hearing overall. And then the question really is, at the end of the day, how do companies respond to that increase in volatility? Is it a hope strategy and they're going to constantly discount that volatility, either what they need to do pricing-wise or do they build in an elevated expectation for volatility and start to edge their pricing higher. I think you heard, as John talked about it in his prepared remarks, that's an area where we're edging our price higher. You heard me say that we printed a 3.6% for the month of July in price. That is one of our biggest inventory months. And our 2 largest inventory months of the year in terms of renewal inventory is January and July, so we're 62% through our inventory for the year. And the 2 areas that we continue to focus on are commercial auto and commercial property and then we've also got a very fine eye on general liability, making sure that we are closely analyzing all the trends that could affect severity and/or frequency in the GL line.

**Operator**

Our next question comes from Mike Zaremski from Crédit Suisse.

**Michael David Zaremski**

*Crédit Suisse AG, Research Division*

Focusing on the expense ratio not the corporate expenses, maybe I've thought about it the wrong way, but if I go back historically maybe 4, 5, 6 years ago, you guys ran at a lower expense ratio then it ticked up for a number of reasons, and it's been coming down fairly nicely. So I've kind of -- should we be thinking that you're kind of seeking to get back to historical levels? Or maybe we should bifurcate Personal versus Commercial, because you name some drivers of some of the expense savings in Personal Lines -- sorry, in yes, in Personal Lines that kind of probably weren't part of the playbook back then. Maybe so, if you can talk more about how to think about the expense ratio?

**Mark Alexander Wilcox**

*Executive VP & CFO*

Mike, it's Mark Wilcox here, I'd be happy to address your comments. And then, obviously, Greg and John can jump in as well. But you're absolutely right, if you go back about 5 years, we were closer to the industry average from an expense ratio perspective and we did see that drift up towards -- sort of peaked in terms of a high point or a low point, so to speak, at the end of '16. We've made good progress in '17 in terms of driving the expense ratio down. And certainly in 2018, we've made excellent progress, we're down, I think it's 110 basis points in the quarter and 130 basis points on a year-to-date basis, so making excellent progress there. We are mindful to focus on the long term not the short term. We're not looking to build any expense deficits in terms of the infrastructure and the investments we need to make in the technology to support the strategy and the future growth of the organization, but we have made good progress on the expense ratio. A couple of things I think that are driving it, one is we have benefited from good growth over the last couple years. We've been disciplined in terms of being able to manage our headcount and infrastructure expense growth, and we've grown that at a lower rate than the overall

expense ratio -- or the growth rate in premium. And we've been able to drive the expense ratio down. I do think it is good to split the Commercial Lines expense ratio from the Personal Lines expense ratio. Personal Lines does run at a -- from an industry perspective, at a lower expense ratio than Commercial Lines and we're very focused on driving that down. I think overall, going back to your comments, from an industry perspective, we still are at probably a 2 to 3 point expense disadvantage compared to the industry as a whole. There is an element of a higher level profitability for Selective versus the industry and some incentive-based compensation in there, whether that's employee or supplemental commissions, that probably adds about 150 basis points to our overall expense ratio. So if you normalize for that, you'd probably cut that deficit in half. But overall, our goal is to drive the expense ratio down. In the past, we had a target out there, more of on a statutory basis, of about a 33% expense ratio. I think longer term, from our perspective, we would expect to focus on driving our expense ratio down on a GAAP basis closer to the industry average, which is about a -- call it about a 32% expense ratio consolidated.

**John Joseph Marchioni**

*President & COO*

Mike, let me just kind of weigh in and give you an idea, over of the past few years, what's been the push and the pull. Some of that up-drift you saw until we caught up, relative to rate level and other things, was the very high profit base. So let's just -- I'll give you an idea. So profit base comp in our numbers were for the full year of '17, were around 4.5 points. When we defined that -- and that's not all in the underwriting expense ratio, but what is in there, the profit -- supplemental commission to agents was the high-water mark, and that was 2.6 points in our overall commission rate in '17. And then profit -- annual cash incentive to our employees was about just under 2 points. Now, what you're seeing, some of that in the quarter, what's drifting that down a little bit is the fact that, as I mentioned in my prepared comments, we have a very disciplined process in how our compensation program works. Our target combined ratio that works to pay out a big part -- half of our compensation is benchmarked to 300 over our weighted average cost of capital irrespective of what our budget is. And to the extent that we're not at that, that comes out of everybody sitting around this table right now in terms of performance. And so obviously, we're 1 point over our original forecast that we told you about. And therefore, that has an effect on that side of the compensation.

But the other thing is, I just -- where we are from a competitive standpoint, from a technology standpoint, we've done some big lifts in those numbers, we put in a new -- so far recently, just to give you an idea, we put in a new billing system, we put in a new general ledger, we put in a new reinsurance system, we built our entire master data management infrastructure to get at the golden record. We're now deploying our CRM strategy relative to that. We've got -- John's gotten an issue on a heavy cadence of new states. So we're adding approximately 2 states systematically in every period. So all of the ramp up in the state and to do all that and open the office and do everything we do has some impact on our expense ratio. And then I would say, everything that we're doing around CX, all those activities. And we expect a payoff for that to come in terms of higher retention, in terms of higher hit ratio. But also, we're not going to be at the same expense level. If you looked at us versus maybe a very large carrier, I would say there's probably 100 basis points just due to scale differential. We're going to amortize all these things I just talked to you about over about a \$2.4 billion, \$2.5 billion book of business. And that, we can't sit there and say, we're going to take that out on the backs of other things that we need to do. So it's something that we're very focused on, we're diligent on and want to systematically drive our expense ratio to the right level that allows us to invest in everything that we need to do. I'm sorry for that long answer, but there's a lot going on in this company right now to get your arms around and what we -- and everything that we -- and the enormity of everything that we're doing.

**Michael David Zaremski**

*Crédit Suisse AG, Research Division*

I appreciate it, and I'm definitely going to have to go back and read the transcript because that color is helpful and you guys clearly have been innovating and reinvesting some of the cost saves. Just curious on your retention comments and all the investments you're making to improve retention, is there a kind of a retention goal you're willing to speak to, maybe a long-term goal?

**John Joseph Marchioni***President & COO*

So I would say -- this is John. We have some internal expectations in terms of how we expect to see retention move based on the initiatives we're making relative to increasing switching costs. We're not -- we don't prognosticate retentions to the outside world and there are also market dynamics there. So let's just leave it at we believe that everything we're doing will improve retentions going forward. But there are countervailing forces from a market perspective that make projecting that a little risky.

**Gregory Edward Murphy***Chairman & CEO*

Yes, Mike, I've got a number in my head, but if I disclosed it, I don't -- I think my car -- I would have to look at my car before I left -- and again, and it's not -- and I want to make sure that the clarity around this is there. I mean, everything we're doing, everything that John is working on, improving the customer experience, what we're doing on that front and then being able to go to an account -- pitch an account with a selective drive opportunity, we would expect our hit ratios, also. And then as our producers that represent Selective start to understand, anyway, my hit ratio has gone up x amount because of that, we expect to get even more and more opportunities on new and that our closure rates would run higher as a result of everything. So we feel that we've got the right strategy in place and we're not going to get pinned down to a number yet.

**Michael David Zaremski***Crédit Suisse AG, Research Division*

Okay. Just curious, these initiatives you're taking to make switching costs maybe more expensive or tougher, is this -- are these things that most of the competition is doing? Or this is...

**Gregory Edward Murphy***Chairman & CEO*

I've not heard -- let's put it this way. We're in the market right now. Now again, these are not telematics products, we're not rating off of it, so this isn't like a rating telematics thing. What we are doing is, we've got, for our commercial fleets, our power units, whether it's a contractor or whatever, we're offering to these -- yet again, I'm going to gate myself. It's in a pilot phase, we're rolling out -- we've rolled it out to our own employees, we've rolled it out to the people our -- the people that have vehicles with Selective. And now, we've got it in pilot mode with some of our agents. But this is a product that's offered free of charge that many of our customers are already paying services for possibly telematics or they don't have any. And then what we're doing is we're offering that as a way for someone to better manage their fleet to get -- so at the end of the day, they know where their vehicles are, they know if they're being idled, they can tell -- game score -- gives game scoring in terms of how is that driver performing. Are they on -- are they driving while they're on the phone? So it detects distracted driving, which we perceive -- we're trying to figure out -- our actuary is sitting across from me right now. He's trying to figure out, have we hit the apex of commercial auto frequencies? And that's what he thinks about every day when he comes to work. Where am I? Where are frequencies going? How will we militate the frequency trends? And a lot of that is around better driving and distracted driving. And I can only tell you, the social issues of people driving distracted, I don't see any change. I see just as many people on the phone, and I see just as many people out there doing whatever they're doing. And that, you've got to find ways to change that. And so we feel that our product is really being presented to, whether they're a contractor, whether they're a manufacturer, as a way to better manage their fleet, better manage their petrol costs, get better driving habits. And that's how we're offering that. And I have not heard of anybody else really in the market. The relationship that we have with this vendor, they -- we're the first in market with them, so I know that they have not really worked with anybody else either.

**Michael David Zaremski***Crédit Suisse AG, Research Division*



That's interesting and good color. Lastly, just curious on commercial auto. Is it a different -- do you -- is the distribution a little different than the rest of your Standard Commercial or it's the same -- for the most part, the same agency groups that you're getting your commercial auto premiums from?

**John Joseph Marchioni**

*President & COO*

Yes, this is John. It's the same group of agents. We write virtually all of our Commercial Lines on a package basis. We write very, very little monoline of any major line, certainly not a lot a lot of monoline auto. So this is packaged business, and it's is reflective of our overall distribution when you think about our mix, which does tend to be a little bit heavier mix towards the various contracting classes, but manufacturing and wholesaling business, community and public services, standard mercantile business. But it is distributed through the same distribution plan and it's not a monoline book of business.

**Gregory Edward Murphy**

*Chairman & CEO*

Mike, there's no programs in here.

**Operator**

And as of the moment, speakers, we show no further questions in queue.

**Gregory Edward Murphy**

*Chairman & CEO*

All right, well, great. We appreciate your participation in the call today. If you have any follow-up matters, Rohan and Mark are available for you, and thank you very much for your participation on the call today.

**Operator**

And that concludes the conference for today. Thank you for your participation. You may now disconnect.

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