S&P Capital IQ

CONTENTS

Mercury General Corporation NYSE:MCY

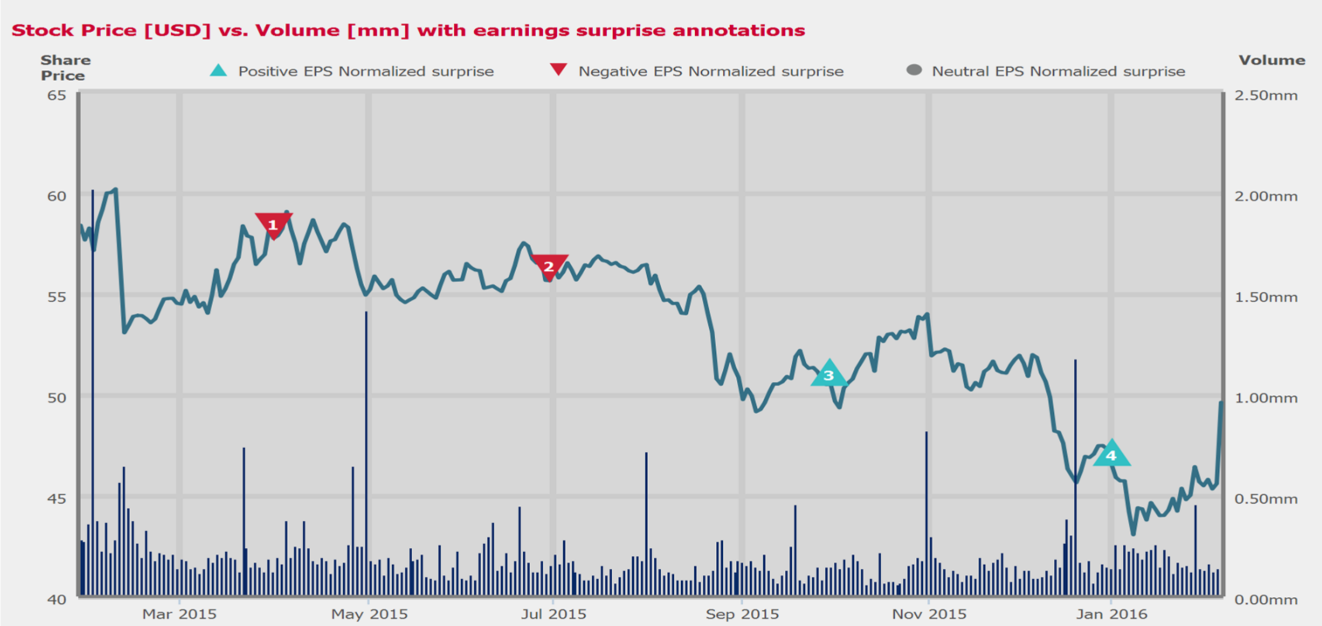
FQ1 2016 Earnings Call Transcripts

Monday, May 02, 2016 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2016-			-FQ2 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.68	0.13	(80.88 %)	0.74	2.60	2.87
Revenue (mm)	780.35	797.67	2.22	772.35	3155.19	3310.30

Currency: USD
Consensus as of May-02-2016 3:06 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2015	0.73	0.59	1 (19.18 %)
FQ2 2015	0.67	0.64	2 (4.48 %)
FQ3 2015	0.58	0.59	3 1.72 %
FQ4 2015	0.45	0.52	4 15.56 %

Call Participants

EXECUTIVES

Christopher Graves
Chief Investment Officer and Vice President

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

ANALYSTS

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

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

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

Presentation

Operator

Good morning. My name is Heidi, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Quarterly 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
Chief Executive Officer, President and Director

Thank you very much. I would like to welcome everyone to Mercury's First Quarter Conference Call. I'm Gabe Tirador, President and CEO. In the room with me is Ted Stalick, Senior Vice President and CFO; Robert Houlihan, Vice President and Chief Product Officer; and Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter. Our first quarter operating earnings were $0.13 per share compared to $0.59 per share in the first quarter of 2015. The deterioration in operating earnings was primarily due to an increase in the combined ratio from 99.1% in the first quarter of 2015 to 103.9% in the first quarter of 2016. Our results in the quarter were negatively impacted by $40 million of unfavorable reserve development and $8 million of catastrophe losses. The majority of the unfavorable reserve development in the quarter came from our California and Florida auto bodily injury coverage. The development occurred across multiple accident years with about $6 million relating to accident year 2015 and the remainder to older years. Catastrophe losses in the quarter were primarily from rainstorms in California and hailstorms in Texas. Excluding the impact of unfavorable reserve development and catastrophe losses, the combined ratio was 97.6% in the quarter compared to 99.1% in the first quarter of 2015.

In California, we recorded an increase in severity in the mid-single digits during the quarter as compared to the first quarter of 2015. California private passenger auto frequency was up slightly in the quarter as compared to the first quarter of 2015. In California, last year, we implemented several rate increases. In May 2015, we implemented a 6.4% rate increase in Mercury Insurance Company and in August 2015, we implemented a 6.9% rate increase in California Automobile Insurance Company. Mercury Insurance Company represents about half of our company-wide premiums earned, and California Automobile Insurance Company represents about 17% of our company-wide premiums earned. This year in California, we implemented a 5% rate increase in late March 2016 for Mercury Insurance Company and a 6.9% rate increase was recently approved by the California Department of Insurance for California Automobile Insurance Company. We expect to implement the California Automobile Insurance Company rate increase in June 2016. Our rate activity is consistent with what we are seeing in the market.

Outside of California, our results were negatively impacted during the quarter by unfavorable reserve development and catastrophe losses. Increasing loss cost trends and higher loss ratios that come with an increase in new business also negatively impacted our results during the quarter. To address profitability outside of California, we are increasing rates and tightening our underwriting. Excluding the impact of unfavorable reserve development and catastrophe losses, the combined ratio outside of California was about 106% in the quarter compared to 101% in the first quarter of 2015. The expense ratio in the quarter declined to 26.4% from 27.7% in the first quarter of 2015. The decrease in the expense ratio was primarily due to moderately lower total operating expenses, which decreased by approximately $4.5 million coupled with a 6.4% increase in net earned premiums. The operating expenses in the quarter included a slight reduction in net advertising expense from $16 million in 2015 to $15 million in 2016 and a reduction in profitability related accruals.

Premiums written grew 7.7% in the quarter primarily due to higher average premiums per policy and an increase in new business policy sales. Company-wide private passenger auto new business applications submitted to the company increased 7% in the first quarter of 2016, and homeowners new business submissions were down 3%. In California, we posted premiums written growth of 6.9%. Outside of California, premiums grew 11.4% in the quarter.

Outside of California, our loss adjustment expense ratio was too high. Accordingly, we are implementing various changes to improve our loss adjustment expense ratio, including a reduction in force we recently implemented that eliminated approximately 100 claims positions, primarily in our New Jersey and Florida hubs. The net annual savings from this change is approximately $7 million per year. We will record approximately $2 million in severance-related costs in the second quarter of 2016.

Lastly, we have not been able to profitably penetrate the Michigan and Pennsylvania market and believe our resources are better spent focusing on our other states. Accordingly, we recently made the decision to exit the states of Michigan and Pennsylvania and have filed our exit plans with each respective department of insurance. The company expects that once our exit plans are finalized, it will take about 1 year for the bulk of the policies to be off the books. In 2015, Michigan and Pennsylvania together produced $14.4 million of written premiums with a combined ratio of 137%. For these 2 states in 2015, the written premiums represented less than 0.5% of the company's total written premiums and contributed an underwriting loss of approximately $0.07 per share. In 2014, Michigan and Pennsylvania produced $18.4 million of written premiums with a combined ratio of 130%.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Greg Peters from Raymond James.

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

I had just a couple of questions. First, could you step back and update us on the consolidated financial position of the company and remind us why the first quarter disappointment doesn't really affect management or the board's perspective on the dividend outlook?

Gabriel Tirador
Chief Executive Officer, President and Director

I think we've discussed that before. We have a very strong capital position right now. We're writing little above 2:1 in writings. I was saying that we have a pretty strong capital position that has allowed us to pay dividend in situations like this with dividend payout ratios above 100, and we know that on a long-term basis we can't have that. And at current investment income levels, we need to get to about 98.3% combined ratio to be able to fund a dividend. But our target is a 95% combined ratio, and our results are going to improve. We have the rate increases that we have in California that start to earn in third and fourth quarter probably the most. You're going to see those rate increases fully earned, especially in the fourth quarter on the MIC rate increase. So we certainly recognize that we can't continue to have a combined ratio at this level. But long term, we really do not expect to have that target combined ratio. Again, we expect our combined ratio to be above 95% on a long-term basis. Having said all that, it's up to the board to evaluate the factors and make a decision on a quarterly basis, but we think that our prospects going forward are going to be much better and that we also believe that the results are going to improve quite a bit going forward.

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

I appreciate it. And then just as a follow-up, you spoke of the 98.3% to earn the dividend, the target of 95% and then, we're sitting back processing this $40 million adverse reserve development. So $6 million of it apparently is for the 2015 accident year. Could you provide us some color on the sense of allocation of the remaining $34 million by accident year? And I guess, ultimately, with the rate increases coming online, in the third and fourth quarter, is it reasonable to assume that that's going to result in improvement in the loss ratio or because of the higher accident year results that it's just going to sort of -- you're going to sort of be treading water for a period of time until you can get yet another round of rate increases approved?

Gabriel Tirador
Chief Executive Officer, President and Director

I hand over to you, Ted.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Hi, this is Ted. I'll handle the development question. It's spread primarily across '14, '13 and '12 , with '14 being of the $34 million being the highest amount. I don't have the exact numbers, but essentially '14 is the highest, and I believe it gets progressively lower as -- and then, actually '13 and '12 are about the same amount. So that's how they spread across those accident periods.

Gabriel Tirador
Chief Executive Officer, President and Director

And then looking forward with respect to the profitability. If you take a look at the accident quarter California combined ratio, I think we're right around 97% combined ratio based on what we booked with the reserve development. So if that continues and we have no further development in subsequent quarters, and you have loss cost trends that hopefully stabilize, I think that you should see an improvement in the combined ratio. With the 5%, 6% that we're earning here in California in the third or fourth quarter, we have an accident year combined ratio of 97% or so, you should see improved results.

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

Okay. Just one follow-up to that and then I'll re-queue. I guess when I look at the first quarter results, and granted, a lot of it, as you point out, is coming from 2014, '13 and '12 as it relates to the adverse reserve development. Does this give you ammunition to go back to the California regulators and ask for yet another rate increase on top of the rate increase that you have implemented or will be implementing over the next couple of quarters?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I guess the short answer, any time you have results that are not favorable, yes. That does give you more support to raise rates, is the short answer to that. We do think that in California Automobile Insurance Company we will be probably asking for more rate, that's coming. And Mercury Insurance Company, we think, depending on what happens in loss trends, we think that we're pretty much where we need to be right now. But in California Automobile Insurance Company, which represents, I think, I said 17% of the earned premiums, strong likelihood that we're going to be filing for more rate.

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

And does that happen on an annual basis? Or how often are you allowed to do that?

Gabriel Tirador
Chief Executive Officer, President and Director

You can file -- there's no timetable with respect to when you have to file as long as there's not one pending, which there's not one pending now because it's just got approved. You can file tomorrow if you wanted do. Now whether it's not going to get approved in the next 30, 60 days, it does take time in California.

Operator

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

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

So a couple of questions. First, can you just repeat the combined ratio outside of California? It just went by me too quick. I want to make sure I heard it right. And then, also if you could remind me of the mix of 6 months and 1 year premiums and then I guess, the last -- the policy mix for your business. And then the last question I had is with all the rate increases and all of your efforts and everything you're doing to control the improvement in the loss ratio, could you go into more detail on thought about how it might impact growth going forward?

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. 106% on an accident year basis, Alison, was the combined ratio outside of California. As far as the mix between 6 months and 1 year, Robert do you -- most of it is 6 months. I don't know if we have a percentage.

Robert Houlihan
Chief Product Officer and Vice President

It's heavily weighted toward 6 months. I don't have the exact percentage off my fingertips.

Gabriel Tirador
Chief Executive Officer, President and Director

Okay, heavily weighted toward 6 months though. And your question regarding growth going forward, any time you raise rates, Alison, your growth is going to be impacted. We're also taking some action with respect to some national accounts outside of California, national agencies that have been running high, and we curtailed some of their business. So my expectation is that growth is going to slow down from a policy unit standpoint. You'll see that new business sales will start to slow.

Operator

Your next question comes from the line of Greg Peters from Raymond James.

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

I'd like to just step back for a moment and have you go back and talk about frequency and severity trends, particularly in California. And I know you've made some opening comments, but perhaps you could give us some additional color just so we have a sense of what the conditions look like, a better sense of what the conditions look like in that state.

Robert Houlihan
Chief Product Officer and Vice President

Well, one of the things we look at, Greg, is industry trends. And I believe in physical damage, and bodily injury the trends were showing in the 5% to 7% range on severity, and some were in the low single digits on frequency. And that's pretty consistent with what we're seeing in our 2006 (sic) [2016] trend. We're very close to the industry trends on frequency and severity.

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

Have you seen any moderation in frequency as it relates to, say, last year? Or is it -- are you still seeing the same consistent trend from last year? It seems that the latter, but I just want to confirm that.

Robert Houlihan
Chief Product Officer and Vice President

It's interesting because we -- in the first quarter of '15, we saw a fairly large increase in frequency compared to the first quarter of '14. But when we looked at that closer, it looked like the first quarter of '14 actually was sort of unusually low, and then what we saw throughout '15 is frequency sort of moderated, and I think we ended the year around 2% or low single digits. And that has kind of continued into '16 kind of the same frequency trend.

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

Okay. I guess, just to close out one other question, considering the growth in the top line, and I was struck by the change in investment income in the first quarter versus the first quarter last year. I'm just curious if there's been any change in perspective in the way you're allocating assets in your investment portfolio, perhaps you could just talk about what's going on there.

Christopher Graves
Chief Investment Officer and Vice President

Sure, how are you doing, Greg? It's Chris. The past 2 years, as you probably have noticed, we were able to grow investment income. It is probably with a bit of irony now that I'm facing more challenging comps despite the fact that the Fed has finally gotten off the fence and started raising short-term rates. But the mix last year was much more aggressively shifted towards municipal bonds from common stocks and that was more of a market decision. I've just not have a lot of confidence in market valuations on stocks and felt municipals were a better place to be, and that actually turned out to be a pretty good call in hindsight for last year. So the mix currently still is weighted heavily towards municipal bonds. Unfortunately, everyone else has identified value in municipal bonds. And with the negative rates abroad, we're seeing actually demand from Asia for munis from what some of the big folks I talk to tell me. Anything with a positive rate is worth buying. So the yields in the market right now that I'm looking at, I'm right around the belly of the curve is something in the neighborhood of 2% and 2.5%. And for a number of years, we've been buying bonds with the expectation that the economy was going to grow, rates would move higher, and once we got to about this point in time, we'd be able to reinvest in a much higher rate environment. Well, obviously, that's not the case. So we've got bonds currently rolling off this year that has book yields 4.5% or higher. So it makes the reinvestment much more challenging and that's simply it. And so, we're doing what we can to reinvest and try to make up as much income as we can and try to find opportunities around the edges. But I'm less optimistic that we're going to be able to grow investment income as we did in the past 2 years, and I think it's going to be a bit of an uphill battle for this calendar year.

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

Right. Chris, just, I'm pretty sure I know the answer to the following question but you can just confirm it, exposure to things like the energy complex and/or Puerto Rico or other municipalities, or debt instruments that may be having some problems. I'm sure it's pretty minimal if nonexistent, but could you confirm that?

Christopher Graves
Chief Investment Officer and Vice President

Yes. No, I would have to knock on wood with this answer. We've been fortunate on the muni side that we've avoided many of the problems out there. We don't have exposure to Puerto Rico. We didn't have any exposure to Detroit or San Bernardino, Mammoth, any of the others that have fallen out of bed. On the equity side, back in 2014, we had much higher energy exposure on stocks, and rolling into 2015 we certainly had some, and we've rolled that exposure down considerably. So at this point that exposure is minimal only on the equity side. We really don't have any debt exposure on energy.

Operator

Your next question comes from the line of Ken Billingsley from Compass Point.

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

I have 3 initial questions, and I apologize, I got on a little late, so if you addressed this in the commentary, I can read it in the transcript. But just on net premiums written growth, obviously, that surprised us a little bit here, I mean, it was stronger than expected. Was there anything that you discussed, any items that you may be carrying over going forward or anything in the quarter that were one-time in nature?

Gabriel Tirador
Chief Executive Officer, President and Director

They're just basically rate. Higher average premiums per policy was really the big driver, Ken. It's higher rates.

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

So it was almost all rate related, and you were saying that the second half of 2016, we could even see another bump in there related primarily to rates as well?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. I would say, yes. It's primarily related to rate. As I mentioned in my prepared remarks, our new business policy sales were up, but really, the driving force is the higher average premiums per policy.

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

Okay. On the expense ratio, striking out the acquisition cost, just the other operating expense, ratio continues to be trending down year-over-year. I know the second quarter is going to have a one-time adjustment but anything that you're doing there differently? Were you reducing expenses in other states? Or is this a trend that we would likely see continuing obviously with the adjustments that you mentioned in the press release?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Well, we are actively managing our expenses and trying to keep those aligned. I think partially what's happening here, Ken, is that our earned premiums are going up, and we kind of been able to hold the line on the operating expenses so that makes the ratios improve. That's really what's going on.

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

And would you say that that's -- and I know it was something you discussed in prior quarters, is -- are we there yet? Or is there still even more room for improvement on that portion of the expense ratio?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Our goal is to improve that and the loss adjustment expense ratio. So yes, there is more room for improvement.

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

So there's more earned premium coming through on the current base, and you're not looking to necessarily even having to hire in other parts. And I know that you have 100 people coming out in the second quarter, but you're not looking to replace that in another pieces of the business?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Correct.

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

Okay. And then did you have any commentary on reinsurance, kind of expectations, costs, or you're fundamentally kind of hearing a mixed bag from some reinsurers. So any discussions you've had with them regarding, obviously, expectations given recent storm activity? Are you able to flow through any of those to help keep cost down and not have to raise rates as much so you don't lose as much business. Can you give any color on that?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we don't use a lot of reinsurance, very little reinsurance, primarily on our property business. And we have a cat -- our biggest reinsurance is our catastrophe cover, which, I think, renews on July 1. We still don't have indications on where the pricing's going to be there, but we really don't rely a lot on reinsurance, Ken, so it's not a significant factor for us.

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

And how much of the $40 million was net of reinsurance?

Gabriel Tirador
Chief Executive Officer, President and Director

The $40 million -- yes, yes, yes.

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

On the reserve chart?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, yes.

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

Okay. So there was no reinsurance -- none of that hit any of your cat layers? That was all absorbed by you?

Gabriel Tirador
Chief Executive Officer, President and Director

No, no. We have $100 million retention on the cat. We also buy from facultative reinsurance on our homeowners business, but again, it's not material.

Operator

Your next question comes from the line of Greg Peters from Raymond James.

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

Just one follow-up question on the advertising campaign. I know that, that was a -- something that you were hoping would help improve your penetration in other states. And I'm just curious where you are with the national advertising campaign in terms of dollars spent last year, and what you're planning to spend this year and how it foots with your withdrawal from a couple of the markets that you talked about before.

Gabriel Tirador
Chief Executive Officer, President and Director

I think our advertising budget this year, Greg, is $42 million in '16 and it was $44 million in '15, so very comparable. And based on our 2015 results, we're recovering the -- we were recovering the vast majority of our advertising cost, how we look at it. And in the first quarter of '16, we actually recovered all of our advertising costs. So we feel that it's working. The impact of the Michigan and Pennsylvania is not going to be material because they were very small states. Obviously, the bulk of our advertising dollars get allocated to our California market, which is our biggest market. So again, spend is going to be very similar to last year at this point $42 million, as I think I mentioned, versus $44 million a year ago and Michigan and Pennsylvania are not going to have a material impact on us.

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

Is the spend for this year skewed in 1 quarter more so than another? Is it fairly even distributed across all 4 quarters?

Gabriel Tirador

Chief Executive Officer, President and Director

No, the first quarter by far we spend the most. I think, we spend $15 million this quarter, and it's -- that's an annualized rate you'd have $60 million right, and we're only planning on spending $42 million.

Operator

[Operator Instructions] And there are no further questions at this time. I turn the call back over to the presenters.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, thank you very much for joining us this quarter, and we hope to bring better results in future quarters. Thank you very much.

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