S&P Capital IQ

CONTENTS

RLI Corp. NYSE:RLI

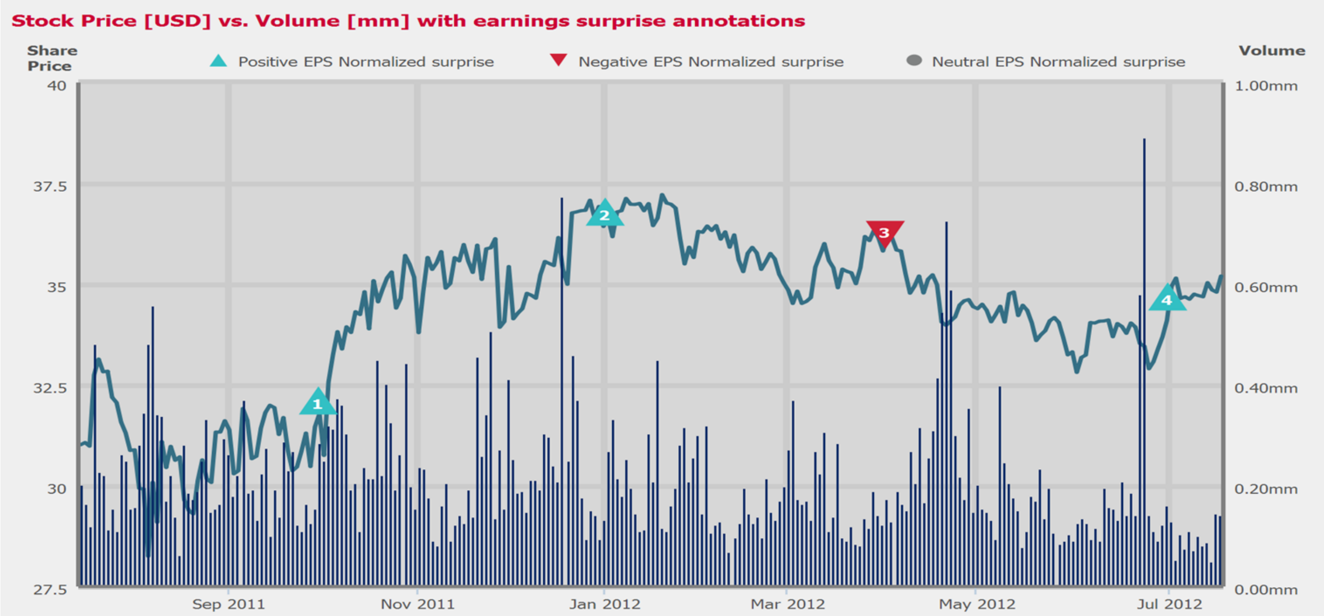
FQ3 2012 Earnings Call Transcripts

Thursday, October 18, 2012 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2012-			-FQ4 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.47	0.51	▲8.51	0.48	2.03	2.12
Revenue (mm)	161.48	169.64	▲5.06	163.82	643.36	683.04

Currency: USD
Consensus as of Oct-18-2012 2:59 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2011	0.49	0.62	▲1 26.53 %
FQ4 2011	0.55	0.68	▲2 23.64 %
FQ1 2012	0.53	0.48	▼3 (9.43 %)
FQ2 2012	0.57	0.58	▲4 3.51 %

Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Jonathan E. Michael
Chairman and Chief Executive Officer

Michael J. Stone
Director

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

DeForest R. Hinman
Walthausen & Co., LLC

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Randolph Binner
FBR Capital Markets & Co., Research Division

Raymond Iardella
Macquarie Research

Unknown Analyst

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. Third Quarter Earnings Teleconference Call. At this time, I would like to inform you that this conference is being recorded. [Operator Instructions] Before we get started, let me remind everyone that through the course of the teleconference, RLI management may make comments that reflect their intentions, beliefs and expectations for the future. As always, these forward-looking statements are subject to certain risk factors, which could cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including in the annual Form 10-K, which should be reviewed carefully. The company has filed a Form 8-K with the Securities and Exchange Commission that contains the press release announcing third quarter results.

RLI management may make reference during the call to operating earnings and earnings per share from operations, which are non-GAAP measures of financial results. RLI's operating earnings and earnings per share from operations consist of net earnings after the elimination of after-tax realized investment gains or losses.

RLI's management believes this measure is useful in gauging core operating performance across reporting periods, but may not be comparable to other companies' definitions of operating earnings. The Form 8-K contains reconciliation between operating earnings and net earnings. The Form 8-K and press release are available at the company's website at www.rlicorp.com.

At the request of the company, we will open the conference up for questions and answers following the presentation. I will now turn the conference over to RLI's Vice President of Corporate Development, Mr. Aaron Jacoby. Please go ahead, sir.

Aaron H. Jacoby
Vice President of Corporate Development

Thank you. Good morning to everyone. Welcome to the RLI earnings call for the third quarter of 2012. Joining me on today's call are Jon Michael, Chairman and CEO; Mike Stone, President and Chief Operating Officer; and Tom Brown, Vice President and Chief Financial Officer.

I'm going to give some brief opening comments on the quarter, then turn the call over to Mike to talk about operations and market conditions. Then, we will open the call to questions, and Jon will finish up with some closing comments.

From our perspective, there were several things worth highlighting this quarter: An 88 combined ratio; 6% gross premium growth; continued favorable reserve development; and strong growth in book value per share, up 12.5% since year end, all within the context of still improving market conditions.

Operating income was $1.02 but, as usual, there were a few items that influenced this quarter that are worth pointing out. First, we had $18.1 million of favorable development from prior year's loss reserves. As those of you who have followed RLI for a while know, reserve levels are subject to quarter-by-quarter adjustment based on our actuarial process and there can be, and oftentimes have been, significant volatility in these levels from quarter-to-quarter.

Second, Hurricane Isaac and other smaller cat events amounted to $5.6 million, similar to last year's Hurricane Irene impact. Also of note to some, in the quarter our crop reinsurance book posted a $3.2 million loss on the 2012 crop reinsurance year. This result represents the impact of moving the 2012 multi-peril loss ratio to $110 million during the third quarter.

Premium growth was up 6% on a gross basis, with our casualty segment leading the way, up 14%. Although investment income continues to be a challenge for the industry, our portfolio's total return was admirable, not only in the quarter, but also year-to-date where it returned 7.1%. So bottom line, $1.02 of operating income and an 88 combined ratio and continued strong growth in book value of 12.5% year-to-date, all in all, another good quarter.

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

Michael J. Stone
Director

Thanks, Aaron, and good morning, everybody. I'll try to provide a little color and talk about the marketplace and what we're seeing. Well as Aaron said, a very good quarter, positive underwriting results, 88 combined ratio, 6% gross premium written growth. Casualty growth 14% on an 84 combined ratio is very satisfying and provides reason for an upbeat view. We are cautiously optimistic as we proceed.

Casualty rates up some 5%, more in some lines, particularly commercial umbrella. Economy is showing some signs of life and some geographies are better than others. For example, the Northeast seems to be performing better than the rest of the country, but we're seeing some life in California and certainly Texas and some in the Southeast.

Our GL, our primary liability product, our largest product, saw growth in gross written premiums, some 5% year-to-date. Our CBIC products acquired last year are performing well. We're seeing a little bit of growth there, around 5% as well. Transportation, showing some positive uptick. Gross written premiums up 15% in the quarter and 10% year-to-date.

I'd like to talk about the canary. The canary is not dead but it's starting to look for the oxygen. Good signs for casualty but still fragile, still a surfeit of competition. Casualty feels better than any time recently, not the halcyon days of the early to mid-2000s, but we're on the right path.

Property. Crop. Aaron spoke to the results of $110 million loss ratio. We think this represents a 1 in 25, 1 in 50-year event. Still above [ph]. But we still like the business, it's diversifying and it's a good business over time.

Our quota share agreement with ProAg renews on 1-1. We hope to renew on comparable terms. Overall property growth written premium was flat, combined ratio of 100. Not acceptable, but without cat and crop, a 90 combined ratio. Same positive rate overall, some 3% in the quarter. We're continuing to reunderwrite our marine business and we are seeing some improvement. Not enough, but directionally it's positive. And our gross written premium on that product is flat for the quarter.

E&S property, our surplus lines property business. Overall flat gross written premium year-to-date, but we're seeing positive rate on the wind, still driven by RMS 11. We're through a whole cycle of renewals on RMS 11 so the increases will begin to diminish in that line, particularly given the relatively benign cat season, certainly hurricane season.

Surety. Gross written premium up 8% year-to-date, down 2% for the quarter. The year-to-date number is driven mostly by CBIC. Competition remains fierce in most of the surety products, with no less than some 3 new competitors entering this segment in the quarter. With the economy not growing significantly, there's not enough business to go around.

Contract surety that we've been managing carefully over the past few quarters, with the economy in kind of a bit of trouble. We saw our gross written premium down some 9% in the quarter. Current economy demands disciplined underwriting approach. The public sector construction market, where most bonding occurs, continues to be weak. Overall surety combined ratio of 70. So excellent underwriting performance and a testament to our diversified product mix in this segment and the positive impact of the acquisition of CBIC in 2011. Overall, a very positive underwriting performance. A testament to our dedicated, experienced underwriting, claim and support staff.

With that, I'll turn it back to Aaron.

Aaron H. Jacoby
Vice President of Corporate Development
Thanks, Mike. We can now open the call up for questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from the site of Randy Binner.

Randolph Binner
FBR Capital Markets & Co., Research Division

I had a question about -- just on property. I understand the comments on the underlying results still being good. But we were surprised to see such a high loss related to Hurricane Isaac, and I don't think -- I mean, based on what we're seeing from some of the other carriers that have reported so far, that does not seem to have been an issue for them. So I was wondering if there was kind of some unusual concentrations or unusually high losses associated with that storm, if you could provide color on that, and kind of what claim type geographies those might have been in.

Michael J. Stone
Director

Yes, Randy. It's Mike Stone. We're not as big as some others. We write surplus lines property and sometimes we'll get, I would say, unlucky on some of these storms. We'll have an unusual number of losses -- severe losses, and I think we saw that in this hurricane. I would suspect if you look back over the past 6 or 7 years to the hurricane events that you've seen typically, we've done better than the industry. And that doesn't always obtain. So I don't think there's anything -- there's nothing that we look at as we evaluate this to say there's something we did wrong from an underwriting perspective. It's just I think we just got a bit unlucky in this storm where we've probably gotten a bit lucky in some prior storms.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And I mean, was it wind? Was it like the roof on a commercial business, or was there like extra flooding or was there anything that stood out from that perspective?

Michael J. Stone
Director

No. I don't think there's anything unusual. It's mostly roofs from wind. Nothing that we could point at that would be particularly interesting or different. We just happen to have too many buildings in the particular area that got hit.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. That's helpful. And then just one real quick one. I guess I didn't, and maybe I wasn't listening close enough, but was the canary comment kind of to suggest that a good spot in transportation underwriting might be passing? Is that what you meant by that?

Michael J. Stone
Director

No. These guys are always laughing at me about the canary, so I have to keep talking about the canary. The canary, when it dies, means something's changing, right? Something's bad. So I do it kind of in reverse. For transportation, it's something good. It's the leader -- transportation tends to be the leader of a casualty turn. So when transportation is starting to get better, that means that the whole segment is probably going to get a heck of a lot better.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. Good. Yes. That's a better takeaway from my end. So that's helpful.

Michael J. Stone
Director

That's the analogy, as terrible as it is, but if I didn't mention the canary, these guys wouldn't talk to me for the rest of the week.

Operator

And we'll move next to the site of our Arash [indiscernible].

Unknown Analyst

Just had a couple of quick questions. First was, was the decline in the tax rate this quarter attributable to the higher allocation to munis?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

This is Tom Brown, Arash. That's correct. We've allocated a little higher portion of our portfolio to tax-exempt securities and had a corresponding improvement in the effective rate.

Unknown Analyst

Okay. And then I just wanted to get just another update this quarter on what you're seeing in terms of the standard carriers backing out of the specialty states, is that continuing this quarter? Is it accelerating? Decelerating? I just want to get your thoughts on that.

Michael J. Stone
Director

Yes. It's Mike Stone again. I think as you see the market start to improve, some of that is driven by the standard lines companies spending more time on their standard line business and leaving a bit of the surplus line space. So I think that's what -- we're seeing that. Is it accelerating? Probably a little bit. It's certainly not a mad rush to the exits.

Unknown Analyst

Okay. I mean, is it fair to say that improvement in exposure of units and just economic improvement is what would, I guess, serve as a catalyst to sort of boost that a little bit more or are there other factors you think would also be important for that to happen?

Michael J. Stone
Director

Well, I think if results get worse -- and they don't seem to be. I saw where Travelers reported this morning and were talking about pretty good results and significant rate increases, so that would indicate to me that they're probably getting a lot of rate in their standard business and are not straying as far as they would have a few quarters back.

Unknown Analyst

Okay. And I apologize if you mentioned this during your opening comments, but the year-over-year NWP decline in property, what was that from?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

This is Tom Brown. Maybe I can answer that. It's largely mix. Slight decline in the crop reinsurance program in 2012 compared to 2011, is probably the driver in that.

Operator

[Operator Instructions] We'll move next to the site of Ray Iardella.

Raymond Iardella
Macquarie Research

Quick question, I guess, following up on the crop reinsurance. Just should we expect any incremental impact in the fourth quarter from crop reinsurance, just as earned premiums kind of go through that in the fourth quarter?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Ray, this is Tom Brown again. It's really hard to predict what's going to happen in the fourth quarter. With the spring crop, a lot of that is coming out of the fields, as you know, in the past, and as we speak. What I can tell you is last year, the actual written premium went down slightly, pretty modestly, $80,000. I don't know if I can read too much into that for the upcoming quarter. We get information from the reinsurer, from ProAg, and react accordingly.

Raymond Iardella
Macquarie Research

Okay. So I guess the earned premium will be similar to what it was in the fourth quarter of last year? Is that the right way to think about it?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, I don't have the -- I can't remember, I think I would say it's slightly down, because I can't recall off hand what the 2011 quarter was, but earned premiums should be around $8 million to $8.5 million in the fourth quarter.

Raymond Iardella
Macquarie Research

Okay. That's helpful. And then maybe -- I know overall on the surety book there was some payroll development, but any update you can give on the contract surety book piece of it?

Michael J. Stone
Director

Yes, it's Mike Stone. Again, as we indicated, the contract surety is something that we are watching closely and things that we thought improved a bit in the quarter. And we think we managed through quite a bit of the loss activity in the first half of the year and feel like things are improving, but it's pretty fragile. The economy is -- is not in a real upswing and contract surety tends to be hurt a few quarters or a year or so after the economy starts to sink. So we hope we're through it. We feel pretty good about our underwriting and the discipline as we've approached this, and we think we've worked through that claim activity that we encountered in late last year and early this year.

Raymond Iardella
Macquarie Research

Okay. That's certainly helpful. And then I think earlier this week, there was another conference call that referenced habitational rates up pretty drastically around the country. Just curious, A, are you seeing that as well? And then there was another comment about the DIC book in California having increased demand. Are you seeing that or are you still kind of cautious on rate adequacy in the DIC book?

Michael J. Stone
Director

Well, on your first question, on habitational, certainly it needs rate, both on the property side and the casualty side. And we are getting rate and where we're not getting rate, we're exiting that business. That's been an underperforming part of both our GL book and our E&S property book over the past several years. It needs rate. On DIC, we're not seeing any increased demand to speak off. We're basically flat, probably down a little bit in exposure because rates are down a little bit to flat. So all in all, we're comfortable with our DIC book, both from a standpoint of exposure and where we are in the marketplace. We're certainly not seeing any increased demand at this point in time.

Operator

And we'll move next to the site of Mark Dwelle.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple of questions. First, circling back around to the crop business. How does it impact your ability to renew that when the government hasn't passed their Ag bill yet and there's really no way of knowing whether they'll even get that done before year end. Is that going to just delay the renewal or does it not have any effect?

Michael J. Stone
Director

It's Mike Stone. I mean, it's not really going to have an effect on our renewal. Obviously, it's less impact to reinsurers but we'll proceed with the renewal, with being able to manage those terms as we go through that renewal process.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

I guess I'm a little curious how you can set a rate on the renewal if you don't know what the underlying will be.

Michael J. Stone
Director

Well, we would expect an incremental change, nothing great. I mean, it's not something -- we've been through this in the past, and I wouldn't suspect that -- it's a quota share deal so it's going to flow through basically, and we're not going to change our seeding terms. So all in all, it's going to flow through. So the industry is trying to manage it the best it can.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Right. Okay. Can you comment on some of the -- over the last couple years, you've launched some new business lines, the design professionals and some of the others. Can you just comment on how those are contributing to premiums at this point? I haven't heard an update on those in maybe a quarter or 2.

Michael J. Stone
Director

Yes. We're happy with the performance of our new products, and certainly design professionals. And we're starting a recreational vehicle, we're starting a security guards, neither of which provided any premium increase. But all in all, some $25 million with CBIC, [audio gap] percent in the quarter. So fairly good impact from new products, including the acquisition.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. Last question, just kind of a capital management question. I'm sure you expected to hear this. Just how are you thinking in terms of special dividend? You've done that the last couple of years. The share buybacks had been a little bit lower this year. Just -- I mean, I know you're not going to give anything upfront but just curious how you're thinking about it at this stage.

Jonathan E. Michael
Chairman and Chief Executive Officer

We'll evaluate it. We always evaluate it, Mark. It's Jon Michael, by the way. We will continue to evaluate capital management, as is always the case. If we can't use the capital, we'll give it back in one form or the other, either in a special dividend or through buybacks.

Operator

We'll move next to the site of John Thomas.

Unknown Analyst

How much higher are the crop losses this year compared to last year or normalized year for the amount of premium you're writing?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

This is Tom Brown. Are you referring to the loss ratio on that, John?

Unknown Analyst

Yes, I guess the loss ratio or the actual dollar amount.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

The loss ratio, as I think Aaron mentioned earlier, is about 110% this year. We would say, compared to historic standards, we've been in the program now, this is our third year, approximately 20 percentage points.

Unknown Analyst

The last 2 years were 20 percentage points, 20%?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

I would say if you -- 20 points -- this year is 20 points higher than the, I would say, the aggregation of the prior 2 years, correct.

Unknown Analyst

Okay. And just another question related to excess capital. With the changing business mix, how do you think about how much surplus you need to support your premiums? Are you finding that you need less net written -- I mean less surplus to support net written premiums? Or is your leverage ratio lower than, say, 4 or 5 years ago?

Jonathan E. Michael
Chairman and Chief Executive Officer

Jon Michael. I don't think it's had that much of an impact on our leverage ratio, just slight. So we haven't seen any appreciable change in that. Probably seen more change in decreasing -- that decreasing primary liability book over that period of time.

Operator

[Operator Instructions] We'll move next to the site of DeForest Hinman.

DeForest R. Hinman
Walthausen & Co., LLC

Can you give us an update on your bond portfolio strategy? You touched on the muni bond exposure, but can you kind of give us some color about your reinvestment yields that you're seeing, where is a good place to put that money to work and where is your portfolio duration sitting at, at this point in time?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

DeForest, this is Tom Brown speaking. Wish there was a better place to put it. We're in a historic low interest rate environment and it's hard to predict the future but we don't see any movement anytime soon. Having said that, the mix has not changed. Start at the highest level. The mix between fixed income and equities hasn't changed substantially. It usually hovers around 80% fixed, 20% equities. And right now, it's at about 78%, 22%, so pretty consistent with historic levels. New Money, we have seen a little bit of an increase going into municipal bonds, around 40%. That's changed the overall mix slightly, but to be real clear, it's 40% of the money that we have available for reinvestments but not -- the current allocation for the entire portfolio is about 30% munis, 40% corporates, et cetera. So we see that new money at a yield about 2.4%, duration around 4 years. Our overall duration has moved out slightly to about 4.86, make it the last quarter we said it was about 4.65.

DeForest R. Hinman
Walthausen & Co., LLC

Okay, that's helpful. And can you kind of update us on the acquisition opportunities and then also your ability to get underwriting teams? And I think in the past, but I could be wrong, you had kind of commented that it was easier to do acquisitions when the market was softer, it was easier to get underwriting teams when the market was softer. Are those opportunities still there as we see some firming in the market? And if they are there, what type of multiples? Are the multiples really increasing by quite a bit that would make us not pull the trigger on any type of a deal?

Jonathan E. Michael
Chairman and Chief Executive Officer

Jon Michael here. We continue to see opportunities. We certainly had started a couple this year. We had the acquisition of CBIC last year and we started 2 new lines that we mentioned earlier with RVs and security guards. And we continue to be active looking at different opportunities and I haven't seen that slow down. I think I've seen a bit of a pickup in anticipation of a much more firmer market.

DeForest R. Hinman
Walthausen & Co., LLC

And when we think about acquisitions, I guess in the past we've historically used cash but I could be wrong. But with the multiple that the stock trades at, have we ever discussed using the shares as a currency to do a transaction at all?

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, that's a great idea and we certainly have. And we will use shares when that's the right thing to do. Whether our counter party want the shares or wants cash, it depends. So we certainly have a strong cash position and we've used that, we used that with CBIC.

Operator

There are no further questions. I will now turn the conference back to Mr. Jonathan Michael. Please go ahead.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thanks again for joining us. Another good quarter, combined ratio of 87.7, premium growth 6% during the quarter. We've had decent-to-good book value growth of 12.5% year-to-date to book value per share of 42 15. We mentioned on the call that we are seeing slight market improvement across most of our lines of business and we hope that continues. Our diversified portfolio is helping us through this period. And we look forward to talking to you again next quarter and having another good quarter. Thanks again and we'll talk to you next quarter.

Operator

Ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 1 (888) 203-1112 with an ID number of 949-6807. This concludes our conference for today. Thank you all for participating and have a nice day. All parties may now disconnect.