S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

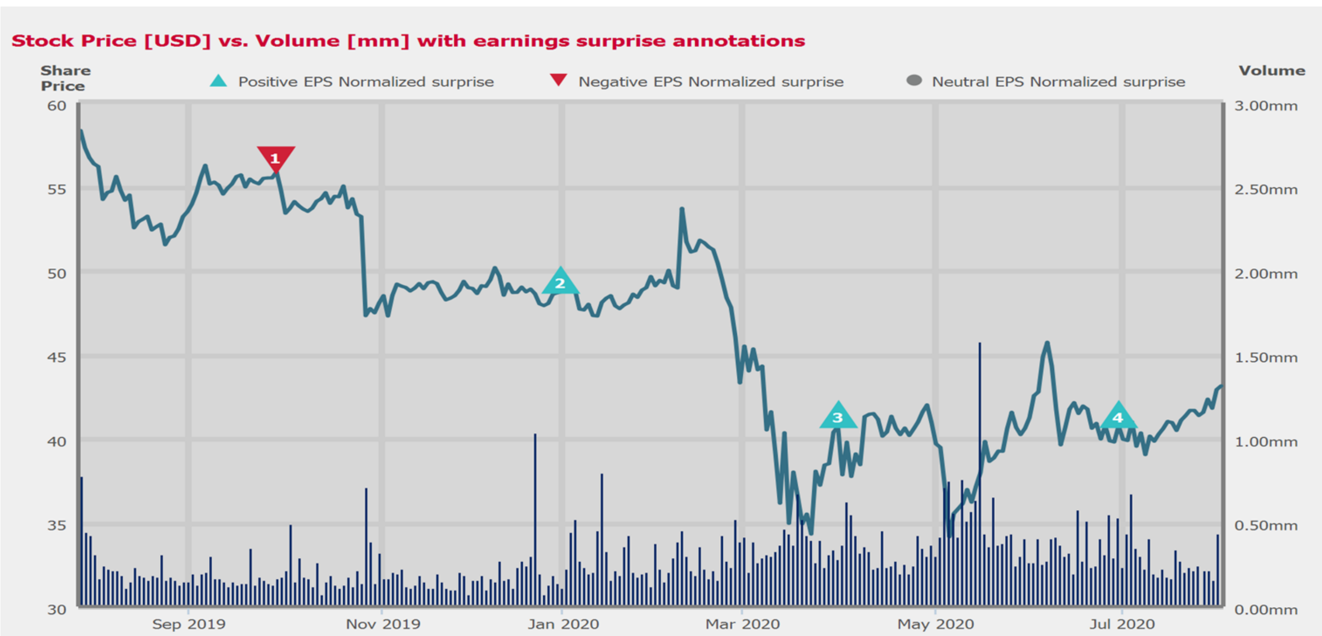
FQ2 2020 Earnings Call Transcripts

Monday, August 03, 2020 5:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2020-			-FQ3 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.34	1.86	447.06	0.90	2.85	3.42
Revenue (mm)	840.71	818.91	(2.59 %)	947.39	3622.96	3733.65

Currency: USD
Consensus as of May-06-2020 10:25 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2019	1.08	0.78	1 (27.78 %)
FQ4 2019	0.18	0.21	2 16.67 %
FQ1 2020	0.84	1.07	3 25.88 %
FQ2 2020	0.34	1.86	4 447.06 %

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Call Participants

EXECUTIVES

Christopher Wadewitz Graves
VP & Chief Investment Officer

Gabriel Tirador
President, CEO & Director

Jeff Schroeder
Chief Product Officer & VP

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

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

Corey J. Wrenn
Pecaut & Company

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good morning. My name is Michelle, and I'll 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 upon 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. Please go ahead.

Gabriel Tirador
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's second quarter conference call. I'm Gabe Tirador, President and CEO. On the phone, we have Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; Jeff Schroeder, 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. Net income in the second quarter was $228.2 million or $4.12 per share, which includes $125.2 million of after-tax gains on our investment portfolio. The rebound in the market in the second quarter helped to partially offset first quarter after-tax losses of $198.5 million on our investment portfolio.

Year-to-date, net income was $89 million or $1.61 per share, which includes $73.4 million of after-tax losses on our investment portfolio. Most of the year-to-date investment losses are mark-to-market adjustments on securities that continue to be held by the company.

Our second quarter operating earnings were $1.86 per share compared to $0.74 per share in the second quarter of 2019. The improvement in operating earnings was primarily due to a reduction in the combined ratio from 98.3% in the second quarter of 2019 to 88.2% in the second quarter of 2020.

Catastrophe losses in the quarter were $12 million compared to $9 million in the second quarter of 2019. The company recorded $12 million in unfavorable reserve development in the quarter compared to $9 million in the second quarter of 2019.

The improvement in the combined ratio in the quarter was primarily due to improved results in our private passenger auto line of business. Lower frequency in the quarter, as a result of less driving from the COVID-19 pandemic, was the primary reason for the improved results. The lower frequency in the quarter was partially offset by an increase in severity in the giveback of $100.3 million of premium to personal auto customers as a result of less driving from the COVID-19 pandemic.

Partially offsetting the improved results in our private passenger auto line of business were worse results in our commercial auto, homeowners and commercial multi-peril lines of business. Although our commercial auto line of business also saw a decline in frequency in the quarter, increases in severity, unfavorable reserve development of $7 million and the giveback of $5.5 million of premiums to commercial auto customers negatively impacted our commercial auto results in the quarter.

In our homeowners line, both frequency and severity increased in the quarter. In addition, $3 million of unfavorable reserve development negatively impacted our homeowners results this quarter. To improve our homeowners results, a 6.99% rate increase in our California homeowners line went into effect in April.

In addition, a 6.99% rate increase was recently approved by the California Department of Insurance. We expect to implement the recently approved rate increase in October. California homeowners premiums earned represent about 87% of company-wide direct homeowners premiums earned and 15% of direct company-wide premiums earned.

Our commercial multi-peril results in the quarter were negatively impacted by a large $5 million fire loss net of reinsurance. In the second quarter, we launched 2 new programs. In June, we introduced our new personal auto usage-based insurance product, MercuryGO in Texas. Early adoption rates are encouraging and above our expectations. We also introduced Phase 1 of our new commercial multi-peril product and system in California in the second quarter. The new product and system have been well received by our agents.

We recently completed our catastrophe reinsurance treaty renewal effective July 1, 2020. The total reinsurance limit purchased increased from $600 million in the prior period to $717 million for the July 2020 through June 2021 period. In addition, the new reinsurance program has wildfire coverage in all layers. Our retention remains the same at $40 million.

Total annual premiums on the new reinsurance program are approximately $50 million. For the prior reinsurance treaty, total premiums were $38 million. More details of the catastrophe reinsurance treaty renewal will be included in our second quarter 10-Q filing.

The expense ratio was 27.2% in the second quarter of 2020 compared to 24.4% in the second quarter of 2019. The higher expense ratio in the quarter was primarily due to the reduction of premiums earned of $106 million due to premium refunds and credits to eligible policyholders for reduced driving and business activities as a result of the COVID-19 pandemic. Excluding the premium refunds and credits, the expense ratio would have been 24.1%.

Premiums written declined 12.5% in the quarter, primarily due to the $106 million in premium refunds and credit. Excluding the $106 million in premium refunds and credits, premiums written declined by 1.2%. In addition, we plan on returning $22 million of July 2020 monthly premiums to eligible policyholders in August. Accordingly, we expect third quarter premiums written and earned to be reduced by approximately $22 million.

We will continue to monitor the extent and duration of the economic impact related to COVID-19 and make further adjustments as necessary. We expect our underwriting and loss adjustment expense ratios to remain elevated in the third quarter as premiums declined from givebacks without a proportionate reduction in expenses.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Greg Peters of Raymond James.

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

I first wanted to just give everyone a heads up. I had some trouble getting accessing the call this morning or this afternoon. Depending on your time zone, they were asking for a conference ID. I don't know if that's normal or not.

But let's pivot back to the results and your announcement around the $22 million of [indiscernible]. Can you talk about the mechanics around that number? And if you're having favorable frequency continue in July and maybe an extent in August to September, is it reasonable to assume that this giveback or refund is going to continue for the near term?

Gabriel Tirador
President, CEO & Director

Let me go ahead and have Jeff talk about the givebacks. Jeff?

Jeff Schroeder
Chief Product Officer & VP

Yes. We saw continued frequency, obviously declines through the month of June and into the month of July, hence, the giveback that Gabe just talked about for July, as far as that continuing into subsequent months, we're going to continuously evaluate that. And depending on how frequency moves over the next couple of months, we will potentially make adjustments to give back and extend that for those particular months. But it's a little early for us to tell at this point.

Gabriel Tirador
President, CEO & Director

I will add that we -- I will add that we did see an increase in an upward slope and frequency as compared to where -- April and May and June and July. So as Jeff mentioned, we'll just continue to monitor and -- every month, and we'll adjust based on the information that's coming in and severity is rising as well. So offsetting some of the frequency benefits, but no question that there was an upward slope in frequency in the month of June and July as compared to April and May.

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

Right. The -- I just -- continuing on with that, that concept, what -- how is the -- how has the interaction been with the California Department of Insurance? I know if I look at your second quarter combined ratio result, that's well below their mandated target. So I'm just curious how the regulatory authorities are getting involved with your process at this point?

Gabriel Tirador
President, CEO & Director

Well, I'm not sure what you mean by it's well below our mandate target. I don't think I agree with that statement.

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

I'm sorry. I thought there was a 96% combined ratio sort of threshold. Maybe I missed...

Gabriel Tirador
President, CEO & Director

No, no, No. There is no threshold of 96% that I'm aware of. They have a template that you have to file, and that template has a maximum that you can take based on the template. And I'll remind you that before COVID, we had rate pending. We had in both companies, something -- I think, on one, a 5 and the other one, a 4 or something like that pending because of severity increases. And I'll add that the template allows for quite a bit more rate increase. So prior to COVID, there was no question that we needed rate and the template allowed for quite a bit more rate than we were asking for.

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

So can you just -- just the final piece of that, how has your interaction with the California Department been as you're announcing these programs? Are they just accepting it? Or are they getting involved? Or I think you characterized it before as they were just asking you to do something and leaving it up to you?

Gabriel Tirador
President, CEO & Director

Yes, that's basically how it's been. We'd -- they basically are aligning companies to do whatever giveback that they see fit, and they're not ordering any kind of specific giveback. And there's no filing required.

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

Okay. Gabe, appreciate it.

Gabriel Tirador
President, CEO & Director

Sure. Sure. Not a problem.

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

Can we pivot to the reinsurance? So more limit, the retention is still $40 million. Is that $40 million per event? Or is it an aggregate in a quarter? Or just help us -- and maybe you can give us a look into your crystal ball and tell us what you think the fire season is going to look like in the third and fourth quarter?

Gabriel Tirador
President, CEO & Director

Well, that's always hard to predict. But Ted, do you want to talk about the reinsurance?

Theodore Robert Stalick
Senior VP & CFO

Yes. Greg, so it's $40 million per event, we did buy more limit. I would like to mention that PG&E came out of bankruptcy on July 1, and that put into place the utility industry subrogation fund, which will cover 40% of future losses caused by their equipment. So we see that as a favorable towards cat losses in the third and fourth quarter.

We've already started having some fires here. There's a big one out in Riverside County. But so far, I don't know if any structures have been burned, and it seems to be going up into the mountains. So we'll see what happens the rest of the year. Normally, the wildfires are the worst when the Santa Ana winds come in, which is generally later in the fall.

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

Great. Can you just go back and walk us through that 40%? Like how does that work? Let's say, if there's an event that costs you $100 million, is $40 million of that going to -- on a gross basis, the $100 million on a gross basis, is the 40% of that covered by subrogated to PG&E? Or walk us through how that works? Obviously, there's got to be some blame involved with them, but...

Theodore Robert Stalick
Senior VP & CFO

Well, if the loss was caused by their equipment and that it's shown to be caused by their equipment, my understanding is, yes, then this fund has been set up where the insurers can submit their claims and get the 40% reimbursement back from the fund.

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

Is that done before or after reinsurance?

Theodore Robert Stalick
Senior VP & CFO

So in that example, the $100 million, that would net down to $60 million. And then you would see it off under our treaty where our re-tender's at $40 million. You would see it off, the amount above $40 million up to the $60 million.

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

Which should be on the $20 million. Right. Perfect. How many events do you -- you have a first event, second event, how many events are covered on your -- under your treaty?

Theodore Robert Stalick
Senior VP & CFO

Our limits are -- we have 1 reinstatement. So -- and then once you exhaust the second reinstatement, you don't have any coverage. So you can have, theoretically, a dozen events that fall within a layer but haven't exhausted the layer.

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

Okay. I guess one other question just around operations. You mentioned your concentration in California, but you also highlighted some initiatives that are going on outside of California. I think you mentioned the Texas initiative, in particular. Do you expect when we get to the end of the year that your non-California premium will be higher or the same as it was last year or lower?

Gabriel Tirador
President, CEO & Director

No, we -- I'm not going to predict that. There's just too much uncertainty going on right now, Greg. I'd rather not take that. All I can tell you is that we're working on improving our segmentation outside of California. We have a new product that we launched, Mercury Advantage, in quite a few states. And the launching of that product has increased new business significantly in the states that we've launched it. We plan to continue to launch it in most -- of the rest of the country later this year and into next year as well. We've got the MercuryGo program as well, the usage-based program that's going well. But there's just too much uncertainty for us to predict where premiums are going to land.

I will say that for the most part, we -- not for the most part, we are keeping our underwriting discipline. So we're taking a long-term view in all our states, I would say that. We are keeping our underwriting discipline going forward. So I'm not going to predict, but there are a lot of things in motion that I think that, from a product standpoint, that are positive.

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

Great. The final question just would be to Chris regarding investments. Just looking at the year-over-year and 6 months, both on the quarter and the 6-month basis, the average yield is down. Can you give us some perspective on how the new money rates compare with the existing portfolio yield? And given what's going on in the interest environment, where the new level will normalize that?

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes. Well, I mean, I think you probably know much of that answer, and that is the new rates compare quite unfavorably to my average rates and where we were just 6 months ago. So cash rates are getting -- they're approaching 0. New money rates, the 10-year treasury, 55 basis points, AAA municipal bonds, about 65 basis points. So you put a bit of a spread on that, and you're looking at 1%, 1.5% out on the curve with significant duration risk. So how long are we going to be in this environment? Big election coming up. I think that's part of the answer. But I think we can expect to be at these low rates for some time to come.

And -- so yes, the comparisons are going to be challenging. We're evaluating different options. Certainly taking more risk, say, on equities is an option, but it's -- we have a very conservative investment policy, and we're actually getting up against those types of restrictions. Dividend yields are attractive compared to fixed income. But again, the risk there is -- there's certain tolerances that we don't want to have to consider breaching. So we're just going to keep pushing the best we can. And I think you kind of already understand that it's probably the most challenging environment we've ever been in.

Operator

[Operator Instructions] Our next question comes from Ron Bobman of Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I hope everyone is well. I had a question about agent compensation. My understanding is that the carriers, in sort of a uniform fashion, even in light of, sort of, of the giveback on consumer premiums, have basically not adjusted agent commissions, and I assume that isn't changing.

But I'm wondering -- and if you can confirm that, that would be great. But I was really wondering about sort of incentive compensation that some of the agents may have, whether it's sort of be, in particular, sort of profitability based. Have there been any adjustments to the sort of profit-based compensation programs to incorporate the impact of COVID and the givebacks?

Gabriel Tirador
President, CEO & Director

Well, to answer your first question on base commissions, you're correct, base commissions have not been adjusted and -- for the givebacks. As far as contingent commissions, we haven't made a determination on that yet.

Ronald David Bobman
Capital Returns Management, LLC

Got you. Okay. And is -- would you say that your peer group is sort of largely in the same spot, it's sort of to be determined? Or have some declared positions to your knowledge?

Gabriel Tirador
President, CEO & Director

I don't know about all our competitors. I don't know. I'm not sure.

Ronald David Bobman
Capital Returns Management, LLC

Okay. Okay. And then if you don't mind, I remember not too long after the fires, I remember you -- I think you sold your subrogation rights to, I guess, a third party for some of the, I guess, fire losses. And I'm wondering if there -- if you have any other remaining sort of fire losses that are sort of either subject to subrogation from the utilities or are potentially, I guess, could be sold.

Is there -- or is everything sort of baked as far as prior year's fire losses? As far as baked as meaning your losses are sort of -- that they are what they're going to be and there's not -- there's not a lot of uncertainty or variability to subrogation opportunities?

Gabriel Tirador
President, CEO & Director

Ted, you want to handle that?

Theodore Robert Stalick
Senior VP & CFO

Yes. So the -- you're right, we did sell the subrogation rights to a third party, although we kept our subrogation rights to the 2017 fires, which was the -- generally known as the Tubbs Fire. And we received an initial payment from the PG&E Trust, I think, just last week. Now that subrogation and any future subrogation came from fully reinsured losses. So all those monies will be returned to our reinsurance partners. So there's really no net reduction in losses for Mercury from that subrogation.

I will mention there was a small benefit to the company from a reduction in reinstatement premiums previously paid on those losses. And that was a little under $2 million that we did record in the second quarter numbers.

As far as subrogation, we do have wildfires from Q4 2019, the Saddleridge Fire, which was in Southern California, and the Kincade Fire, which was in Northern California, those -- both of those were under our reinsurance retention. And it hasn't been determined yet whether those events were caused by the utilities equipment, although there's some evidence that both of them were. So there is the potential for some subrogation on those 2 events. But right now, that's unclear.

Ronald David Bobman
Capital Returns Management, LLC

If there is deemed to be sort of culpability from the equipment, the earlier mention about the California reimbursement fund and the 40% that you mentioned, would these Q4 '19 fires and your losses potentially be eligible for reimbursement from that fund that you mentioned earlier?

Theodore Robert Stalick
Senior VP & CFO

I'm not exactly sure, but I believe that's correct. And I also think that the 40% kind of sets the benchmark for where those claims would be paid out of anyway. So I -- that's all I really know on that. I think our ultimate losses on those 2 claims were in the $25 million to $30 million range right now.

Ronald David Bobman
Capital Returns Management, LLC

Okay. What do you mean by the benchmark of 40%? I don't understand why you chose the word benchmark? What's that mean?

Theodore Robert Stalick
Senior VP & CFO

Well, all I mean by that is that, as these -- as all these fire claims have come in over the years, there's been different varying levels of subrogation as a percentage of incurred losses that have been paid out. And now you have this fund that's essentially saying we're going to guarantee you a 40% payout. So what I meant by benchmark is if there's prior claims that are not eligible under the fund, they'll probably look towards this 40% rate as kind of the standard of what you pay.

Operator

Our next question comes from Corey Wrenn of Pecaut & Company.

Corey J. Wrenn
Pecaut & Company

I have a couple of questions. The first one was, given the low interest rates that you're seeing low returns on invested -- on investments that you're seeing, have you rethought your dividend or your stock repurchase policy at all? It seems like the dividend yield is much higher than the dividend or the return you can get on investment?

And then my second question is that obviously, we've entered into a more technological world. You see the online sales numbers going from 18% to 28%, things like that. And then you have an upstart like a company called Lemonade, which says they can capture, I don't know, who knows what the numbers are, 100,000 data points when you log into their site and things like that. Have you ever -- have you thought about how you can use technology more in the business? And given that, how does having an agency-based model work in today's world?

Gabriel Tirador
President, CEO & Director

Let me first, I guess, answer the first question. As far as the dividend, this is something that the Board reviews on a quarterly basis and makes determination on a quarterly basis based on our prospects, our earnings, the coverage and a lot of factors. And -- so it's something that we just review every quarter. So I'm going to leave that at that. We just, as you know, announced a dividend this quarter as well, a $0.63 dividend.

As far as online, Lemonade, yes, I mean I know of them. I mean 100 data -- 100,000 data points, which I think you're referring to, is potentially the segmentation. We obviously have data warehouse, and we segment our business as well. We're continually trying to update our segmentations. I mentioned earlier that we launched our Mercury Advantage program outside of California, which significantly improves our segmentation, and we've seen very positive results with respect to Mercury Advantage.

In the state of California, which is our biggest market, you're limited to what you can use. So there's more limitations in California because of the regulatory constraints as far as what you can price on and what you can't price on, including homeowners, which is what Lemonade sells.

As far as technology goes, we continue to advance our technology. I mean I can't tell you how many bots that we're using right now. We've improved our agency-facing system. We're improving our online portal, where we're using technology to settle claims, to underwrite our risks. So we continue to try to improve our technology to streamline our operations without sacrificing our underwriting or claims accuracy, and that's the key.

I mean I don't think it's very difficult in this business to write a lot of business, and maybe Lemonade will write a lot of business. And we'll see how they end up on the profitability end of it, but writing business is not typical.

Corey J. Wrenn
Pecaut & Company

Do you think the -- do you have an advantage with the agents' upfront underwriting for you, selecting good business for you? Do you still think you have that advantage?

Gabriel Tirador
President, CEO & Director

We think that our -- I'll put it at this. We think that our agency partnerships are extremely important, extremely important.

Operator

There are no further questions at this time.

Gabriel Tirador
President, CEO & Director

Well, thank you for joining us today. Thank you very much.

Operator
Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.