S&P Capital IQ

CONTENTS

RLI Corp. NYSE:RLI

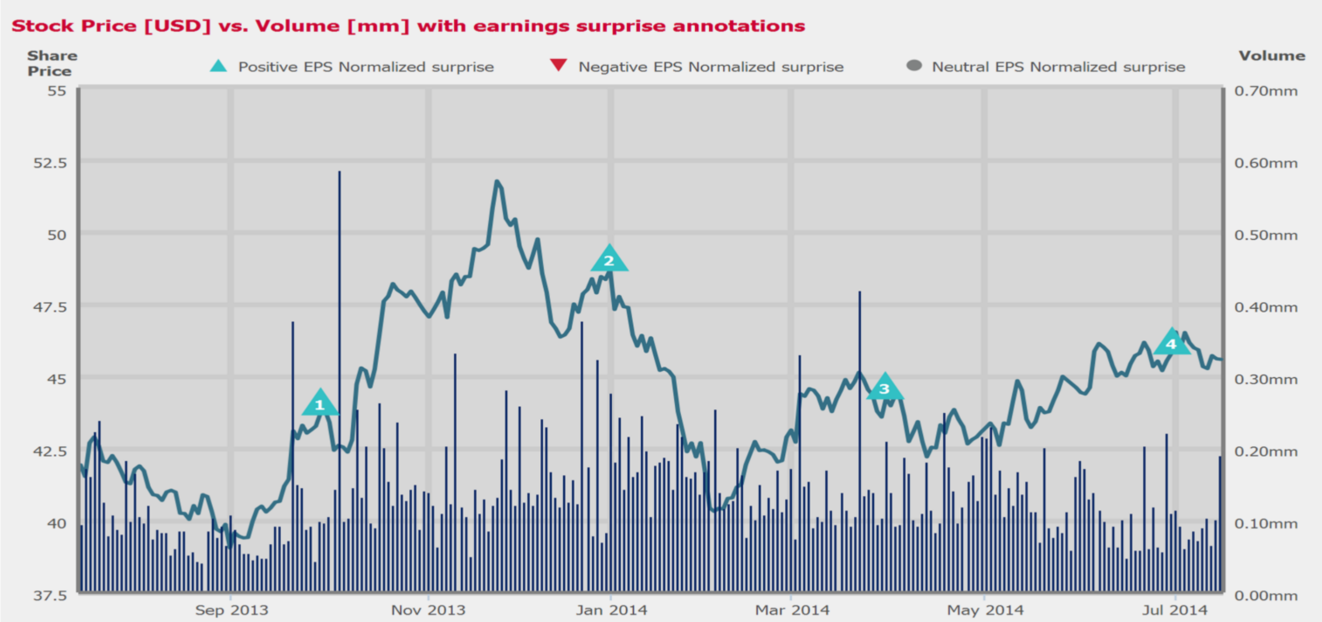
FQ3 2014 Earnings Call Transcripts

Thursday, October 16, 2014 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.60	0.68	▲13.33	0.61	2.43	2.35
Revenue (mm)	185.83	197.66	▲6.37	186.01	742.04	776.52

Currency: USD
Consensus as of Oct-16-2014 6:15 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	0.50	0.70	▲1 40.00 %
FQ4 2013	0.51	0.72	▲2 41.18 %
FQ1 2014	0.52	0.57	▲3 9.62 %
FQ2 2014	0.60	0.66	▲4 10.00 %

Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Craig William Kliethermes
President and Chief Operating Officer

Jonathan E. Michael
Chairman and Chief Executive Officer

Michael J. Stone
Director

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

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

Jeff Schmitt

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Randolph Binner
FBR Capital Markets & Co., Research Division

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. Third Quarter Earnings Teleconference. 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.

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 2014. Joining me on today's call are Jon Michael, Chairman and CEO; Mike Stone, President and Chief Operating Officer; Tom Brown, Vice President and Chief Financial Officer; and Craig Kliethermes, Executive Vice President, Operations. I'm going to turn the call over to Tom first to give some brief opening comments on the quarter's financial results, then Mike and Craig will talk about operations and market conditions. Next, we'll open the call to questions and Jon will finish up with some closing comments. Tom?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Thanks, Aaron. Good morning. We're pleased to announce another good quarter on the strength of our underwriting results and continued growth in investment income. Starting with our most important metric, we posted an 83 combined ratio in the quarter, which is consistent with our year-to-date combined ratio of 84. Underwriting profits are strong in each segment with the Casualty and Property segments both coming in at an 86 combined ratio while Surety reported an impressive 67. Consistent with prior quarters, reserve releases had a positive impact stemming from both Casualty and Surety segments.

Catastrophe results were nominal in the quarter with the American Canyon earthquake impacting operating earnings per share by less than $0.01. Again this quarter, the numbers attest to our underwriting discipline.

On the premium side, gross premium was up 3% and net premium was up 8%. Both growth rates consistent with year-to-date performance as well. Each of our segments experienced growth in the quarter, and we're particularly pleased to see 6% growth in surety premium because it represents our lowest combined ratio segment and also one with continued competitive pressures. All in all, this quarter's growth was consistent with our expectations and market conditions as well as our ongoing emphasis on underwriting profitability. Craig and Mike will elaborate more on market conditions in a moment.

Turning to investments. Growth in investment income remains a positive contributor, up 4.4% in the quarter and 6.2% year-to-date. Although we have been able to maintain average yields on a larger invested asset base in recent quarters, we are acutely aware that we're faced with a challenging current yield environment.

On a total return basis, fixed income effectively earned its coupon in the quarter, returning 0.6%. Equities, however, were down over the quarter posting a negative 1.1% return. Investee earnings contributed favorably to results in the quarter with $2.9 million of investee earnings up 14% from last year. This increase is primarily attributable to our investment in Maui Jim.

In total, the combination of underwriting and investment results drove operating earnings per share of $0.68 in the quarter, which when combined with the first 2 quarters, drove a strong 12% growth in book value year-to-date.

I will now turn over the discussion to Mike Stone. Mike?

Michael J. Stone
Director

Tom, thank you. Good morning, everybody. Another excellent underwriting results again this quarter. It's a testament to our discipline, our underwriting discipline and our product diversification.

As Tom indicated, 83 combined ratio for the quarter, 84 year-to-date. Gross written premium up 3% but net was up 8% due to better reinsurance terms that we've obtained throughout the year. In our Casualty business, gross written premium was up 3%. Our professional liability and package business continues to grow out its footprint and now is up and admitted in all 50 states, gross written premium up some 27% in the space. In our commercial umbrella business, gross written premium was up 8% but growth rate is slowing and some competition has reentered the space. We're still seeing a little bit of rate in the space as well.

Transportation was down 27% due to competitive pressures. However, we were up some 50% in the third quarter last year. Again, the industry has a short memory as only a few quarters back, much pain was being felt in the space. We'll see what happens next.

Medical professional liability, also very competitive. Gross written premium is down 27% in the quarter. In our largest product, general liability, our primary liability surplus lines business was up some 2% for the quarter, and we're still seeing, basically, flat rates in the space. Overall, casualty rates basically flat overall, was up some 1% in the quarter. Still a good story but casualty becoming less robust.

Now in our Property segment, gross written premium up 2%. In the CAT business, that's wind and quake, we're seeing burgeoning competition from standard companies, surplus lines companies, alternate capital and CAT -- we saw CAT wind rates down some 10% for the quarter and quake down some 6%. This space will continue to be challenging through year end with another benign, nearly nonexistent U.S. CAT quarter, along with increased capital allocation to the space, will continue to drive rates south. RLI has deep producer relationships, experienced innovative frontline underwriters and longtime excellent reinsurance partners. So we'll continue to perform well in this product arena.

In our RV, Recreational Vehicle business, which is reflected in this segment, experienced an increase in physical damage claims throughout the year resulting in an increase in reserves of some $2 million. We are actively raising rates and vigorously under -- reunderwriting this product.

Our Marine business continues to improve. Our gross written premium was down some 13% year-to-date and 4% for the quarter. They were essentially breakeven. We'll take the applause now. We're still pushing rates some up 5% in the quarter.

Our Surety business. As Tom indicated, a good story here. Gross written premium up 6% in the quarter, 3% year-to-date, combined ratio of 67 in the quarter and 70 year-to-date. Surety results reflect some

20% increase in gross written premium in our account driven commercial surety, and both miscellaneous and our transactional surety business and contract surety business were up as well. While our energy business was down some 10% and some 15% year-to-date. We continue to see heightened competition in this space and significant new competition in energy surety arena. Just a word to the wise, we have 30-plus years of deep underwriting expertise in the energy surety area. It's not a space for generalists or neophytes.

Overall, another excellent underwriting quarter, a testament to our RLI associates who performed yeoman work in deteriorating insurance market environment. We are well positioned with a diverse product portfolio, superior underwriting and support talent to outperform the competition.

Craig will now discuss our crop and reinsurance issues.

Craig William Kliethermes
President and Chief Operating Officer

Thank you, Mike. I didn't want to hit on the ceded reinsurance. We don't actually place any significant treaties this quarter, in the third quarter. However, I did want to comment a little bit on the net written premium growth relative to the gross written premium, and I've seen some notes and comments about what were the drivers and I want to set that record straight.

First and foremost, the risk-adjusted reinsurance prices have decreased 10% to 20% across our entire portfolio and that has been the main driver of the net premium growth. We've also had product mix changes that continues to evolve for us, with heavier weighting on growth products in the transactional space where we cede less because we need less capacity. We've also added about $7.5 million year-to-date premium from Prime Insurance, which we take all net.

Lastly, but it seems to be the lead, what I've seen and read, is that we've had some -- we have taken in a few select spots we've increased our retention, but that is not a major driver for us. We did take a small or a little bit bigger retentions in places where we've reached scale and the underwriting has warranted it. Overall, we're preparing for 2015 right now where we still see an abundance of reinsurance capacity.

On the crop front, year-over-year premium's relatively flat. During the quarter, we did increase the loss ratio a couple of points in PCI to reflect lower commodity prices overall. We expect bountiful yields to offset lower prices, but we also expect the net impact of these movements to fall right about at a farmer's typical deductible. So there will be some claims, and we felt that the loss ratio adjustment at this time is the correct cautionary move.

As you know, our partner, ProAg CUNA, announced a recent change in ownership. In late September, we were given notice of cancellation on the assumed crop program effective at year end 2015. The provisions of our contract permit us to retain a 2% quota share on the ProAg portfolio for the 2015 crop year. So expectations should be that our gross written premium will be down approximately 80% on a gross basis and 70% on a net written premium basis in 2015. We've enjoyed the partnership with ProAg. HCC has acquired a very good team. As we feel we have learned a lot about the ag space over the last several years, we will plan to continue to look for other opportunities in this space.

I'll turn it back over to Aaron now.

Aaron H. Jacoby
Vice President of Corporate Development
Thanks, Craig. Operator, we can now open the call up for questions.

Question and Answer

Operator

[Operator Instructions] Our first question today comes from Arash Soleimani with KBW Investments.

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

Just a couple of quick questions. First, given the increased competition that you're noting, that you're seeing, is it fair to say -- or are you seeing specialty risk return to the standard market again? Or has that not played out?

Michael J. Stone
Director

This is Mike Stone. Yes, we're seeing a little bit of that. I mean, there's a considerable competition in the surplus lines space and at this stage in the cycle, we start to see a little bit of the standard lines companies come in. I mean, they're in there. It's just probably a little bit of increase in the space at this time, particularly in the property area.

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

Okay, great. And can you just, in terms of the ProAg, I think you said it was at year end 2015 the relationship ends. Can you just quantify that one more time in terms of the impact here, gross written?

Craig William Kliethermes
President and Chief Operating Officer

We'd expect gross written premium and net written premium to be $8 million to $10 million next year.

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

$8 million to $10 million down?

Craig William Kliethermes
President and Chief Operating Officer

No, $8 million to $10 million gross and net to us. So that's about 80%, about 80% down on a gross basis and about 70% down on a net basis.

Operator

Our next question comes from Randy Binner with FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

I think these questions are for Mike, but the first one is just in the excess and surplus lines area. You mentioned that you were up, I think, 2% on net but rates were flat. I guess, I mean, I assume competition's pretty stiff, but where are you seeing kind of the macro economy for that segment? Meaning, we see E&S kind of getting more usually impacted by a better economy and more small business formation, hiring, et cetera. What's your feel kind of broadly in that segment, how that's driving premium in addition to the impact of competition from other insurers?

Michael J. Stone
Director

Well, I think we said that it's basically flat, and our net base is up a little bit for the E&S space. Yes, certainly as the economy improves and we see more economic activity and we are seeing that, in the construction space, where we have quite a bit of our business through general liability and commercial umbrella. We see some improvement there. No question about that. The problems that we see are the standard lines companies packaging up business and increased competition from other surplus lines players. So net-net, we're still holding our own. It's still a pretty good marketplace, but it feels a little worse than it did 1 quarter ago and a little worse than 2 quarters ago. So trend is not in the right direction but it's still -- like I said, it's still pretty good. We've got rate for the last couple of years. So if it stays flat for a while, that would be a good thing.

Randolph Binner
FBR Capital Markets & Co., Research Division

Great. And on the energy piece of it in particular, so energy prices are dropping, the price of oil, I guess, most notably. I mean, do you see an immediate impact in that when you're talking about -- and I'm sorry, this is over to energy surety -- but is that something that comes through immediately? Does that affect kind of the demand for surety on new projects? Or is that more of a lagging impact?

Michael J. Stone
Director

Well, yes, this is -- it is in the surety arena. We're not in the energy property or energy liability business directly. So in the surety segment, yes, it has an impact. It certainly has an impact on -- one of the underwriting aspects of this is the assets that were -- so it's the oil in the ground. As that gets less valuable, we have less effective collateral. And you'll see less drilling activity, which drives this business as well. So yes, it has an impact, and our premiums are down there. That's one of the reasons but a bigger reason is we see more competition in that space.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay, and just one other just detail question on the recreational vehicle property damage claims. Is that an issue of kind of normal loss trend or typical loss trend versus too soft a price? Or was there particular events that caused that?

Craig William Kliethermes
President and Chief Operating Officer

Well, we would say both. Certainly, we believe in retrospect the pricing was inadequate, and we've actually already filed and obtained rate increases in almost all 50 states. So we actually started that process about 3 or 4 months ago to get those, but as you know, as admitted business, it takes a little while. You have to go through the regulatory process. But we have approval in most states, and it has been in more of an increased frequency. We've had a few severe losses, one-off type things, not necessarily weather-related but arson-related that were unusual. And we've kind of pointed out a certain distribution channel that's been a problem for us. So we're trying to address that by shutting off that volume.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay, and would the increased frequency just be attributed to like a better economy and more baby boomers out on the road with their RVs? Is it just kind of more use and targets out there? Or what do you think drove the frequency?

Craig William Kliethermes
President and Chief Operating Officer

Yes, I mean, also in summer months, during the summer months, you always get an increase in frequency but yes, we would attribute it to that.

Michael J. Stone

Director

And also, Randy, this is a -- it's a fairly small book in our overall property segment. I just wanted to -- we just wanted to point out the fact that, that was one of the reasons that maybe our combined ratio was a little bit higher than you would expect given what's happened in the catastrophe arena this year.

Randolph Binner
FBR Capital Markets & Co., Research Division

No -- yes, understood, I just -- it was -- it wasn't an area that I've -- maybe I've been missing the -- any RV stuff, I just hadn't seen it and -- but even, I mean, obviously, RVs drive more in the summer, but even on a seasonally adjusted basis, your frequency was higher, just to be clear on that, right?

Michael J. Stone
Director

Yes.

Craig William Kliethermes
President and Chief Operating Officer

Yes.

Operator

Our next question comes from Ken Billingsley with Compass Point.

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

I wanted to ask 2 questions. One really is a confirmation. When you talked about the ceded reinsurance business, I believe you gave a number that pricing within reinsurance costs had declined 10% to 20%, was that correct?

Craig William Kliethermes
President and Chief Operating Officer

This is Craig. Yes, that's correct.

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

And when -- now when I look at the retention ratio in general, it did still, it's still -- it's the highest it's been in the last 2, 3 years, but you said that you didn't have any new renewal -- treaties renew this quarter. So could you just maybe just walk through why you're benefiting? It seems a bigger benefit now than you have maybe in the prior quarters.

Craig William Kliethermes
President and Chief Operating Officer

So if you think about that, so if you remain -- if your retentions remain stable on the -- and the amount of premium you see drops by 10% to 20%. That's going to lead to, obviously, a higher ratio, retention ratio. And then as I had mentioned, products like, Mike mentioned our professional liability business, which is more transactional, we just don't need the capacity. We're only putting out $1 million, $2 million limits. So we don't buy as much reinsurance there. Those products are actually growing, okay? Some of our other products where we utilize reinsurance a little more heavily, our D&O business, our umbrella business, they're more flat for the year. So you're getting a mix, kind of an underlying mix issue that's being driven by our products that use reinsurance less extensively.

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

And so this 10% to 20% decline though, that was still in place for the last 2 quarters then as well? It just didn't have as big an impact? And is...

Craig William Kliethermes
President and Chief Operating Officer

Yes, well, some of our treaties were placed during the second quarter. So they wouldn't really -- you wouldn't have started to see that come through till the end of the second quarter or maybe third quarter.

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

Okay. It was a second quarter event, okay. The other question I have, just last one was on pricing. How are -- your premium on a net basis, obviously, is growing, how is that growing in relation to rate versus expanded customers? And then from a customer base, is it new or existing customers that are, I mean, increasing exposure?

Craig William Kliethermes
President and Chief Operating Officer

Ken, this is Craig again. Let's see. The -- on the pricing part, on the net basis, overall, the pricing is slightly up, as Mike said, say, 0% to plus 3% on average across our portfolio. So it's less than it used to be. So we are seeing some increase there. As far as new customer or expanding outside share of wallet kind of concept with selling more to this existing product base, that's happening as well, obviously, because a lot of our growth is coming in the professional liability segment where we're trying to offer a property and casualty package at the same time we offer professional package. So we're seeing an increased take-up rate on existing customers and of course, there are some new customers in there, too, but it's probably half and half, I would say, across our portfolio.

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

And I have one more question, if you don't mind. I just want to talk about -- I believe Mike had mentioned a benign CAT season so far, which maybe it just reflects on you but we've already seen 2 companies today, or yesterday, report surprising higher major and nonmajor CAT losses. Can you talk about maybe why what you're seeing, maybe it's a little different than maybe what's being experienced at, say, Allstate or Platinum?

Michael J. Stone
Director

It's Mike Stone again, Ken. I didn't listen to their calls, I didn't read their results so I don't know what drove that, but certainly, we had next to nothing when it comes to the -- call it the American Canyon earthquake, that thing in Napa, and while we have a business in Hawaii, there was a very little loss from that hurricane. And we haven't seen any other events in this quarter. It's been, from our perspective, nearly nonexistent.

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

Okay. And the current hurricane that's headed towards Hawaii, any cause for concern on your book?

Michael J. Stone
Director

I mean, it's a hurricane that's headed to Hawaii. So we'll pay attention to it. We'll pay attention to it. I mean, our book in Hawaii is not that large, but we'll pay attention. We're prepared, we've got -- our retention is such, we'll be fine. It's just -- Hawaii really hasn't been hit very hard for some 30 years, I think. So it's a little bitty speck out in a very big ocean, by the way.

Kenneth G. Billingsley

Compass Point Research & Trading, LLC, Research Division

Sure, and so -- but you have reinsurance coverage that would limit if they were to be impacted fully?

Michael J. Stone
Director

Yes, we have reinsurance coverage, and we've got coverage that would be part of that. So we -- I mean, if it's a large hurricane, we'll have a loss but it's well within our expectations, not a great big deal.

Operator

Our next question comes from Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple just kind of clarifications, really. In the Surety segment, if I'm understanding your comments, I mean, essentially, you described almost all of the lines being positive except for energy, which was negative. Is that a fair characterization?

Michael J. Stone
Director

Yes, from a premium standpoint, yes.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. How is that different from last quarter where the tone of your comments seemed to be, I'll say, more generally negative across the entire book? I mean, how was this quarter different?

Michael J. Stone
Director

Well, I think the last quarter -- yes, last quarter -- for this quarter, we had a really good premium quarter for commercial umbrella where our account-driven, license and permit business, and that can be a little variable. It's not that big. So if we hit on a few accounts or we get a few accounts that are actually using the capacity that we provide, our premium will jump up a bit. Certainly, the contract's been fairly flat and our miscellaneous business is fairly -- it's just basically an annuity, it just kind of up a little bit each quarter as we grow out that business. So the one that's been under pressure has been the energy surety business over the last -- for the last 9 months, for the last -- for all of this year, and it continues to be under a bit of pressure.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And there's not really a material, a major rate impact to the growth in the period? It's really just straight business.

Michael J. Stone
Director

Yes. Typically, Surety business, the rate's fairly steady, where you see the change is on terms and conditions around collateral, indemnities and that kind of stuff.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Same question on the crop business. That's all recorded as premium within the property segment. Is that correct?

Michael J. Stone

Director

That's correct.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And then within the investment portfolio, the -- any particular changes in where new money investment is heading there, or continue to...

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Mark, it's Tom Brown. It's -- reinvestment is primarily going into fixed income during the quarter and the allocation between fixed income and equities remains pretty consistent with the historic ratios of 80-20, 20% equities.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Any change in the mix heading towards municipals?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Municipals are down slightly from year end in the mix, and we did, and I think, move a little bit into higher yield bank-type loans, small portfolio about $40-plus million, still within the fixed income complement.

Operator

Our next question comes from Jeff Schmitt with William Blair.

Jeff Schmitt

Just on the investment yield, just a quick question on could you speak a little bit about the duration of the fixed-income portfolio and sort of how it's trended and where you see that going?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Sure, happy to, Jeff. It's Tom Brown. The duration is still well within our historic ranges. It's probably ticked down a couple of percentage points from about 4.8 to 4.65 in the quarter and it's really just -- we're really finding ourselves a little more neutral on the yield curve.

Jeff Schmitt

Okay. And do you see that sort of maintaining that going forward? Is there thoughts of changing that?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

No, again, I think going back historically, we've stayed pretty consistent somewhere 4 to 6 or 5, in that historic range and I don't see it moving much.

Operator

If there are no further questions, I will now turn the conference back to Mr. Jonathan Michael.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you, all, for attending another excellent quarter, low 80s combined ratio. We'll take that anytime. Our net premiums were up 8%. Good cash flow and 12% increase in book value per share so far this year.

It's a tribute to our underwriters and all of our employees for delivering another great quarter like we're seeing here. Thank you, 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 7600500. This concludes our conference for today. Thank you, all, for participating and have a nice day. All parties may now disconnect.