S&P Capital IQ

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Mercury General Corporation NYSE:MCY

FQ2 2017 Earnings Call Transcripts

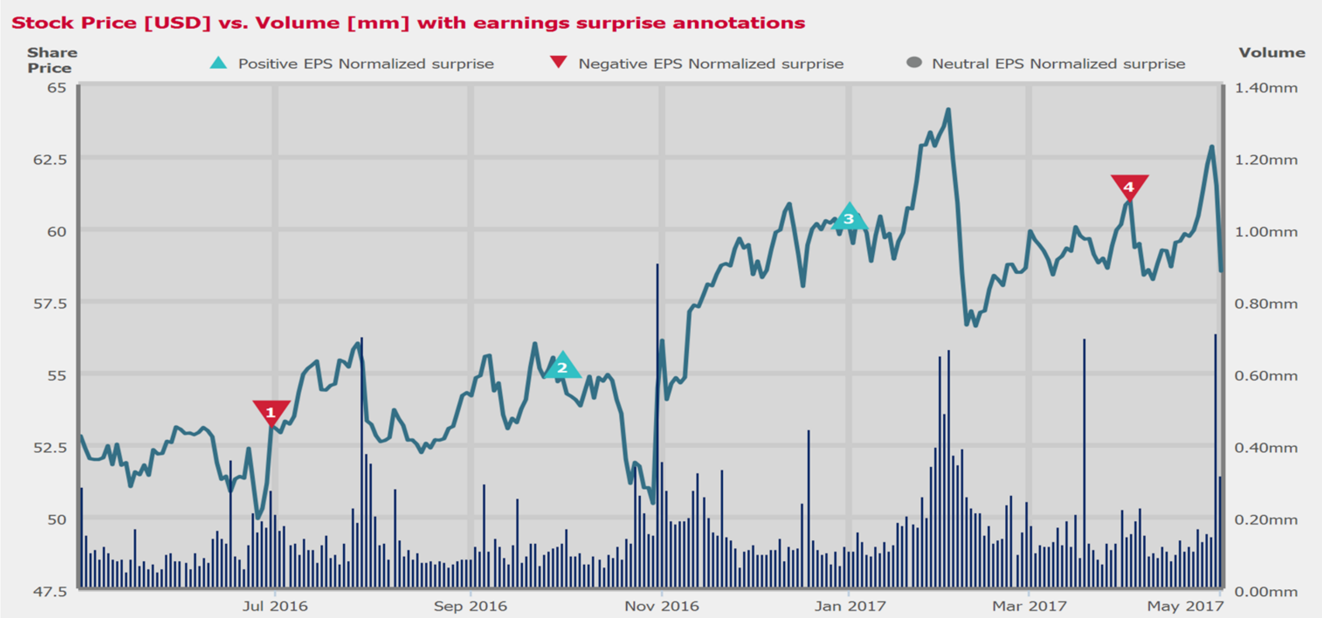
Monday, July 31, 2017 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2017-			-FQ3 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.50	0.68	▲36.00	0.65	1.88	2.50
Revenue (mm)	815.85	797.65	▼(2.23 %)	846.78	3273.98	3406.52

Currency: USD

Consensus as of Jul-11-2017 5:07 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2016	0.59	0.35	▼1 (40.68 %)
FQ3 2016	0.54	0.67	▲2 24.07 %
FQ4 2016	0.51	0.58	▲3 13.73 %
FQ1 2017	0.54	0.20	▼4 (63.64 %)

Call Participants

EXECUTIVES

Gabriel Tirador
Chief Executive Officer, President and Director

George Joseph
Founder and Chairman

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

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

Presentation

Operator

Good afternoon. My name is Krysta, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General's second quarter conference call. [Operator Instructions] This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial 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 second quarter conference call. I'm Gabe Tirador, President and CEO. In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President, 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.

I am pleased to report, our second quarter operating earnings of $0.68 per share improved significantly as compared to our second quarter 2016 operating earnings of $0.35 per share. The improvement in operating earnings was primarily due to an improvement in the combined ratio from 101.7% in the second quarter of 2016 to 97.8% in the second quarter of 2017.

Our results in the quarter were negatively impacted by $10 million of catastrophe losses, primarily caused by severe Midwestern weather, including tornadoes in Oklahoma. In addition, we recorded $10 million of unfavorable reserve development, which came primarily from our commercial lines of business. This compares to second quarter of 2016, which had $11 million of catastrophe losses and $22 million of unfavorable reserve development.

Excluding the impact of catastrophe losses and the unfavorable reserve development, the combined ratio was 95.3% in the quarter. The improvement in the combined ratio was primarily due to an improvement in our personal and commercial auto combined ratio.

Our second quarter auto combined ratio was 97.2% compared to 104.6% in the second quarter of 2016. Partially offsetting the improvement in our auto combined ratio was a deterioration in our homeowners and California commercial property combined ratio. Our homeowners combined ratio was 98.9% in the second quarter of 2017 compared to 91.4% in the second quarter of 2016.

In our California commercial property line of business, several large losses negatively impacted the results in that line. We posted a combined ratio of 129.9% in the quarter compared to 84.9% in the second quarter of 2016. Historically, our California commercial property line has produced favorable underwriting results. The expense ratio was 24% in the second quarter compared to 25.4% in the second quarter of 2016. The lower expense ratio was primarily due to a decrease in acquisition costs, a lower advertising spend and cost efficiency savings.

To help offset increasing loss trends, we have been increasing rates in most states. In California, we implemented a 6.9% personal auto rate increase in California Automobile Insurance Company effective in May, and a 6.9% rate increase in our homeowners line is going into effect in August. In addition, a 5% rate increase is pending approval with the Department of Insurance for Mercury Insurance Company. Personal auto premiums in Mercury Insurance Company represents about half of our company-wide premiums earned and California Automobile Insurance Company represents about 14% of our company-wide premiums earned. California homeowners premiums represent about 11% of our company-wide premiums earned.

Premiums written grew 2% in the quarter, primarily due to higher average premiums per policy. Company-wide, private passenger auto new business applications submitted to the company decreased approximately 9% in the quarter as we continue to focus on improving profitability in our private passenger auto line.

The 9% decline in new business application is an improvement over the 16% decline we experienced in the first quarter of 2017. Company-wide, homeowners applications were relatively flat in the quarter. 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 with Raymond James.

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

A couple of questions for you. First of all, just if I step back and look at big picture with the net premium written only up about 2%, both in the second quarter, pretty much approximately on a year-to-date basis, I'm curious why the top line seems to be stalling when you're getting these rate increases approved and implemented?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, it's primarily a result of lower application. It has an impact on our new business applications and it also has an impact on retention as well. I will say that most of that is coming from outside of California. I think, in the quarter, our California new business applications for private passenger auto were relatively flat but they were down quite a bit, over 30%, I believe, outside of California. So when you combine it, the apps were down about 9% or so, but it's really just a function of less new business applications and renewal applications being written in total.

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

Okay. And is there a period in time later this year where we'll anniversary the difficult trends in new business apps or is that something that is likely to occur in 2018?

Gabriel Tirador
Chief Executive Officer, President and Director

I think that the new business apps are going to continue to have an impact on the renewal business, for instance, in the next few quarters. So I think, we mentioned at the end of last year that we were expecting relatively minor growth in 2017. As far as 2018, we don't have any guidance for you on that yet.

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

Okay. So switching gears to the margin improvement, the combined ratio. When I look at the second quarter results, it appears that part of the reason for the improvement was both a lower policy acquisition cost and other operating expense ratio. And I'm curious what the drivers were behind the improvement in those 2 components in the second quarter?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Greg, it's Teddy here. So the expense ratio was less favorable impact that Gabe mentioned earlier. Q1 and Q3 are typically our higher advertising spend, and Q2 and Q4 are lower quarters for advertising spend. So that lower advertising spend in Q2 definitely helped the expense ratio. And then, we had slightly lower acquisition costs and some operating efficiencies that are also reflected in the 24%. We do expect that third quarter expense ratio will take back up to be closer to the 25% range that it's been earlier.

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

I see. And was -- has the advertising budget for the full year '17, is that down compared with the full year '16 or is it flat?

Gabriel Tirador
Chief Executive Officer, President and Director

It's down maybe a few million dollars year-over-year.

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

Okay. Another question for you is just regarding reserve development. If I look at the results for the first half of the year last year in 2016, it seemed like the -- at least what you're reporting was most of the adverse reserve development related to auto liability. And the first half of this year, it seems to have migrated over to the property book. Should we take some solace from the result this year to infer that the auto liability reserve position has stabilized? Or am I reading too much into it?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Well, the auto reserve liability has stabilized. There's minimal development. And if you remember, the numbers last year were quite large, I think, $80 million or something like that for the whole year. There's quite of a bit of that, that happened in the first half of the year. This year, it's pretty much isolated to some very large losses in our commercial property lines.

Gabriel Tirador
Chief Executive Officer, President and Director

The development factors are much more stable when we take a look at historical factors. Last year, they have jumped up quite a bit. But now over the last several quarter, we've seen those development factors in our triangles to be much more stable.

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

Okay. And one last question, then, I'll requeue. You said the underlying combined ratio ex reserves and caps was 95.3%. Is -- I think that -- is that your target or is your target for underlying lower than that?

Gabriel Tirador
Chief Executive Officer, President and Director

Our target historically has been a 95% combined ratio.

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

Is that including caps and development or excluding?

Gabriel Tirador
Chief Executive Officer, President and Director

That's everything.

Operator

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

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

I was wondering if we could -- if you could talk about expenses a little bit more and maybe what you're doing with commissions. And then, if it's possible, if you could just quantify a little bit how much of the lower expense rate is due specifically to ad expensing or commissions, et cetera?

Theodore R. Stalick

Chief Financial Officer and Senior Vice President

Well, the commissions are adjusted periodically, and Alison, we've had a gradual downward trend in our average commission rates probably for the last several years. And so that continues to get reflected in the results. The second part of your question was around the ad spend? Could you clarify the second part of your question?

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

Yes, I didn't know if you could quantify, maybe just give us a little bit more mathematically the effect? I know you talked about the seasonality, but I don't know if there was a way you could quantify how much, what the effect is by quarter of these items on the expense ratio? You may not have -- I get it but.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes, let me see it.

Gabriel Tirador
Chief Executive Officer, President and Director

While he's looking for that information, Alison, I will note that our commissions have been coming down over the last several years. But in California, our average commission rate, ballpark, is around 16%, which is still above probably several points above industry average. Outside of California, I would say it's closer to 13%, which is still a very competitive commission rate. So although the commission rate has been helping us, it's been trending downward. And California has been trending downward as a result of the fact that the profitability hasn't been there as well. So our base rate commission has been trending downward. It's still several points, as I mentioned earlier, above the competition. And again, outside of California, we're at about 13%, and that's pretty close to where the competition is at.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

And on the ad expense, the second quarter is more than a full point lower than the first quarter was on the expense ratio.

Operator

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

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

There seems to be a lot of emerging technology around smartphones and apps that have the potential to help reduce and/or affect distracted driving. And I'm just curious if you have a perspective on some of these products, if you've looked at them, and if you're beginning to think about them as it relates to your book of business?

Gabriel Tirador
Chief Executive Officer, President and Director

It is something that we have looked at and, in fact, have tested. I've actually tested myself, I put the app on my phone and they say I'm not as good as a driver as I think I am. But anyway, Robert, do you want to mention some of the stuff we're doing there?

Robert Houlihan
Chief Product Officer and Vice President

Yes, we've certainly been monitoring the space. We're looking at doing a test in commercial auto using a smartphone app for used space insurance. On personal line side, it's an intriguing development, it helps lower the cost of UBI program relative to the older approach using a dongle and the on-board diagnostic port. We still have some concerns in the independent agent channel, how this can be sold without just sort of cannibalizing business we would have otherwise sold at a higher rate. And that's like we're intrigued by the technology and we're doing some testing in commercial auto. But on personal lines, we're just continuing to monitor at this point.

Gabriel Tirador
Chief Executive Officer, President and Director

And I will say, Greg, in our biggest market in California, you're not allowed to use these devices for how you drive. The only way you can use these devices is for your annual miles, then you drive, and there are another means to get the annual mileage. So in California, which is our biggest market...

Robert Houlihan
Chief Product Officer and Vice President

We do have a program to verify mileage in California.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, we have a verified mileage program in California. So this would be really, right now, I think, something that we would do outside of California.

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

Great. Excellent color. I guess, one final question, I realize Mr. Joseph has probably got at least another 20 years left in the tank, and frankly, I'm jealous, but one of the most frequently asked questions I get from other smaller shareholders is about the estate plans for Mr. Joseph's stock. So just with the sincerest respect for Mr. Joseph and everyone, I was wondering if there's some sort of relevant update or answer you could provide me would be helpful.

George Joseph
Founder and Chairman

Yes. Well, I own about 17% of the stock and my ex-wife owns -- oh, I'm sorry. I own 35% and she owns 17%. So we have an agreement with her, which probably won't be applied until it's to her estate. Mercury and/or me have the option to buy that stock. She has to present it to us first. My wife is quite a bit younger than I am and we don't need to sell stock for estate purposes. We have provided other liquid investments to take care of whatever estate tax would be assessed upon my wife's or my ex-wife. Now either my death or my wife's death, whichever occurs later, because upon my death, there would really be no estate tax to pay, and my wife is about 30 years younger than I am. So we have -- we're aware of the problem and the concern. We have done what I think is necessary to address it.

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

Thank you for that color, Mr. Joseph. So does your 30-plus-percent stock then just transfer to your wife in 20 years from now when you meet our maker?

George Joseph
Founder and Chairman

It's in a trust, and she is the beneficiary of the trust. And there's provisions in the trust that restricts her right to sell the stock because the intent is that the stock stays, even after her death, stays in the family.

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

Excellent. And I have no other questions on that subject. I really appreciate your answer. Congratulations on the quarter, everyone.

Gabriel Tirador
Chief Executive Officer, President and Director

Thank you, Greg.

Operator

Your next question comes from the line of Wesley Guylay with Wesley Guylay Capital.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

I would like to ask, Gabe and Mr. Joseph, if in view of these higher rates that are coming in and the more stable development in the prior results as well as the lower expense ratio, does the company expect to go back and meet its goal of a 95% combined ratio looking ahead at the near future?

Gabriel Tirador
Chief Executive Officer, President and Director

Wesley, we don't forecast or we don't give any guidance, but that is definitely our goal. Our goal is to hit a 95% combined ratio, although we don't provide guidance as to when we're going to think -- when we think we're going to hit that, but that is our goal.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

Yes, I don't mean putting a date on this thing, but I -- wondering if the top is comfortable enough for that goal looking at the sharply improved results of this quarter.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, that's -- we -- a lot of it depends on loss trends and what happens with loss trends, and we're trying to stay above -- on track with the loss trends, Wes. But -- which is why we keep making lines for trend, right, to keep it with trend. And if we're successful there and we keep -- there's a lot of things going on in the company right now, I will say this, Wes, to try and improve every aspect of the business, whether it's on the expense side or on the indemnity side, on the claims, underwriting, market segmentation, agent relationships. Every facet of the business right now is focused on trying to improve the profitability of this company.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

So you're -- it's pretty clear that you are focused on trying to get this profitability up to where it should be, which, in my mind, would reflect the company's long-term combined ratio goals?

Gabriel Tirador
Chief Executive Officer, President and Director

That is correct. That's our objective. That's our objective.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

So I'm wondering if Mr. Joseph is comfortable with that as well.

George Joseph
Founder and Chairman

I'm always comfortable with the 95%, provided there's some growth, Wes.

Wesley Richard Guylay
Wesley Guylay Capital Management, L.P

Yes. I agree. Okay. But it looks like there's a deceleration of this cutback in new business applications, and that should help in the future as well.

Gabriel Tirador
Chief Executive Officer, President and Director

Yes.

Operator

[Operator Instructions] And we have no further questions at this time, sir.

Gabriel Tirador
Chief Executive Officer, President and Director

Okay. Thank you for joining us this quarter. We look forward to talking again next quarter. Thank you very much, everyone.

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