S&P Global
Market Intelligence

RLI Corp. NYSE:RLI

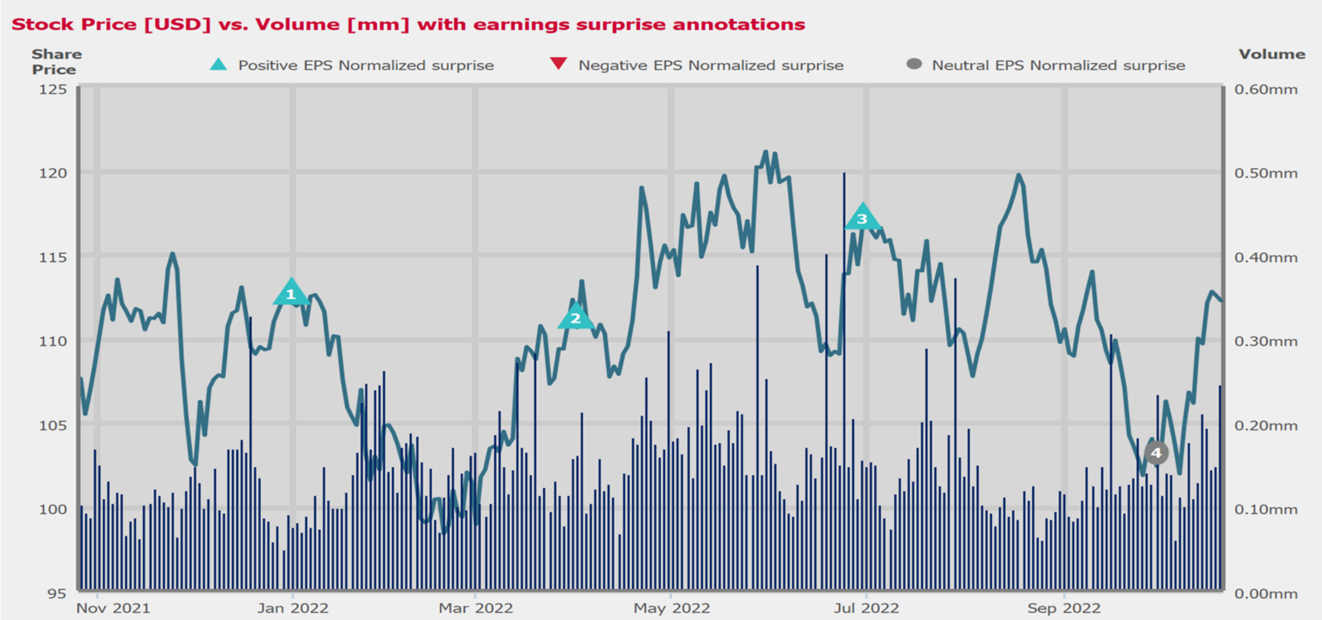
FQ3 2022 Earnings Call Transcripts

Thursday, October 20, 2022 3:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.50	0.50	0.00	1.13	4.52	NA
Revenue (mm)	408.33	859.49	110.49	322.27	1203.09	NA

Currency: USD
Consensus as of Oct-20-2022 3:36 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	0.91	1.26	38.46 %
FQ1 2022	0.98	1.43	45.92 %
FQ2 2022	1.06	1.49	39.25 %
FQ3 2022	0.50	0.50	0.00 %

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Call Participants

EXECUTIVES

Aaron Paul Diefenthaler
Chief Investment Officer & Treasurer

Craig William Kliethermes
President, CEO & Director

Jennifer Leigh Klobnak
Chief Operating Officer

Todd Wayne Bryant
Chief Financial Officer

ANALYSTS

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

Mark Alan Dwelle
RBC Capital Markets, Research Division

Matthew John Carletti
JMP Securities LLC, Research Division

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good morning, and welcome to the RLI Corp. Third Quarter Earnings Teleconference. After management's prepared remarks, we will open the conference up for questions and answers.

Before we get started, let me remind everyone that for 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 factors and uncertainties, which could cause actual results to differ materially. Please refer to the risk factors described in the company's various SEC filings and in the annual report on Form 10-K, our supplemental Forms 10-Q, all of 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.

During the call, our line management may refer 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 gains or losses and after-tax unrealized gains or losses on equity securities. Additionally, operating earnings and operating EPS excludes equity and earnings of Maui Jim and related taxes due to the sale of RLI's investments.

RLI's management believes these measures are 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 a reconciliation between operating earnings and net earnings. The Form 8-K and press release are available on the company's website at www.rlicorp.com.

I will now turn the conference over to RLI's Chief Investment Officer and Treasurer, Mr. Aaron Diefenthaler. Please go ahead.

Aaron Paul Diefenthaler
Chief Investment Officer & Treasurer

Thank you, Victoria. Good morning, everyone. Welcome to RLI's Third Quarter Earnings Call for 2022. Joining us today are Craig Kliethermes, President and CEO; Jenn Klobnak, Chief Operating Officer; and Todd Bryant, Chief Financial Officer. Per our usual process, Todd will and walk through financial results for the quarter. Craig and Jen will offer commentary on our product portfolio and current market conditions. We will then take your questions and Craig will close with some final thoughts. Todd?

Todd Wayne Bryant
Chief Financial Officer

Thanks, Aaron. Good morning, everyone. Yesterday, we reported third quarter operating earnings of $0.50 per share, which were negatively impacted by losses from Hurricane Unit. Apart from Ian, underwriting results on the current year remains strong and benefits from prior year's reserve releases were accretive to earnings. All in, we experienced 13% top line growth and posted a combined ratio of 97% for the quarter. Combined with a very strong first half of the year, our year-to-date combined ratio was 85.3%.

Investment income advanced 19% in the quarter as reinvestment rates continue to move higher and operating cash flow remains strong and supportive of incremental investments in the portfolio. I'll talk more about Maui Jim in a minute, but net realized gains of $573 million for the quarter reflect the sale of its minority investment. From a net unrealized loss perspective, equity securities declined $26 million during the quarter as market volatility continue.

Craig and Jim will give some color on the market landscape in a minute, but at a high level, all 3 segments experienced growth as we continue to benefit from favorable conditions in most areas of our business. From an underwriting income perspective, the quarter's combined ratio was 97% compared to 94.6% a year ago. Both periods were impacted by elevated hurricane losses.

Hurricane Ian losses in the quarter are within our preannounced range and a total of $40 million net of reinsurance. $33 million of that is from our Property segment and $7 million impacted casualty for a number of our packaged policies are reported. Net of bonus-related impacts, the event totaled $34.8 million or $0.60 per share net of tax and added 12 points to the quarter's combined ratio. From a loss perspective, all 3 segments experienced favorable prior year's reserve development.

Casualty experienced $28 million in favorable development with notable contributions from general liability, commercial access, executive products, small commercial and miscellaneous professional liability. Property posted $3 million favorable emergence with the largest benefit from our Marine business.

In surety, commercial and miscellaneous were responsible for the bulk of that segment's $2 million in positive development during the quarter. Moving to expenses. Compared to last year, our quarterly expense ratio increased 2.5 points to 40.4%. This result was impacted by increased bonus and incentive related accruals. On a year-to-date basis, our expense ratio was 39.2%.

Turning to investments. Total return performance was -3.4% during the quarter and minus 13.5% on a year-to-date basis. Balanced portfolios continue to be challenged by the current environment as both stocks and bonds trade lower in price. As we discussed in our second quarter call, the majority of these declines remain unrealized without the need to sell significant portions of the portfolio.

Strong operating cash flow and increase in fixed income yields have offered a welcomed opportunity to purchase high-quality assets that understand investment income. Today, new money yields are achievable in the 4.5% range without having the need to reach down to the credit spectrum or for longer maturities.

Moving to other investments. We recorded an $18 million loss in the quarter from our equity and earnings of Maui Jim. This result was driven largely by transaction-related expenses incurred by Maui Jim from the company's sale. As previously announced, we received $686.6 million in exchange for our shares in Maui Jim.

Final proceeds remain subject to customary post-closing working capital and other adjustments, which could modestly increase this amount. Prior to sale, our carrying value of Maui Jim was $108.4 million, inclusive of the quarter's loss. Our net earnings with realized gain loss in the quarter, taxes and other sales-related amounts reflect $437.7 million or $9.56 per share from the sale of this minority investment.

Lastly, book value per share was $30.7 to end the quarter, up 16% from year-end, inclusive of dividends and was heavily influenced by the realized gain on Maui Jim. Obviously, this transaction generated a significant amount of capital. As always, our first preference is to deploy capital in support of our business, which we have been doing. We regularly evaluate our capital position relative to the opportunities we see as we look forward. This is the time of year we have historically evaluated any excess capital position, and we expect to follow the same approach in the fourth quarter of this year.

All in all, a very good quarter and strong first 9 months of the year. And with that, I'll turn the call over to Craig.

Craig William Kliethermes
President, CEO & Director

Thank you, Todd and Aaron, and good morning, everyone. A good quarter, all things considered. First and foremost, our hearts are with their policyholders and their families who have been affected by Hurricane Ian. Our talented claim team is on the ground and helping them as I speak. We never lose sight of our purpose or our promise to pay for covered fortuitous losses in exchange for a fair premium.

This is our time to fulfill our obligations and help insurers recover and restore their businesses as quickly as possible. This is what we are focused on delivering. Stepping up and paying for what we owe helps customers regain their livelihood and eliminate the needless involvement of public adjusters, litigation costs and reputational damage frequently cast upon our industry after such an event.

We are doing our part to help our customers and hope the rest of the industry is focused on the same. Despite this very large event, we were able to report an underwriting profit in the quarter. This is a testament to our diverse product portfolio at both the business unit level and overall. For the product experienced profitability challenges, we can typically count on several other uncorrelated products that are performing well to counterbalance the underperforming ones.

This quarter, our E&S casualty, executive products and surety were some of our largest contributors in helping us maintain underwriting profitability. At the same time, we were able to grow across all segments, which resulted in a total growth of 13% for the quarter and 17% year-to-date. All segments remain profitable year-to-date. We continue to see opportunities to grow what we know profitably. Industry losses from Ian may lead to an even harder catastrophe-exposed property market with tight capacity going forward. This may spill over into some casualty lines. Our strong balance sheet, high-performing businesses and broad portfolio of specialty products positions us well to take advantage of any disruption that may occur.

I'll now turn it over to Jenn for color by segment.

Jennifer Leigh Klobnak
Chief Operating Officer

Thanks, Craig. I'll start with the Property segment. Premiums grew 40% in the Property segment, including 8% positive rate change this quarter. The segment is led by E&S property, which is also the largest contributor to our catastrophe portfolio in terms of premium and exposure. Hurricane rates were up 25% in the quarter, and we continue to push on terms and conditions such as deductible.

To offer some perspective, we started achieving rate increases on hurricane business in 2018. Since January 1, 2019, the cumulative rate increase on our hurricane book is 110% and new business pricing is higher than renewals. Additionally, we have been steadily improving terms and conditions. Currently, we can write as much business as we want, but we manage exposure growth by continuing to focus on our geographical spread of risk and providing lower limits on new business than on renewal accounts.

The majority of our Hurricane Ian and loss occurred in the E&S Property division. The loss estimate accounts for inflation and potential litigation and is based on observations and discussions with our insurers and our producers through site visits over the last couple of weeks. We have been able to visit most of the sites with larger limits exposed and have advanced money to help with mitigations to respond to our insurers' immediate needs.

The storm made landfall in one of the industry's peak catastrophe zone, which is also one of our highest exposed geographies. Despite the estimated end loss, the E&S Property division by itself still posted an underwriting profit through the first 9 months of 2022. It should be noted that due to the storm, there are noncancellation rules in place in Florida through the end of November.

Our underwriters have leaned into the Florida property market opportunity this year and recognize that direct terms will likely improve given the posturing of the reinsurance market. Our property reinsurance coverage comes up for renewal at 1:1, and we are expecting some rate increases. We manage our business to ensure we can entertain new opportunities with our producer partners through all cycles.

We will adjust our appetite based on the availability and cost of capacity and are prepared and willing to walk away from business if the market becomes irrational. We have additional businesses in this segment that are achieving profitability and worth mentioning. The Marine division grew 25%, while producing an underwriting profit. We've been obtaining notable rate increases for 4 years.

In the third quarter, rates increased 6%. We're seeing more opportunities by expanding our team and staying in front of our brokers. That same customer service spills over into our Hawaii Homeowners book, where we grew by 17%. We celebrated our 25th year service in Hawaii homeowners market with an appreciation event in Honolulu for over 160 of our partner agencies in September.

Our local Hawaii presence and underwriting and claims service continued to translate into positive results for us and for our customers. Although the Property segment reported a 110 combined ratio in the quarter, it was an improvement from last year's third quarter, and the segment is on pace to outperform last year's results with an excellent 82 combined ratio year-to-date.

Turning to our surety segment. Premium was up 12% in the quarter, with all products contributing. We continue to see the impact of inflation on project value, which drives some of the growth in our contract surety premium. We have added to staff in this segment and are seeing more opportunities through cross marketing initiatives. We continue to monitor this segment closely given ongoing shortages in the construction labor market, increasing interest rates that can impact project funding and timing and overall economic conditions. Although this market continues to be highly competitive, we achieved an 81 combined ratio and will continue to selectively find opportunities in surety.

Finally, cash premiums grew 3% for the quarter, led by E&S general liability, which was up 25%. This construction-focused business is truly competitive, especially in the Northeast, where several carriers offer broader terms and conditions. Our growth has been driven by opportunities outside of the Northeast. Our transportation group experienced 10% growth in the quarter, which was driven by the public auto product, which continues to see more buses in service compared to last year's third quarter. Both the public auto and specialty commercial auto markets are stable, and we are able to find opportunities to obtain appropriate terms and conditions.

A top portion of our transportation book is still very competitive with multiple sources of new capacity and have emerged in the last 18 months. Finally, our first umbrella product has grown 19% in the quarter as we continue to strengthen relationships with all of our distribution channels.

We are watching growth closely, give us severity trends and the lag and state insurance department rate approvals. We work with our producers to navigate the opportunities in states where it takes longer to adjust our pricing terms and conditions. Account segment's growth was offset by our executive products group, where the exit from cyber and transactional liability has almost run its course.

We are also experiencing strong headwinds from brokers on public D&O and side business where they have obtained access to more than a dozen new markets, including many Maui Jim over the last 12 months. We have adjusted our underwriting in this changing market, resulting in a 3% rate decrease for the quarter.

Moving to another layer within the insurance tower for some accounts, and then walking away from town when the terms become unsustainable. Excluding the impact from this business unit, the Casualty segment's premium would have grown 10% in the quarter. Overall, cash segment rates increased 3% for the quarter. The cash loss ratio was elevated as hurricane losses and our general binding authority book are included in this segment.

The disruption in this space is allowing us to implement some notable changes. We continue to raise rates and tighten terms and conditions for all coverages for our GBA products as we work towards underwriting profitability. Overall, the cash segment finished with a 93.7% combined ratio for the quarter.

And now I'll turn the call back over to Craig for some further comments.

Craig William Kliethermes
President, CEO & Director

Thank you, Jen. We continue to benefit for very good underlying results for our company. We are poised to take advantage of tighter capacity and a harder market. We believe there will be a flight to quality affecting relationships ranging from reinsurers, distribution partners, insurers and underwriters.

We have the financial strength, reputation and underwriting expertise to benefit from any resulting market displacement. RLI is a great home for future employee owners who share our values of discipline, accountability and ownership.

I would be remiss if I didn't mention the large gain on the sale of Maui Jim this quarter. Maui has been a great investment for our company, and we will continue to remember the deep shared history of our 2 companies, Mahalo to the entire Maui Jim team. I also want to thank all of our associate owners for delivering again this quarter. Responsiveness following catastrophic events is where reputations are earned or forfeited.

While we can't stop natural catastrophes from occurring as owners we realize that if we continue to take care of our customers, we will take care of our future.
Thank you. Now I will turn it back to the moderator, who will open up for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Matt Carletti at JPMorgan.

Matthew John Carletti
JMP Securities LLC, Research Division

Couple of questions. One, Jenn, you kind of first on the active year loss ratio, I wanted to follow up on Jim's comments there. I think you mentioned that there was some impact from Hurricane Ian losses as well as one other item I didn't catch. It looks like it went up if we look at kind of 9 months versus 6 months run rate, 2 to 3 points is -- if we were to strip that out, would it be relatively unchanged kind of sticking at that 64% that we saw in the first half.

Todd Wayne Bryant
Chief Financial Officer

Matt, it's Todd. I'll take that. I think the bigger driver is what you're seeing from a casualty, the catastrophe impact. That's really what's driving it. You can get a little bit of movement between quarters. And I would look more to the year-to-date on that. And I think we're at 65% from the as underlying, which is about a point better than what we were last year. So I really would kind of focus on the year-to-date when you take a look at that. You can get a little bit of movement between quarters. But the large impact is that if those cat losses.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. Great. That's helpful. And then just one other one, if I could. Net investment income took a nice step-up in the quarter. Is that largely kind of just rates earning in related and therefore, largely sustainable? Or was there any kind of onetime there that might have given us a little benefit this quarter that we shouldn't repeat going forward?

Aaron Paul Diefenthaler
Chief Investment Officer & Treasurer

Matt, it's Aaron. Thanks for the question. Yes, it's really just us putting money to work pretty consistently. Operating cash flow last year was very strong, and we've seen investment income up now going back over the last 4 quarters on a comparative basis. So it's really both the combination of new money yields being up pretty consistently here in 2022, plus larger amounts of cash flow just being put to work really in fixed income more so than anywhere else.

Operator

Our next question comes from Greg Peters of Raymond James.

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

This is actually Sid on for Greg. Just looking at the Southeast property market and the current state of it and the outlook for reinsurance pricing and tightening capacity possibly, could you guys just give an updated outlook for growth in the property business there? And if there's been any change on the outlook for that business?

Jennifer Leigh Klobnak
Chief Operating Officer

This is Jenn. So the Southeast property market and in particular, Florida remains a very open space to do business. There's a lack of capacity. And I think we're going to see more of that as we move towards 1:1 and through the reinsurance renewal process. There's a number of MGAs in that space that are currently looking to negotiate their capacity for next year and I think are going to struggle through that process. This is the season of meeting with reinsurers. So we've been to a number of meetings. We've been doing some traveling and the reinsurance market is looking to take some action here from a rate standpoint and also push on other terms and conditions such as retention.

So I think some markets will struggle to get the coverage they need to really stay in that space, particularly on an admitted basis. I think the fact that we focus in that area on a non-admitted basis really helps us react to what we need in that market. So for us, we would like to continue growing, but it will depend on the term an conditions we can secure from our reinsurance partners. As we approach them, our -- our main focus is that we do things differently than other markets. We control our own claims. We take a lot of care with underwriting, understanding what the exposure is. So our pitch is to have them give us their capacity versus other people.

We hope that they buy that pitch because we would like to continue to take advantage of this market. And I think you can see from our results in 2022 that despite we had a lot of growth, we had a large event, but we were still able to make an underwriting profit year-to-date in our E&S division. So we'd like to continue doing that, but it will be dependent on what we can obtain here on 1:1 and that's still in process. So you have to be determined.

Operator

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

Mark Alan Dwelle
RBC Capital Markets, Research Division

A couple of questions. First, with respect to -- you talked in pretty good detail about how the property market has tightened up and so forth. And I think that's pretty well expected and understood. Is there any signs yet as to whether any of the EM losses and resulting hardening of the reinsurance market is spreading over to casualty lines at all? Or is it maybe too soon to tell...

Jennifer Leigh Klobnak
Chief Operating Officer

Mark, this is Jen. I think it's too soon to tell as we listen to the reinsurers, talk about what they want to accomplish, they would like it to spill over but we don't know that, that's going to happen. We'll have to see from a primary standpoint, I think the issues that have been going on for years in terms of loss trends, frequency, severity, et cetera, are kind of just continuing in that market. So nothing bleeding over that we can see from the end at this point in time.

Mark Alan Dwelle
RBC Capital Markets, Research Division

Second question, kind of staying in that same general vein on casualty. -- you had commented in terms of the D&O market that some of the pricing there have been softening and you mentioned some new markets. Can you give any -- just maybe additional color on what you think is maybe causing that market to soften. I guess I would have thought D&O as kind of a textbook example of a social inflation type market that would be depressed in a period where markets are -- been negative and adverse economic conditions, but seemingly that's not the case from a pricing standpoint.

Jennifer Leigh Klobnak
Chief Operating Officer

Sure, Mark. I think the issue here is we had 3 years of very significant rate increases, all in the market. And so a lot of people saw that and thought maybe I should get in and get some of that rate. And so we have had people enter. The other part of it is just the number of deals available if you think about how many IPOs are not occurring these days that used to be. There are less deals to get on. So there's a little less insurance being procured. And so everybody is fighting for those accounts. So I think the combination of those factors is causing the market to soften. And so that's what we're seeing.

Mark Alan Dwelle
RBC Capital Markets, Research Division

Okay. That's helpful. And I guess my third question, Todd, I guess, alluded to the disposition or the utilization of the Maui Jim proceeds a little bit in his prepared remarks. So I'm not real optimistic I'm going to get a lot more insight. But I -- the one question I wanted to ask is, as you and your Board consider dividends, special dividends or any other potential use. Are you thinking about that from a net income perspective, a comprehensive income perspective or an operating earnings perspective...

Todd Wayne Bryant
Chief Financial Officer

This is Todd, Mark. I think we think about all of those, right? I mean, I think you're looking at all factors, you're looking forward on what you think growth might be. You're going to consider what the reinsurance market may be like. So -- we do take a rating agency view of some of this, right? Some of that's gap based, some of that staff base. We have internal models that we do ourselves. So it's really an all-in view on all of those aspects.

Mark Alan Dwelle
RBC Capital Markets, Research Division

Maybe if I ask it differently, if somebody is thinking that the -- there was a nearly $10 gain on Maui Jim. And accordingly, there would be a $10 special dividend associated with that. That would probably be too expansive of a way to think about it, right, in view of the way comprehensive income and operating income has behaved?

Craig William Kliethermes
President, CEO & Director

Yes, Mark, this is Craig. I mean I think it's very much like Todd said, we're going to look at all the opportunities in front of us. Obviously, the preference is to put our capital to use. You've seen we've grown a bit. and we're going to have to do all that, as Todd talked about the modeling we have to look at all that and then look forward to see what we think the market opportunities are going to be out there, and then we'll have to make a decision. So hopefully, that helps.

Operator

Our next question comes from Meyer Shields at KBW.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

I want to go back to the Casualty segment. I completely understand, I think it was Todd's comments about looking at year-to-date numbers, but there was an increase in the year-to-date from, call it, 64% in the first half to 65% now. I was hoping if you could talk us through what's changing the company view.

Todd Wayne Bryant
Chief Financial Officer

I don't think our view is changing, Meyer. I mean I think from an underlying from a core loss ratio standpoint, we don't have a different view. Again, I mentioned a little bit of noise you may get between quarters. I don't want to go down a ratable on unallocated loss adjustment expense, maybe attributed between current and prior years. But it really is -- our view has not changed. So from a -- is it a point higher than what you saw through the second quarter it is, but the underlying view has not changed on our part.

Meyer Shields
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That helps. I mean I'm happy to go through into the rabbit hole, but I see what you're saying. The same question, if I can, on the expense ratio for casualty. That seemed high, and that surprised me given both the cat losses and the underlying. I was hoping you could explain if anything unusual that's going on there.

Todd Wayne Bryant
Chief Financial Officer

Not been unusual. I mean we did and this crosses across all segments. We did have a onetime bonus that was related. I mentioned that there was some impact there related to the transaction. You're seeing that through policy acquisition, i.e., divisional expense, some home office expense, -- so nothing unusual. As mix changes, I guess, I will mention, is mix changes a little bit, right. Some of our small commercial personal umbrella, a few of those products as they grow, they may have a marginally higher commission rate. Would that account for maybe 0.5 point or less on the expense ratio. It could, but nothing material at all, Meyer.

Operator

At this time, there are no further questions. I'll now turn the conference over to Mr. Craig Comes for some closing remarks.

Craig William Kliethermes
President, CEO & Director

Well, thank you. Thank you all for joining us. A pretty good quarter overall. I want to thank the entire RLI ownership team. We hopefully can finish strong, and we'll see you next year, I guess. Thank you.

Operator

Ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 18668139403 with an ID pound of 841395. This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.