S&P Capital IQ

CONTENTS

Selective Insurance Group, Inc. NasdaqGS:SIGI

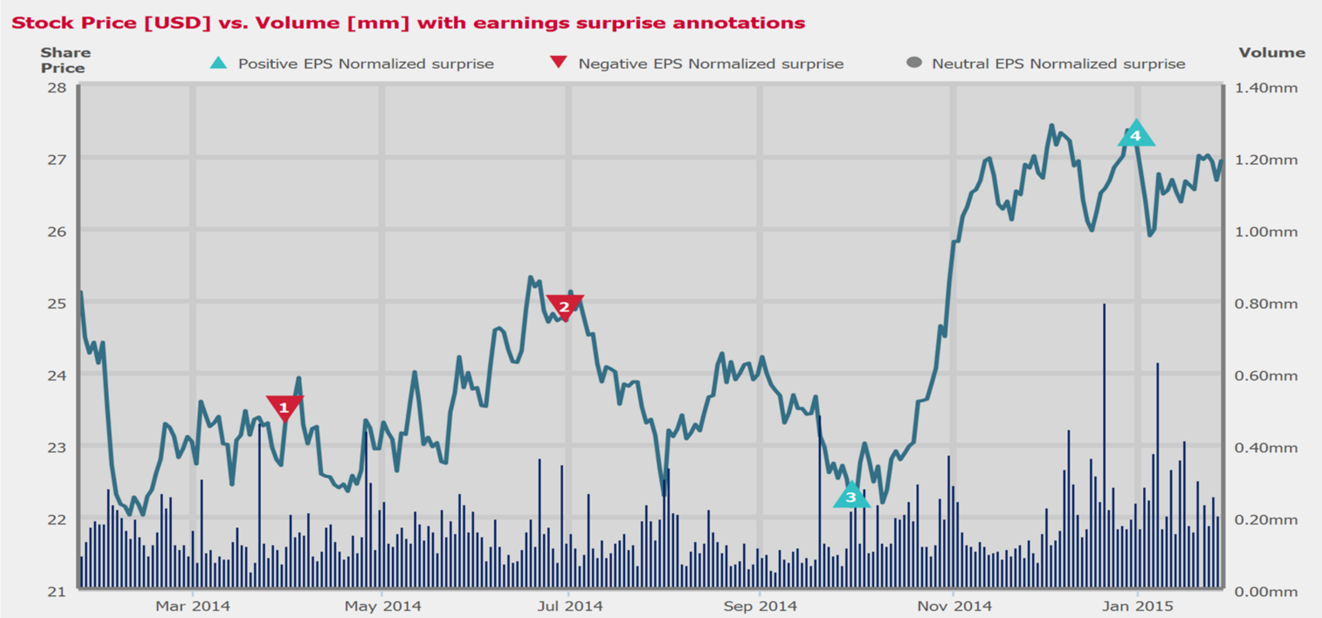
FQ1 2015 Earnings Call Transcripts

Thursday, April 30, 2015 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ1 2015-			-FQ2 2015-	-FY 2015-	-FY 2016-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.45	0.48	6.67	0.46	2.37	2.53
Revenue (mm)	511.18	523.90	2.49	515.86	2076.18	2162.67

Currency: USD
Consensus as of Apr-29-2015 10:40 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2014	0.33	0.23	(30.30 %)
FQ2 2014	0.49	0.46	(6.12 %)
FQ3 2014	0.51	0.76	49.02 %
FQ4 2014	0.66	0.72	9.09 %

Call Participants

EXECUTIVES

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Gregory E. Murphy
Chairman and Chief Executive Officer

Jennifer W. DiBerardino
Former Senior Vice President of Investor Relations

John J. Marchioni
President and Chief Operating Officer

ANALYSTS

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Presentation

Operator

Good day everyone. Welcome to the Selective Insurance Group's First Quarter 2015 Earnings Call. At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Ms. Jennifer DiBerardino. Ma'am, you may proceed.

Jennifer W. DiBerardino
Former Senior Vice President of Investor Relations

Thank you. Good morning, and welcome to Selective Insurance Group's First Quarter 2015 Conference Call. This call is being simulcast on our website, and a replay will be available through June 1, 2015.

A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call, is available on the Investors page of our website, www.selective.com. Selective uses operating income, a non-GAAP measure, to analyze trends and operations. Operating income is net income excluding the after tax impact of net realized investment gains or losses as well as the after tax results of discontinued operations. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties. We refer you to Selective's Annual Report on Form 10-K and any subsequent Form 10-Qs filed with the U.S. Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining me today on the call are the following members of Selective's Executive Management Team: Greg Murphy, CEO; John Marchioni, President and Chief Operating Officer; Dale Thatcher, CFO; and Ron Zaleski, Chief Actuary.

Now I'll turn the call over to Dale to review first quarter results.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Thanks, Jen, and good morning. We're off to a good start in 2015 despite another difficult winter throughout our footprint. For the quarter, we reported operating income per diluted share of $0.48, up from $0.23 a year ago. Our statutory combined ratio for the quarter was 93%, improving from 100.8% a year ago, and our underlying combined ratio, excluding CATs and prior year casualty development, improved by 4.5 points to 91.9%. As you analyze the results for the quarter, I'd like to remind you that last year's first quarter included a $0.09 EPS benefit and a 1.7 point statutory combined ratio benefit from the sale of our self-insured group business.

While CAT losses were elevated due to winter weather at 5.3 points, they were lower than 7.5 points reported a year ago. Non-CAT property losses were also elevated due to weather at about 2 points above expectations for the quarter, but about 5 points lower than first quarter 2014.

Favorable prior year casualty reserve development in the quarter was $20 million or 4.2 statutory combined ratio points compared to $14 million or 3.1 points a year ago. The development is related to the benefits of our underwriting and claims initiatives over the past several years while our overall reserve position continues to be very strong. For the quarter, overall statutory net premiums written grew by 9%, driven by steady retention levels, renewal pure price increases and higher new business.

Standard Commercial Lines premiums were up 9%, benefiting from renewal pure price of 3.5%, steady retention of 84% and a new business increase of 28% to $88 million. For the quarter, this segment generated a statutory combined ratio of 89.7% compared to 100.3% a year ago. The improvement was driven by earned rate exceeding expected claim inflation, favorable reserve development and lower CAT and non-CAT property losses.

Including 7.3 points of favorable development, workers' compensation reported a 90.7% statutory combined ratio in the quarter, improving approximately 15 points from a year ago. The favorable development is largely attributable to continued lower-than-expected frequencies. We're also beginning to see some decreases in severities, resulting from the claims initiatives we have instituted to address workers' comp results.

General liability also reported strong profitability with a 73% combined ratio. This line benefited from 17.4 points of reserve releases, also, largely driven by continued favorable claim frequencies. Our strong pricing in recent years has also contributed to these improved results.

Partially offsetting the overall favorable reserve development was adverse development of $1 million and $3 million in commercial auto and BOP, respectively. The change in commercial auto is reflective of trends being seen in the broader industry while BOP was driven by few large claims in recent years that were responded to in our reserving process.

Standard Personal Lines statutory premiums declined 3% in the quarter as targeted nonrenewals and lower new business impacted production. Retention remained at 82% while renewal pure price was a strong 6.4%. The statutory combined ratio in Personal Lines was 105.1%, including 8.7 points of catastrophe losses. In the prior year period, the statutory combined ratio was 104.5%, including 11.1 points of CAT losses.

Homeowners reported a combined ratio 113.7% in the quarter compared to 121.7% a year ago as extreme winter weather impacted both areas. On an x CAT basis, the combined ratio improved 3.1 points in the first quarter of 2015. Renewal pricing in this line remains strong at 9.9%.

Personal auto combined ratio in the quarter was 106.7%, up from 100.9% a year ago. This quarter, no development was recorded in this line compared to over 5 points of favorable prior year casualty development in the first quarter of 2014. Renewal pure price for the quarter was 3.5%.

Excess and Surplus Lines continue to generate strong growth with a 26% increase in statutory net premiums written. The E&S statutory combined ratio in the quarter was 102.1% compared to 97.9% in the first quarter of last year. Adverse reserve development of $1 million added 2.6 points to the combined ratio this quarter. Also included is the impact of catastrophe losses and 2 large fires in the quarter, which, together, increased the combined ratio by 0.9 points compared to a year ago.

Moving to the investment portfolio. After tax net investment income declined to $21 million from $26 million in the first quarter of 2014. The decline was largely driven by losses in energy-exposed limited partnerships that were negatively impacted by declining oil prices in the fourth quarter of 2014. Strong alternative income in the first quarter of last year also made for a difficult year-over-year comparison. As a result of lower alternative investment income and the continued low interest rate environment, our earned after tax portfolio yields declined to approximately 1.7% from 2.3% a year ago.

The after tax new money yields averaged 1.8% in the quarter as we continue to invest in high-quality fixed income products. Cash flow increased in the quarter as new money yields edged higher from the fourth quarter despite a decline in treasuries. However, new money yields were still below our 2% expectations for full year 2015.

Our fixed income portfolio continues to be highly rated with an average credit quality of AA- and a duration of 3.7 years, including short-term investments.

Within the overall portfolio, the pretax unrealized gain position increased to $128 million from $124 million at the end of 2014. The pretax unrecognized gain position in the fixed income held-to-maturity portfolio was $15 million or $0.17 per share on an after tax basis.

On the income statement, you'll notice a higher-than-usual realized gain in the quarter, which reflect the sale of some equities as we transitioned our equity portfolio to better diversify exposure while still focusing on a dividend income strategy. Equities remain at 4% of invested assets and the portfolio continues to be limited to U.S.-listed securities.

Surplus and stockholders' equity each ended the quarter at $1.3 billion while book value per share grew 3% from year-end to $23.11. Annualized operating ROE was 8.5% in the quarter, in line with our weighted average cost of capital off 8.5%.

Now I'll turn the call over to John Marchioni to review insurance operations.

John J. Marchioni
President and Chief Operating Officer

Thanks, Dale. Insurance operations delivered solid overall statutory results in the quarter with a combined ratio of 93% and x catastrophe combined ratio of 87.7% and net premiums written growth of 9%. These results are evidence of our strong position in the market and ability to properly grow our business.

One of the company's strategic imperatives is to grow, but not at the expense of overall profitability. Last quarter, we announced structural changes to our small business teams. The purpose of these changes was to improve our underwriting efficiency on smaller accounts while allowing the AMSs to increase their focus on middle market opportunities.

We also told of you of our intention to increase our share of wallet with existing agents by deploring -- deploying more agency management specialists, or AMSs. In the first quarter, 12 new AMSs were hired and we added 25 agencies within our footprint. These changes contributed to the new business growth of almost 30% had both -- as both submission and quote activity increased in the quarter compared to last year. We are pleased with these early successes.

The market seems to be acting in a rational manner as the low interest rate environment dampens overall returns and pressures companies to generate better underwriting margins. In this context, strong distribution partner relationships, technology and superior underwriting capabilities provide Selective with ample opportunity to grow profitably.

On the renewal portfolio, we continue to balance rate and retention by providing our underwriters with tools they need to make informed decisions. During the first quarter, Standard Commercial Lines retention remained strong at 84%, and renewal pure price was 3.5% on a written basis. This is approximately 50 basis points above our expected claim inflation while earned rate is about 200 basis points above claim inflation.

For our highest quality standard Commercial Lines accounts, which represent 53% of our premium, we achieved renewal pure rate of 2.3% and point-of-renewal retention of 91.3%. On our lower quality accounts, which represent 10% of our premium, we achieved pure rate of 7.6% and point-of-renewal retention of 83%, which offers an opportunity moving forward to push for additional rate even if retention levels decline. It is important to have this level of pricing sophistication to survive and thrive in this more competitive market. In addition to pricing in excess of expected claim inflation, underwriting and claim improvements are contributing to our profitability.

Workers' compensation, which has been a challenging line for us and the industry, has been an area of emphasis. On the underwriting side, we are targeting specific classes of business for reunderwriting and increasing our mix of lower hazard-grade business. In claims, we are seeing significant improvements in outcomes as a result of our strategic case management unit, workers' compensation escalation model and fraud detection and recovery models. These efforts have us well positioned to achieve the guidance that we laid out in the beginning of the year for our workers' compensation combined ratio of below 103%. As Dale mentioned, our combined ratio for the quarter was 90.7%.

In Excess and Surplus Lines, we see opportunities to write a greater share of our retail agency E&S business and aggressively grow through wholesale agents across our 50-state footprint. Having introduced a new rater in the fourth quarter of 2014, we intend to leverage this technology with our distribution partners and will continue to invest in our technology infrastructure by implementing a new policy issuance system.

We write contract-binding business on the small end of the E&S spectrum with an average policy size of $3,100. Given our experience in writing high volumes of low average premium accounts and the fragmented manner in which this business is currently placed in the market, we believe we are well positioned for continued growth and profitability in this line of business.

In Standard Personal Lines, production was impacted by several factors that resulted in a 3% decline in statutory net premiums written. First, as we've implemented ongoing rate increases and made updates to our rating models, there has been some expected disruption to renewals. Despite the disruptions, these are important actions to improve the quality and rate adequacy of our book.

Second, the strategic nonrenewal of dwelling fire policies and targeted nonrenewal actions on underperforming business, although diminishing continue to provide a headwind to production metrics. While dwelling fire and nonrenewal started at the beginning of 2014, we began nonrenewing New Jersey policies in July. This was the biggest part of our dwelling fire book. And as we progress through the year, we will see less premium impact from these actions.

And third, new business has declined due to our overall competitive position. We feel the new product rollout of the Selective Edge and future rollouts planned for this year will strengthen our competitive position as we target the consultative buyer. In fact, the Selective Edge rollout continues to be well received by our agents as we hold sales meetings across our footprint, and use of our enhanced endorsement is increasing.

On the auto side, the combination of our Edge and summit endorsements accounted for 25% of new business, up from 15% that summit represented in the first quarter of 2014. For home, we now offer 4 levels of coverage. And in March, our Edge product accounted for 20% of new business. Overall, we are very pleased with our underwriting progress and momentum.

Now I'll turn the call over to Greg Murphy.

Gregory E. Murphy
Chairman and Chief Executive Officer

Thank you, John. Good morning, and welcome to our First Quarter Conference Call. As was the case last year, we started off 2015 with higher-than-expected CAT and non-CAT weather-related losses. It should not slow down the significant underlying improvements in our operations due to: one, written and earned pure renewal price increases that still outpace expected inflation; two, retention at point of renewal by underwriting quality group, proving that it improves underwriting performance and is strong overall; three, significant benefits from our multidisciplinary effort that produced profitable workers' compensation results; and four, changes to our Commercial Lines growth capacity by adding more AMSs and creating small business teams that are producing increased levels of new business. These are just a few of the many initiatives that should produce ongoing underwriting profit improvements necessary to meet our long-term operating return on equity targets of 3 points above our weighted average cost of capital, which is currently 11.5%.

In the interest rate environment and assuming 4 points of catastrophe losses, we need to deliver a 90 Edge CAT combined ratio to reach our 11.5% target. We view the unrelenting pressure on investment returns as a competitive advantage for Selective if our net premiums written to surplus ratio of 1.5x is twice the industry ratio. For us, each one point of combined ratio generates one point of operating return on equity.

In this ultra-low interest rate environment, the industry will produce about 6 points of ROE from its investment portfolio, which should create ongoing pressure to produce underwriting profits or operating return on equities will decline below 6%.

We're achieving strong top line growth in a disciplinary manner through the numerous strategic initiatives that John articulated. We're also taking advantage of the dislocations in the marketplace from companies that are trying to address their underwriting profitability issues in a socialized manner. We're successful because of our sophisticated underwriting tools to evaluate new business opportunities while maintaining rate discipline.

Overall, renewal pure price increases for the quarter were 3.9%, in line with our 4% goal for the full year of 2015. While the pricing environment has softened over the course of the year, we continue to have success working with our agency partners to achieve price increases above expected claim inflation.

The financial integrity of our balance sheet is solid with a very strong reserve position, conservative investment portfolio, a well-diversified reinsurance program and debt with an average maturity of 21 years. With this secure foundation supporting our strategic initiatives, I feel good about our achievements and our ability to continue to drive long-term profitable growth.

Cash flow remains very healthy. But given the first quarter performance of our alternative investments related to energy, we're lowering our 2015 after tax investment income guidance to $100 million from $105 million. Otherwise, 2015 guidance remains unchanged as follows: a statutory combined ratio x catastrophes of 91%, not including any additional reserve development, either favorable or unfavorable; catastrophe losses of 4 points; and weighted average shares of $58 million.
Now I'll turn the call over to the operator for your questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from the line of -- from Mr. Vincent DeAugustino from KBW.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

So fun topic here, workers' comp Schedule P. If we look at the closed claim ratio in accident year '14, we see that drop-off pretty substantially. And I was hoping to get some color on to what extent some of those claims initiatives and the investigative aspect of those might either be keeping the claims open longer or from the other side of any of the claims consolidation as far as physical location and staff, if that's had any temporary delay on that metric. And then on the flip side, if we look at the average paid claims metrics, we see that go up about 25% on accident year '14. So I just wanted to see if we can get some color on those 2 trends and then connect that with some of the severity comments that you have this morning.

Gregory E. Murphy
Chairman and Chief Executive Officer

Yes, Vince, this is Greg. Yes, I know it is a lot, Vince. And I would say that they kind of -- crowned us a little bit. Obviously, moving all the claims to Charlotte, I don't think created any outrageous dislocation relative to settlement patterns because I think it was done very orderly by a very season group of people that we have in that operation now. And I would say that our intent, ultimately, is to increase disposal rate, and you should see that in terms of number of claims being settled earlier. But I think it's a little early to sit there and start drawing absolute 100% conclusions either way. I do think you'll see the data push around a little bit relative to the new staff. And I would comment overall that some of the increases in paid, some of the savings that you're starting to see on a claim-by-claim basis is really a result of our strategic unit and the benefits that they're having on a more serious claims or potentially serious claims. And you're starting to see that flow through. But the true benefits of having a medical-only unit, having some of the things that we've done, I think you'll start the see those more so as we move through '15. So I wouldn't draw too much conclusions either way right now on the data. It is just too early relative to when all these changes have done and you need more time for this to manifest itself through.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay, fair enough. There's certainly a lot going on there. And John, on your AMS comments for this morning. I just wanted to make sure I understood or, at least, caught the comments right. So the new business improvement, you'd attribute more to the AMS strategy than the increased agency of deployment strategy? Or is that really just one of the same and comprehensive kind of between the 2.

John J. Marchioni
President and Chief Operating Officer

Yes, that's a good question. So the overall agency appointments are not all that significant in the overall picture. And when you think about the time it takes to ramp up a newer appointment, that's not a major contributor in the quarter. I think the major drivers you pointed to -- and it's not just the addition of AMSs and their focus on middle markets, it's moving more small accounts into these small business teams, giving them a little bit more authority to get business rate than they've had in the past, which has the double effect of increasing our performance and efficiency and throughput on small, but also allowing AMSs more time to focus on what was a little bit more of a longer time -- term sales process of acquiring middle market business. So I would say both of those are generating performance. And the other point would be -- new AMSs take some time to get up and running in a territory. And we think that, that provides us some real opportunity going forward as these folks start to mature in these roles and really help us drive greater market penetration with our existing agents and make strategic appointments across our footprint where it makes sense.

Gregory E. Murphy
Chairman and Chief Executive Officer

And this is Greg. I would just say that as John articulated, the 2 levers that we look at in the business, the first is the agency share in a state, which is currently 14. Your question to John is that 14 -- as we've indicated, we want to push that up to 25 over time. That will happen much slower. But the share of wallet aspect, which is around 7 countrywide, the goal is to push that to 12. I think you'll see the benefits of that measurement come through NPW much quicker than you'll see the benefits of premium coming through by increase in the agency representation from 14 to 25 for the reasons John just went through. But the share of wallet you should start to see the benefits of that coming through NPW way quicker than the agency representation in the state.

Vincent M. DeAugustino
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Great, And then just one last one, on the 3.9% kind of rate trend this quarter versus the 4% plan. If that were to continue to decelerate throughout the year, can we assume that a lot of the other initiatives that you have going on can pick up the slack and that's why we get the affirmation on the 91% x CAT goal there?

John J. Marchioni
President and Chief Operating Officer

Yes. This is John. I think -- we certainly look at loss ratio improving year-over-year as a combination of the 2. Over the past couple of years, the earned rate over trend has been a big driver. But as we transitioned through '14 into '15 and look forward, we do expect to continue to get a bigger contribution on the loss ratio side from the underwriting initiatives as well as the claims initiatives, as we see rate come under a little bit more pressure. And we continue to focus on driving rate right around the loss trends target, but we think there's more improvement on the loss ratio for mix and claims.

Gregory E. Murphy
Chairman and Chief Executive Officer

And Vince, again, just overall, I would say that we don't expect any weakening of price in the Personal Lines area, particularly on the home front. So you've got to remember the 3 -- the 4 is an aggregation of all 3 segments. So we don't envision any weakening of that price at all. And then the same thing is true, E&S price needs to improve. That needs to uptick. And I think your comments are more directed around the Commercial Lines aspect. And obviously, when you weight them out, that's at the lowest level of the 3 segments is the expected level of the Commercial Lines pricing.

Operator

[Operator Instructions] Our next question comes from the line of Mr. Mark Dwelle of RBC.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Apologize if you guys covered this earlier. I was little late getting on to the call. The 4.2 points of favorable development, can you allocate those between the -- you probably already did, the -- between Personal and Commercial? And was there any meaningful amount that was in the comp line?

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Yes. Mark, basically the comp line has $5 million of favorable development. The general liability line had $20 million of favorable development. And then you saw the BOP and the commercial auto each had adverse development of $3 million on the BOP and $1 million on the commercial auto, and then E&S also had $1 million of adverse development. So none showing up in the Personal Lines.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful. On the workers' comp, I mean, that's the best number I've ever seen. It's probably a record. What do you -- how do I ask this question though? What do you think the real sustainable long-term rate is there? Do you think there were anything in the quarter that kind of made that number better than expected? Or is it just the cumulative fruits of a long period of labor that has kind of finally gotten us to a very good place?

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

I would reiterate our guidance that we expect to deliver below 103 combined ratio for workers' comp for the year. Obviously, a single quarter can have different volatility in it. So clearly, it's a combination of a lot of hard work that we've been putting into the workers' comp line. And it's early yet, but all signs are favorable, and we're encouraged by that.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

On the underlying trends, is there anything noticeable in either loss frequency or loss severity that might be enhancing their results? Or -- I'm just trying to get an understanding of the number.

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

We are seeing decreases in both frequency and severity. The frequency side, we attribute, at this stage of the game, to the fact that we've made a big push to modifying the underwriting side of things to go to the lighter hazard classes, and that's really showing some positives in terms of the frequency of claims. And then the centralization of the claims handling in Charlotte with the strategic case management unit seems to be having a real positive impact on the severities of claims. So on an overall basis, as I said, it's early, but all signs are very encouraging.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

It's good stuff. In the commercial auto, the adverse development there, is that older accident years or more recent?

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

It's a little bit more recent. It's in the '13 and '14 kind of time frame that we're seeing that. But again, it's only a $1 million adverse development. So it's not a big number for a very big line of ours. But as you know as well, we like to stay ahead of any kind of negative trends, and we react much more quickly to anything that we see that even has the whiff of negativism.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

No worries. It's definitely -- I was just trying to get some sense of...

Dale A. Thatcher
Former Chief Financial Officer, Executive Vice President and Treasurer

Sure.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Or there was something old that boomeranged on you or something that you're being proactive on.

Operator

[Operator Instructions] And speakers, at this time, we don't have additional questions. You may proceed.

Gregory E. Murphy
Chairman and Chief Executive Officer

Well, thank you very much for your participation this morning. If you have any follow-up questions, please contact Jennifer or Dale.

Thank you very much.

Operator
And that concludes today's conference. Thank you, all, for participating. You may now disconnect.