S&P Capital IQ

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Mercury General Corporation NYSE:MCY

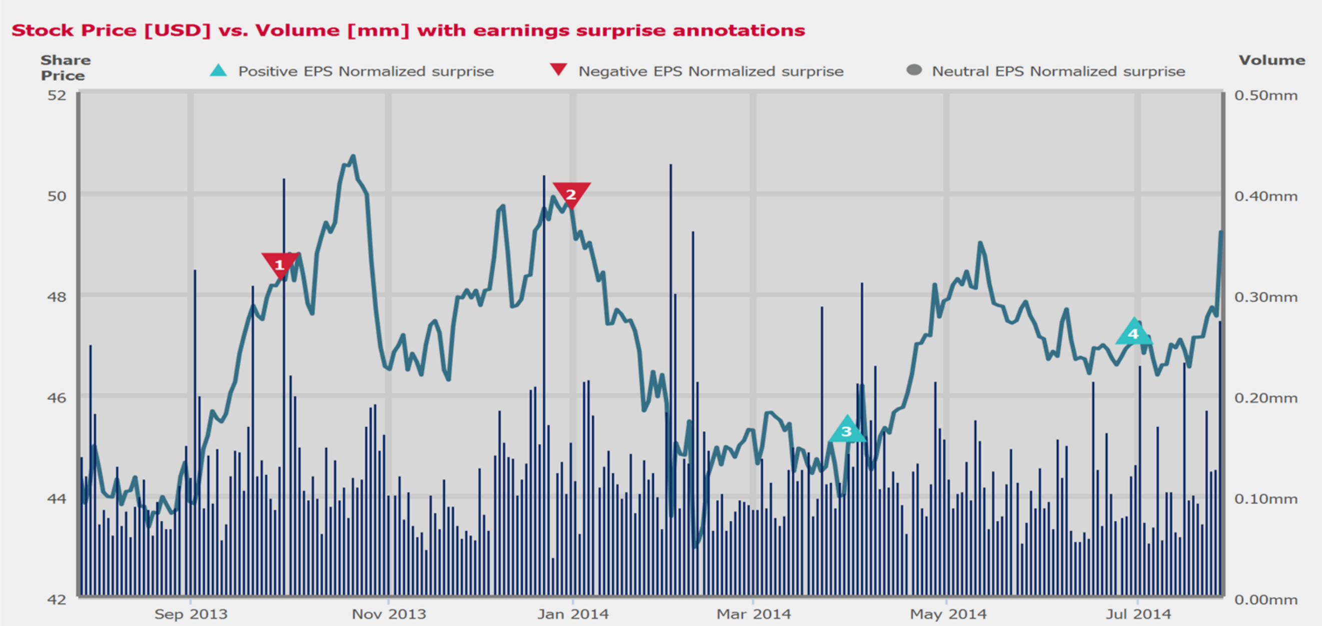
FQ3 2014 Earnings Call Transcripts

Monday, November 03, 2014 6:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.61	0.81	32.79	0.52	2.74	2.66
Revenue (mm)	736.60	720.15	(2.23 %)	698.17	2858.24	2977.41

Currency: USD
Consensus as of Nov-03-2014 2:32 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	0.64	0.53	1 (17.19 %)
FQ4 2013	0.53	0.33	2 (37.74 %)
FQ1 2014	0.61	0.77	3 26.23 %
FQ2 2014	0.70	0.83	4 18.57 %

Call Participants

EXECUTIVES

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

ANALYSTS

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BofA Merrill Lynch, Research Division

Gary Kent Ransom
Dowling & Partners Securities, LLC

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

Ronald David Bobman
Capital Returns Management, LLC

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

Presentation

Operator

Good morning or afternoon. My name is Michelle, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Quarterly Conference Call. [Operator Instructions] This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial and industry trends, which may affect Mercury General's future operating results and financial position. Such statements involve risks and uncertainties, which cannot be predicted or quantified and which may cause future activities and results of operations to differ materially from those discussed here today.

I would now like to turn the call over to Mr. Gabriel Tirador. Please go ahead.

Gabriel Tirador
Chief Executive Officer, President and Director

Thank you very much. I would like to welcome everyone to Mercury's third 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 and 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. The company posted operating earnings of $0.81 per share compared to $0.53 in the third quarter of 2013. The combined ratio was 96.7% compared to 99.2% in the third quarter of 2013. Higher-average premiums per policy were a major contributor to the improved results.

Also adding to the positive results was a 5.5% improvement in investment income due to a higher invested asset balances, favorable reserve development of $2 million and a low level of catastrophe losses, totaling just $1 million for the quarter.

Written premiums continue to grow, although the 2.2% growth rate posted this quarter is the lowest quarterly growth rate this year. Rate increases have had a positive effect on premiums written, but policies written and Policy-in-Force accounts have declined.

During 2014, the company took the following rate actions: A 6% rate increase was implemented in January for our Mercury Insurance Company in California personal auto book of business, which represents about half of our company-wide premiums written; an 8.25% rate increase was implemented in January for our California homeowners book of business, which represents about 10% of our company-wide premiums written; a 6.9% rate increase was approved and went into effect in October 2014 for our Cal Auto California personal auto book, which represents about 15% of our total written premiums.

We have taken rate decreases in several states outside of California during the first half of 2014, which has led to a significant increases in new business volumes in those states. And we have a 6.9% rate increase pending DOI approval in our Mercury Insurance Company personal auto book of business.

California continues to experience positive premium growth but states outside California have experienced negative growth. The company continually balances growth and possibility objectives and addresses these in many means, including rates, underwriting, expense initiatives, advertising and distribution.

For 2015, we expect to improve our growth prospects outside of California through the rate changes taken this year, coupled with increased advertising spend and distribution.

As we have previously reported, we have adjusted our combined ratio targets outside of California to be above a 95% combined ratio, as we have priced our products to expense targets we have not yet achieved, but expect to achieve over the next several years.

Loss cost for California personal auto are in line with our expectations. Both frequency and severity trends are in the low single-digit range. However, they are slightly elevated compared to the first half of the year.

In other states, loss trends vary a lot by state, but are generally moderate, with the exception of New York where trends have been running high.

For California homeowners, we are experiencing increased law severity trends because the 8.25% rate increase in January was preceded by a 5.5% rate decrease, the results for California homeowners have not improved yet this year. We have taken additional steps to improve our California homeowners business, including the rollout of a new aligned homeowners product in the third quarter. The new product has led to an increase in policy applications.

We recently announced the planned acquisition of Workmen's Auto Insurance Company for $8 million, which is expected to close in the first quarter of 2015 pending regulatory approval. Workmen's is a Los Angeles-based nonstandard auto writer that is expected to produce about $30 million in premiums in 2014.

This acquisition fills a strategic niche for Mercury as Workmen's nonstandard auto product will complement Mercury's more preferred product offerings. Mercury's product offerings, including its policy provisions are more preferred in mid-market and are not tailored to the 2 nonstandard market. We believe Workmen's auto product will allow Mercury to better penetrate the nonstandard market in California.

Year-to-date, the company posted a combined ratio of 96.4%. Looking forward, our fourth quarter results tend to be the worst of the year. We generally expect our fourth quarter combined ratio to be higher than the rest of the year by several points due to increased loss frequency and higher severities caused by seasonal driving [indiscernible] weather. That said, it is hard to predict with certainty whether the combined ratio will be higher as there are many factors currently unknown or beyond our control.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Vincent DeAugustino from KBW.

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

Just to start, so on Workmen's, so I can appreciate the comments you guys have made about filling the nonstandard kind of slot for you guys. And so what I was kind of curious about is as that closes and you kind of bring that in-house, what type of changes, if any, that you'd be making to their filings? And then how -- just because, I mean, from looking at it, it's been kind of challenged from a profitably standpoint on there end, but I assume that you guys would be taking some of your expertise and then leveraging that on a go-forward basis. So I'd be just kind of curious what you guys will be looking to do with that going forward.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, with respect to the profitability, Workmen's just recently implemented a 6.9% rate increase in California. And so we'll be taking a look at whether or not we need additional rate increases in 2015. We also believe, Vincent, that increase in the production is going to provide them with some needed efficiencies. Their LAE and expense ratios are just much too high. But just to clarify something, in order for us to offer a third nonstandard price point in California, the Department of Insurance and California statutes require us to qualify for what's called a supergroup exemption, which means that certain operations including sales, marketing, pricing and underwriting have to be separated from our other operations. So the Workmen's purchase is going to allow us to qualify for the supergroup exemption as their operations will be managed separately from our other operations, but it's a way for us to better compete in this nonstandard market. Now there's certain back-office operations that we are allowed to combine, and that includes, for example, claims, finance, human capital. But certain other operations do have to be maintained separately. So we're going to take a look, or Workmen's, I should say, they're going to take a look at their overall rate advocacy. They're going to take a look at the segmentation. We're going to take a look at their distribution. And Workmen's, I'm pretty sure, are going to be making some changes through all those aspects in the business.

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

Okay, good to know. And I think the structure now makes a lot more sense to me. So that's definitely good. As far as looking at the Policy-in-Force changes, so it looks like we've started the inflection point for both homeowners and auto and so -- and also looks like the commercial auto growth has been pretty strong. So just as we think about those mix changes going into our model, I know you guys don't give us the sort of by line loss performance anymore, but as far as just thinking conceptually about how each of those products rank, growth outside of California, commercial auto, homeowners growth, how would each of those rank in profitability versus, say, just the core California auto product? Just so -- the question is really getting at as you grow in each of those buckets, should we anticipate margin expansion to the overall aggregate book?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I think in California -- compared to California, auto is -- I think, that's what your question, Vincent, and I think homeowners is running hotter right now. California homeowners are running hotter, although we have that rate increase that's still earning in and we have a new product, but it is running hotter than our California prior passenger auto. Outside of California, as I've mentioned before, we expect to run hotter outside of that California than in California for the next several years as, we're pricing our products to expense targets we haven't achieved yet. And that we have a goal to achieve certain expense targets by 2017, and we're putting plans in place achieve that. But in the interim, we can expect that the profitability outside of California is not going to be where California is at. I don't know if that answers your question or not, so...

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

And then on commercial auto, sorry if I missed it, that would be a little bit better, I would assume?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. No, commercial auto is an exception. That would be -- our targets in commercial auto are better.

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

Okay, got you. And then just sort of -- just a modeling question. As far as other expenses running a little bit higher, I mean, I just wanted to see relative over the last few quarters the tick up there just to make sure, again, from a modeling standpoint, understanding the drivers.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Well, on the expense run rate, we had some savings from last year's restructuring but a large portion of that was in claims and affected the LAE ratio. We did have some cost savings from our commission changes outside of California that didn't go into effect until the second quarter, and those will take a few quarters to fully impact in the false acquisition costs. But in addition, we've reduced some cost outside of -- although we've reduced some cost outside of California, our premium volume is down. So we have fixed costs spread over declining premium volume outside of California. And then finally, the expense ratio was higher this quarter due to some higher profitability-related accruals that we booked. So with that, I mean we're still kind of projecting a normal run rate of the expense ratio around 27% this year.

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

Got you. And then -- so the $58.5 million this quarter and other operating expenses versus, say, the $53.8 million last quarter, I mean that's going to be roughly -- mostly the cost outside of California spread over a fixed or fixed cost spread over kind of the shrink premium base?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Partially and also some of the profitability-related accruals.

Gabriel Tirador
Chief Executive Officer, President and Director

Our margins are better this year than it were last year, so the profitability-related accruals are up.

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

Was it a good thing? So just I guess, one or 2 last one. So on the litigation issues with the news on noncompliance because I'm always just eager get an update there if there is one.

Gabriel Tirador
Chief Executive Officer, President and Director

There was actually a call on the 2004 noncompliance. There was a call with the Judge, Mass, Friday to get an update on where the judge was at. And basically, the judge says that they expect to issue a ruling in mid-November, is what the judge told the parties. And that ruling then goes to the Commissioner and it may or may not become public for another 30 days, so it goes directly to the Commissioner. So we're probably looking -- if the judge does send out this ruling in mid-November and if the Commissioner waits the full 30 days, we're probably looking mid-December, late December before we find out the ruling, Vincent. You get that, Vincent?

Operator

Your next question comes from Gary Ransom from Dowling & Partners.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Yes. On Workmen's, is there any overlap with the agency force that they operate through? Or is there any new agent that you're bringing in, in that acquisition?

Gabriel Tirador
Chief Executive Officer, President and Director

I'm sure there's going to be some overlap, but as an example, in the L.A., Orange County area, they don't have that many agents right now, very, very few agents relative to the size of the market. They probably have, I don't know, something like 30, 50 agents in the L.A., Orange County area. So there's a lot of opportunity from our standpoint to increase this distribution.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Okay. And on the homeowners product, can you tell us a little bit more about what the features of the new product are that make it attractive?

Gabriel Tirador
Chief Executive Officer, President and Director

Sure. I'll let Robert Houlihan handle that one.

Robert Houlihan
Chief Product Officer and Vice President

I would say, new products. There's 3 areas where we've improved significantly. We've moved to our guide wire platform, so that provides much better technology than we had for our previous product. We've also added a lot of new features to the program. Before, some of our coverages fell short of what the competition offered. Now we sort of match those coverage and expand it and have some coverage features above and beyond what's offered by many of our competitors. And then lastly, we've moved to buy apparel rating, which we think gives us a much more accurate rating going forward. And we've seen -- we off-balance to 0 relative to the pricing on our old product, and we've seen about a 25% increase in new business applications with the new program. About 5% or so of those are rewrites, so the net 20% we see are sort of incremental investments.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Can you give an example of what the new coverage features were?

Robert Houlihan
Chief Product Officer and Vice President

Yes. So some of the new features, we have got water backup coverage -- service line coverage. We have a home system protection program, so that covers breakdown in any mechanical features in the household, we have IV fraud expense and resolution coverages with the new product.

Gary Kent Ransom
Dowling & Partners Securities, LLC

Just one broader question like capital adequacy. Could you talk a little bit about where you stand and what your view is of your capital base at this time, being mindful that you're adding on the $30 million of premium next year and your payout ratio is relatively high? Where do you stand right now?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we believe we stand, we're in a good position with respect to our capital position. We're writing at about 1.9:1. Obviously, the acquisition of Workmen's is not really going to move the needle at least in the short run. We have always maintained a dividend policy backdating, I believe, back to 1985 when the company went public. That's been our -- the Board of Directors has continually maintained that dividend policy for all these years. That's how we distribute back our capital. The capital position that we do have today, the strong capital position allows us to maintain this dividend in times where maybe we're not -- the earnings aren't as we would like. So overall, I think that we're comfortable with the capital position that we have today.

Operator

Your next question comes from Alison Jacobowitz from Bank of America.

Alison Marnie Jacobowitz
BofA Merrill Lynch, Research Division

I'm going to assume that's me. It's Alison Jacobowitz. Most of my questions have been answered, but I'm just wondering if looking at the policy, Policies-in-Force and the pressure in the auto business, is there just any more color or details you can provide as to the environment inside and outside of California?

Gabriel Tirador
Chief Executive Officer, President and Director

Inside California, it's the environment is competitive, and we have taken rate increases in California that have impacted our new business sales, and that has had a negative impact on the Policies-in-Force here in California. Outside of California, we reduced rates, Alison, as I mentioned earlier -- earlier in the year, and that had a very significant impact on new business sales outside of California. Now albeit, average premiums are down when you take a rate reduction. But we believe that in '15, our new competitive rates, coupled with some increased advertising spend that we plan on doing, will allow us to grow outside of California in '15. In California, it's going to remain a challenging environment to grow significantly in California, excluding our acquisition of Workmen's and what we may be able to do with the Workmen's acquisition in a nonstandard area.

Operator

Your next question comes from Rob Bobman (sic) [Ron Bobman] from Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I have a question. You made a comment, Gabe, I think, regarding the Workmen's in the nonstandard concentration, in essence that Workmen's complemented your nonstandard book. I guess, it was sort of -- maybe it's weak in certain areas. Could you elaborate on sort of the elements of your existing nonstandard book and where it's strong and where Workmen's sort of feels the void?

Gabriel Tirador
Chief Executive Officer, President and Director

Sure. Let me just first start off by saying that our preferred company in California, that's where our statutory good drivers go into, in Mercury Insurance Company. And the nonstatutory good drivers go into Cal Auto. But that doesn't necessarily mean it's a true nonstandard company. I mean, that's just by statute that we have risks that are by statute good drivers going to our preferred company and by statute that are non-good drivers going Cal Auto. Now we don't have -- for example, in policy provisions of typical nonstandard writers are much more restrictive than what we have as an example. Workmen's has those types of restrictions. We are not in -- we don't have agencies that are pointed in many areas that are pointed by really 2 nonstandard carriers. So it's a different market. We think it's a sizable market here in California, it's probably over $1 billion size market here in California for enabling 2 nonstandard versus our historical nonstandard here in California for Cal Auto, which is our nonstandard carrier here. So there are differences between the 2.

Ronald David Bobman
Capital Returns Management, LLC

Good. Could you just elaborate what do you mean by on that restriction with...

Gabriel Tirador
Chief Executive Officer, President and Director

No. Policy restriction, what's afforded in the policy? What kind of coverages are afforded in the policy? There are more restrictions in nonstandard type of policies where, as an example, there may not be any coverage for permits of used driver in a nonstandard policy. Where in our policy, we provide a coverage for that.

Operator

[Operator Instructions] Your next question comes from Ken Billingsley from Compass Point.

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

I just had a couple of questions on the nonstandard business. And I understand you're talking about the Cal Auto looks a little different than the nonstandard Workmen's that you just bought. But what percentage of your business would you consider not prime and I guess, maybe, historically, you would have considered your nonstandard business prior to Workmen's acquisition?

Gabriel Tirador
Chief Executive Officer, President and Director

I think, Cal Auto represents about 15% of our auto book. Is that -- maybe the...

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

[indiscernible]

Gabriel Tirador
Chief Executive Officer, President and Director

The total book. No, I would say it's closer to 25% probably of our auto book, of our California auto book, something in that neighborhood.

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

And was there anything that prevented you from putting in some of those restrictions and building out the Cal Auto book? Or did you specifically need or desire to create that third bucket to essentially target customers depending on the risk profile?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we needed that third bucket. As I've mentioned earlier, we needed that third nonstandard price point. And to get that done, I mentioned earlier, we need that supergroup exemption, which I described earlier in the call.

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

Okay. So you needed a supergroup exemption and that stimulated the Workmen's acquisition?

Gabriel Tirador
Chief Executive Officer, President and Director

I'm sorry?

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

You -- it was easier -- I guess, my question is it something that you could not have developed in-house or was the Workmen's just attractive to maybe accelerate the pace of creating that group?

Gabriel Tirador
Chief Executive Officer, President and Director

Much more difficult to do in-house from approval and regulatory standpoint.

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

Okay. And last question I have is -- this is regarding comments for outside of California, and I apologize if I misinterpreted earlier statements on calls, did I understand that your expense ratio outside of California, the agent commission that you pay are a little bit higher than what you pay in California? So first off, is that true? And if so, can you talk about how much more it is and maybe how that has helped develop business on the plan?

Gabriel Tirador
Chief Executive Officer, President and Director

No, it's not accurate. It's actually less than it is in California by quite a few points.

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

Outside of California is -- you were paying a smaller agent commission that was -- will...

Gabriel Tirador
Chief Executive Officer, President and Director

Yes.

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

Will that change as you're looking to grow, to be competitive or -- as you mix your advertising? Or will you expect that to stay the same?

Gabriel Tirador
Chief Executive Officer, President and Director

We expect that the stay the same. As -- we made some changes earlier in the year with respect to compensation commissions, but we expect that to stay the same going forward.

Operator

At this time, I have no further questions. I'll turn the call back over to the speakers for closing remarks.

Gabriel Tirador
Chief Executive Officer, President and Director

We like to thank everyone for joining us this quarter, and we look forward to speaking with you in the fourth quarter. Thank you very much.

Operator

Thank you, everyone. This concludes today's conference call. You may now disconnect.