S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY

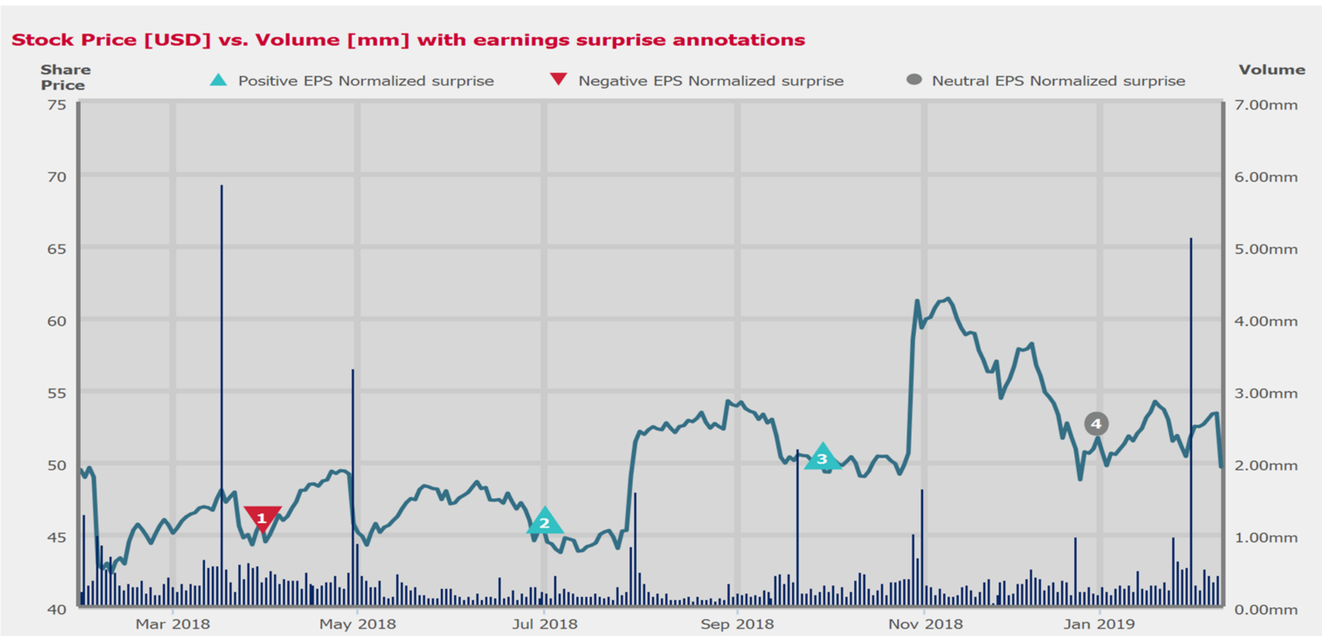
FQ4 2018 Earnings Call Transcripts

Monday, February 11, 2019 6:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2018-			-FQ1 2019-	-FY 2018-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.46	(0.26)	NM	0.85	2.37	1.80
Revenue (mm)	832.44	850.61	▲2.18	905.19	3477.46	3495.63

Currency: USD
Consensus as of Feb-11-2019 2:35 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2018	0.30	0.07	▼(76.67 %)
FQ2 2018	0.55	0.88	▲60.00 %
FQ3 2018	0.71	1.11	▲56.34 %
FQ4 2018	0.46	(0.26)	NM

Table of Contents

Call Participants

EXECUTIVES

Gabriel Tirador
President, CEO & Director

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Ronald David Bobman
Capital Returns Management, LLC

Samir Khare
Capital Returns Management, LLC

Presentation

Operator

Good morning. My name is Erica, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Fourth Quarter 2018 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. Sir, you may begin.

Gabriel Tirador
President, CEO & Director

Thank you very much. I would like to welcome everyone to Mercury's fourth 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; and Chris Graves, Vice President and Chief Investment Officer.

Before we take questions, we will make a few comments regarding the quarter. Our fourth quarter operating loss was $0.26 per share compared to $0.15 per share operating income in the fourth quarter of 2017. Included in the fourth quarter of 2017 results was a $0.13 per share tax benefit from the Tax Cut and Jobs Act of 2017. Included in the fourth quarter of 2018 results was a $0.07 per share tax benefit from the reversal of an IRS rule related to sequestration adjustments from the 2017 Tax Act. In addition, operating earnings deteriorated due to an increase in the combined ratio from 104.5% in the fourth quarter of 2017 to 106.7% in the fourth quarter of 2018, and a lower corporate tax rate applied to the company's underwriting loss in 2018. Partially offsetting the year-over-year reduction to operating earnings was an increase in after-tax investment income from $26.9 million in the fourth quarter of 2017 to $28.6 million in the fourth quarter of 2018.

The combined ratio in the quarter was significantly impacted by catastrophe losses, primarily from wildfire losses in California. Catastrophe losses net of reinsurance were $43 million in the fourth quarter compared to $20 million in the fourth quarter of 2017. In addition, we recorded $5 million of reinsurance reinstatement premiums earned in the quarter compared to $3 million in the fourth quarter of 2017. Unfavorable reserve development was $23 million in the quarter compared to $36 million in the fourth quarter of 2017. Excluding the impact of catastrophe losses, unfavorable reserve development and seated reinstatement premiums earned, the combined ratio was 98.6% in the quarter and 95.6% for the 12-month period ending December 31, 2018, compared to 97.2% and 96.9% for the quarter and 12-month period ending December 31, 2017, respectively.

To improve our combined ratio, we have been increasing rates in most states. In California, a 6.9% personal auto rate increase in California Automobile Insurance Company was recently approved by the California Department of Insurance. The rate increase is expected to be implemented in March 2019. A 6.9% personal auto rate increase from Mercury Insurance Company is pending approval with the California Department of Insurance as well as 6.9% rate increase in our California homeowners line. California personal auto and homeowners premiums represent about 77% of our direct company-wide premiums earned.

After-tax investment income increased 6.5% to $28.6 million. The increase in after-tax investment income in the quarter was primarily due to higher short-term interest rates, an increase in invested assets and a lower corporate tax rate. Investment income in the quarter was down from the third quarter of 2018, primarily due to adjustments in investment income accruals related to investments in private funds. Company-wide private passenger auto new business applications submitted to the company increased approximately 1% in the quarter and company-wide homeowners' applications increased 9% in the quarter.

With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from Christopher Campbell with KBW.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

My first question is on the core loss ratio. That was up about 170 bps year-over-year. So is there anything onetime in that number, like elevated non-cat weather and property, or any like prior accident year auto true-ups from the first 3 quarters?

Gabriel Tirador
President, CEO & Director

No. I mean, I think, we always mentioned that the fourth quarter from a seasonal standpoint is usually higher. We mentioned that in the last conference call that we expect the fourth quarter to be higher. We also had, as you -- as I noted earlier in my prepared remarks, we had some adverse development in the quarter, and as a result of that adverse development, we increased the PICs, too, for the more recent accident year.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. So the core loss ratio, so the 75.9 also includes kind of higher PICs for 2018 as well?

Gabriel Tirador
President, CEO & Director

Yes.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And was that stuff you were just seeing in 1Q? Or does the prior period development -- I guess, what accident year is the prior period development coming from?

Theodore Robert Stalick
Senior VP & CFO

Hi, Chris. It's Ted. The vast majority is from '16 and '15.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And was there any like 1Q '18 or 3Q '18 on that as well?

Theodore Robert Stalick
Senior VP & CFO

We really just look at our development on an accident year basis. The estimates for individual quarters within a year have some relative volatility to them, so we think those quarters' development is less meaningful than that of the annual period. So we just prefer to look at it annually rather than quarterly.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And I noticed in some of the 1Qs, like the past few years, like reserve development has kind of spiked in some of the first quarters. Is there anything special you're doing then in terms of review that just maybe taking a deeper dive there that we could maybe expect some adverse development in 1Q as well?

Theodore Robert Stalick
Senior VP & CFO

I don't think so. We essentially use the same process every quarter. We don't weight it one way or another by quarter. What happened in '18 in Q1 is we did see some development trends spike up, and we reacted to that fairly meaningfully in the first quarter, and that's why we probably saw additional development earlier this year than in the middle of the year.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

And is that mostly just California? Or are you seeing that in your other states as well?

Theodore Robert Stalick
Senior VP & CFO

California.

Gabriel Tirador
President, CEO & Director

So historical trends have definitely increased. Our development factors are higher now than historical trends. And we think that there's been a change in the environment. Over the last several years here in California, there's been increased medical procedures, aggressive attorneys. We've had more policy limit demands than before, and they tend to impact the older accident years because they're the bigger claims. And as a result of that, we've been taking a look at them and saying, look, we got to increase the development factors from more recent accident years. So it's had an impact on the more recent years as a result of that. So we hope it's stabilizing. We hope we're getting closer to stabilization. We've introduced various procedures here in the claims department as well to try to mitigate the impact of this new environment, and we're hoping that in 2019, we'll have a more stable environment.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. Very helpful. And then, just kind of a question on, obviously, you guys had a big gross losses on the wildfires. How did that impact your reinsurance renewals? And I guess, just what happened with your rate online, your purchasing, all that kind of stuff?

Theodore Robert Stalick
Senior VP & CFO

Well, our treaty is July 1 renewal date. So we haven't begun the process of renegotiating or redoing the treaties for this year. We expect there'll be some increase in the rates, modest probably based on the early indications and discussions we've had. That's kind of how we see it right now.

Christopher Campbell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And then, how would that -- obviously, it's been 2 years in a that row that you've been hit with the losses. I guess, just how are you thinking about your retentions going into that renewals? Like is there an opportunity to lower those? Or I guess just...

Gabriel Tirador
President, CEO & Director

It's pretty low right now.

Theodore Robert Stalick
Senior VP & CFO

Yes. Our retention right now is only $10 million. We may be looking at increasing the limit on the top end. So right now, our limit goes up to $200 million, and we may increase the limit on the top end a bit.

Operator

[Operator Instructions] Your next question comes from Samir Khare from Capital Markets.

Samir Khare
Capital Returns Management, LLC

I was wondering if you can talk about how the company calculated their gross cat losses for the wildfires, some of the assumptions, the average severity, et cetera?

Theodore Robert Stalick
Senior VP & CFO

We go through a fairly detailed process. We segregate out all of the total losses and assumed policy limit. We evaluate the policy limit and assume that for several of the coverages, they're going to hit the policy limit, and on some of the large coverages, there will be some percentage of the policy limit. Total losses make up something like 90% of the dollars of the cat loss, so if you get that right, you're going to be pretty close to your estimate. And then, your booking policy limits, the chances for development on those is significantly reduced. On partial, we look at -- partial losses, we look at claims from previous events that are similar in nature, and so, for example, for the 2018 fires, we have previous history from the 2017 fires, and we apply average severities against expected claim counts to come up with the ultimate losses on partials.

Samir Khare
Capital Returns Management, LLC

Okay. And what are you guys assuming -- what averages are you guys assuming for the partials?

Theodore Robert Stalick
Senior VP & CFO

I don't think we're at liberty to disclose that right now. Just that it was comparable to last year '17.

Samir Khare
Capital Returns Management, LLC

Okay. And then, the -- and then, you mentioned that the, I think, 90% of the dollars loss is coming from total claims, claims that are totaled. What percentage of claims is attributable to the total losses?

Theodore Robert Stalick
Senior VP & CFO

The actual count, claims count?

Samir Khare
Capital Returns Management, LLC

Yes. Exactly.

Theodore Robert Stalick
Senior VP & CFO

On the camp fire, it's actually more than half. On the Woolsey, it's significantly less than half.

Gabriel Tirador
President, CEO & Director

In the camp, everything burned down.

Theodore Robert Stalick

Senior VP & CFO

Yes. Camp just is gone. [Overnight] is gone.

Samir Khare
Capital Returns Management, LLC

Okay. And specifically on the camp fire, do you have the gross paid IBNR and IBNR for that fire that you guys are putting up?

Theodore Robert Stalick
Senior VP & CFO

I don't think we're disclosing that. Our ultimate -- our gross ultimate is $206 million, but -- on camp, and a large percentage of that has already been paid out as of year-end.

Gabriel Tirador
President, CEO & Director

In a nutshell, we feel good about where -- what we've done from a procedural standpoint to estimate our gross losses.

Samir Khare
Capital Returns Management, LLC

Okay. And just in general, for all the wildfires, any sign or risk of demand surge that could increase loss estimates from here?

Gabriel Tirador
President, CEO & Director

Well, if you're booking most of it at policy limits, our obligation in our policy limits on the total losses, as Ted mentioned, so.

Samir Khare
Capital Returns Management, LLC

Okay. And then, has the company bought any backup coverage or reinsurance from now until the renewal dates? Or do they intend to do so?

Theodore Robert Stalick
Senior VP & CFO

We have existing limit on our -- most of the layers of our treaty that -- if another significant event happens between now and June 30, we'd be on the hook for the first $40 million. And then, beyond that, I'd say $3 million and then we're -- we'll have reinsurance for something like $160 million.

Samir Khare
Capital Returns Management, LLC

Got it. Okay. And just on the loss trends that you guys are experiencing in California, you guys noted that you guys have converted some of your MIC book to 12-month policies. How much of that book is now 12-month policies? And I'm just asking, I'm hoping to understand if that will -- it'll take longer for any rate to earn in.

Gabriel Tirador
President, CEO & Director

The majority of the in-force book is still 6-month policies. I don't have the exact statistic but it's well over 50% is still 6-month policies.

Operator

And there are no further questions at this time -- I'm sorry, we do have one question from the line of Ron Bobman from Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I had a question about the -- to the go-forward reinsurance tower purchase. With the camp fire generating an excess of $200 million of loss, and with your such a sort of modest participation of 5% looking backwards between the $200 million and $400 million sort of tranche of your tower, I would think that you're going to be -- that you'd be wise to buy a good bit more. And I know you touched on it, I think, in Chris Campbell's question, but could -- it would seem to me that you'd be buying a good bit more. Could you discuss that and what magnitude that might be?

Theodore Robert Stalick
Senior VP & CFO

Currently, we have -- that layer you're talking about is $300 million excess of $200 million, and we placed 5% of that the last couple of years. Really, one of the main reasons why we only place a fraction of that was to get -- to set a price. So now we sort of have a baseline price because we felt like sometime in the future, we may want to place more of that or possibly even all of that. So now we kind of have an anchor of a price from the past, at least a fraction of it, which will allow us to be in a better position when we go forward and buy more of that in the July 2019 renewal.

Gabriel Tirador
President, CEO & Director

And I think there's a good chance that we are going to buy more. How much more, we'll have to wait and see, but I think there's a very good probability that we'll buy more.

Ronald David Bobman
Capital Returns Management, LLC

It would seem with the camp fire just sort of delivering such significant losses, one wildfire taking you through the -- in effect, through your tower, that you bought nowhere near enough and that the magnitude of the incremental buying necessary to protect the balance sheet is so much greater than what you bought historically. Am I thinking about it wrong or?

Gabriel Tirador
President, CEO & Director

No. I mean, I think, you're thinking about it right. I mean, we bought just about the right amount is what we ended up having, but we do think that there's a good likelihood that we're going to buy more coming in July.

Theodore Robert Stalick
Senior VP & CFO

Yes. And I would just add that the camp fire was unprecedented. It was one of the worst wildfires in California history. And so when you kind of look at it that way, the level that we bought was really for an event of that nature. And in essence, we sort of bought the appropriate reinsurance.

Gabriel Tirador
President, CEO & Director

Right.

Theodore Robert Stalick
Senior VP & CFO

But that said, our view of risk changes over time. And as more of these fires are burning in California, we are looking at the higher limits on the reinsurance and protect our capital.

Gabriel Tirador
President, CEO & Director

And not only that, we're trying to learn from this event, trying to find other areas that we may be exposed, similar to camp, and from an underwriting standpoint, trying to learn from it as well. So it's a combination of both underwriting and buying more reinsurance is what we're looking at.

Ronald David Bobman
Capital Returns Management, LLC

The 2017 wildfires were unprecedented until 2018 though, right?

Theodore Robert Stalick
Senior VP & CFO

Yes. That's true.

Gabriel Tirador
President, CEO & Director

Yes.

Ronald David Bobman
Capital Returns Management, LLC

Right. And then, you mentioned policy limits and it -- do the policy actually -- they don't specify a dollar number. Could you discuss about sort of how an insured sort of determines the policy limits on a homeowner's policy when you have a total loss? Like is it simple and straightforward? Or is there more to it?

Theodore Robert Stalick
Senior VP & CFO

No. There is a specified dollar limit on the policy. And it's different coverages. So there's a policy limit for the dwelling. There's a policy limit for living expenses. There's another limit for personal property and -- but it's all -- it's very quantifiable to exact dollar.

Operator

And we have an additional question from Samir Khare with Capital Returns.

Samir Khare
Capital Returns Management, LLC

I just want to ask on the subject of AM Best downgrade in December. Has anything changed in the production front, either volume, quality of business or your acceptance rates of your business coming in?

Gabriel Tirador
President, CEO & Director

No. There's been no -- absolutely nothing from that. I mean, we're still an A-rated company and there's been 0 impact.

Samir Khare
Capital Returns Management, LLC

Okay. And then, previously, you've said that you'd be comfortable with writing up to a net premium to equity ratio of 2.5, which you're pushing. Given that you have the lower AM Best rating now, are you comfortable with the higher underwriting leverage ratio?

Gabriel Tirador
President, CEO & Director

Well, a lot of our business is PPA auto. So with private passenger auto, we're more than comfortable actually writing at even a higher level than that. So we're going to have to watch it with respect to the mix of business as we rewrite more homeowners. The ratios would -- that we target would change, but we feel comfortable where we're at right now.

Operator

And there are no further questions at this time.

Gabriel Tirador
President, CEO & Director

Well, thank you for joining us this quarter and we hope to bring you better results in the first quarter of '19.

Operator
This does conclude today's conference call. You may now disconnect.