S&P Capital IQ

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RLI Corp. NYSE:RLI

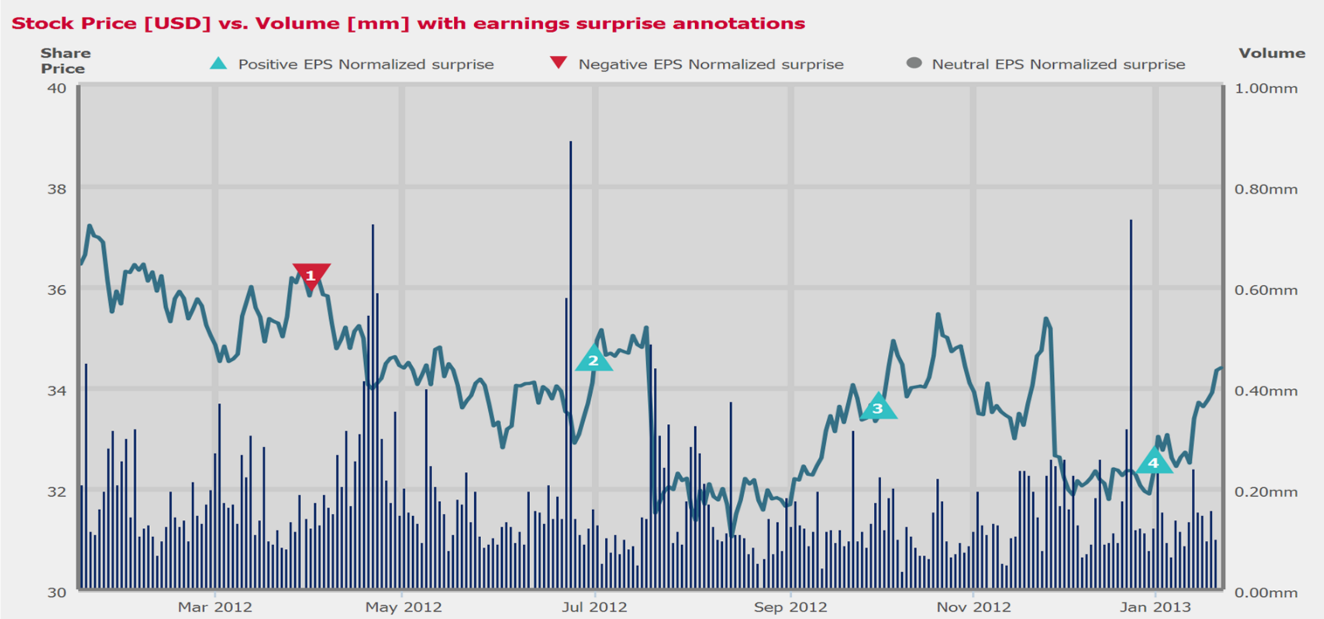
FQ1 2013 Earnings Call Transcripts

Thursday, April 18, 2013 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2013-			-FQ2 2013-	-FY 2013-	-FY 2014-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.52	0.52	0.00	0.58	2.15	2.17
Revenue (mm)	164.98	160.72	(2.58 %)	166.52	676.97	742.02

Currency: USD
Consensus as of Apr-18-2013 2:47 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ1 2012	0.53	0.48	1 (9.43 %)
FQ2 2012	0.57	0.58	2 3.51 %
FQ3 2012	0.47	0.51	3 8.51 %
FQ4 2012	0.22	0.44	4 104.55 %

Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Jonathan E. Michael
Chairman and Chief Executive Officer

Michael J. Stone
Director

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

John Thomas

Kevin Shields

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

Randolph Binner
FBR Capital Markets & Co., Research Division

Raymond Iardella
Macquarie Research

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. First Quarter Earnings Teleconference. At this time, I would like to inform you that this conference is being recorded. [Operator Instructions] Before we get started, let me remind everyone that through 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 risk factors, which could cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including the Annual Form 10-K, which should be reviewed carefully. The company has filed a Form 8-K with the Securities and Exchange Commission that contains a press release announcing first quarter results. RLI management may make reference during the call 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 investment gains or losses. RLI's management believes this measure is useful in gauging core operating performance across reporting periods but may not be comparable to other companies' definitions of operating earnings. The Form 10-K contains reconciliations between operating earnings and net earnings. The Form 8-K and press release are available at the company's website at www.rlicorp.com. At the request of the company, we will open the conference up for questions and answers following the presentation. I will now turn the conference over to RLI's Vice President, Corporate Development, Mr. Aaron Jacoby. Please go ahead, sir.

Aaron H. Jacoby
Vice President of Corporate Development

Thank you. Good morning to everyone. Welcome to RLI's Earnings Call for the First Quarter of 2013. Joining me on today's call are Jon Michael, Chairman and CEO; Mike Stone, President and Chief Operating Officer; and Tom Brown, Vice President and Chief Financial Officer. I'm going to turn the call over to Tom first to give some brief opening comments on the quarter's financial results. Then Mike will talk about our operations and market conditions. Next, we'll open the call to questions, and John will finish up with some closing comments. Tom?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Thanks, Aaron, and good morning. From our perspective, we saw this as another solid quarter. Gross premiums was up 10% over last year. Continuing the segment trends from last year, Casualty was the biggest driver, up 23%, as a result of new product initiatives, as well as certain products achieving both rate and exposure growth. The Property segment was flat, while Surety declined slightly as our underwriters remained diligent in light of tough economic conditions. Net written premium is up 12%. That's 2 points higher than the gross premium growth rate and is largely a result of a new Casualty reinsurance treaty put in place 1 month [ph] that allows us to retain more of the attractive business we write as pricing continues to advance.

Turning to profitability. The combined ratio was a very strong 86.2. Included in this result is $10.8 million of favorable development, mostly from the Casualty segment and from accident years 2008 to 2011. As a result of the higher premium and lower combined ratios, underwriting income advanced 33% versus last year. Regarding investments, it was a great quarter from a total return perspective, with the overall portfolio advancing 2.5% on the strength of our equity portfolio, which was up 11.5%. Investment income continued to trend down due to low reinvestment rates. At the end of the quarter, the fixed income portfolio stood at a consistent 4.9 duration and a 3.7% book yield. Not to be left out, Maui Jim did its part, contributing 19% earnings growth over the last year. The combination of underwriting and investment results drove operating earnings per share of $1.04 per share, up from $0.96 per share last year. The additional contribution from realized and unrealized investment gains drove excellent growth in book value per share of 4.6% since last year, year end. In summary, a positive start to 2013. And now I'd like to turn it over to Mike Stone for further discussion.

Michael J. Stone
Director

Thanks, Tom. Good morning, everybody. Again, just to reiterate, a good underwriting quarter. Another sub-90 combined ratio quarter at 86. Good gross written premium growth, 10% gross and 12% net, as Tom indicated.

I'll try to give a little market color. Rates are moving up modestly, Casualty, some 5%-plus in certain products. Property, 2%. So just nominally, though growing much more rate in our Marine business, and Surety is essentially flat.

Casualty business. Our gross written premium is up 23%. Some products, gross written premium, up significantly more, and rates up nicely. For example, our Commercial umbrella business, premiums up 36%, rates up some 17%, as we're finding pockets of opportunity, allowing us to write business that other markets are walking away from.

Our D&O business, Directors and Officers. Gross written premium, up some 20% and rates up 6%. Again, we're seeing more opportunities as companies pull back and, in some instances, seek significant rate increases, well beyond 15%. We're able to move in and take certain layers of D&O excess programs at nice rates. Our Transportation business, up 55%, while rates are slightly up. Transportation is generally the harbinger of a market change. But in this instance, the distress in the marketplace is really from a few markets, a few carriers, exiting the business, a few MGAs not being able to keep their carrier paper or losing their reinsurance. There is no real rate push here, but there's still considerable opportunity and considerable competition.

Our new products, security guards, medical malpractice, we wrote some $6 million of gross written premium. It's starting to have a good impact on our growth. So off to a good start in those products. Our Property business, basically, flat. The Marine business, though, while our gross written premium's flat as we re-underwrite our business, rates are up some 11% as we push rate and the market responds due to the pain from Sandy and a generally dismal Marine market over the past number of years. As we continue to re-underwrite, we would expect to continue to see improved results in this line.

Our E&S, our surplus lines property book, basically flat. The Catastrophe business is under considerable pressure as capital markets come in on top layer CAT programs, and we're seeing a new model change that's supposed to be effective sometime in the early third quarter, late second quarter with the news that it's going to drive loss costs down in the hurricane-prone areas, and we're already seeing the impact of that even though it hasn't been implemented yet.

Our Surety business, while gross premium written was down some 5%, there's continued heightened competition in this space, with the new entrants seeming to come into this space every month. Markets are willing to extend substantial limits to accounts, cutting out some of the smaller players. Our Contract business, Contract Surety business, is improving as our re-underwriting takes effect and our integration of the CBIC surety gains traction. Overall, as indicated, the surety market has considerable competition, but we have good products, good underwriters, and we'll continue to perform well. Overall, very good underwriting quarter. Market is in limbo, up a bit, then down a bit. So basically, going sideways. Trending better, and we're still cautiously optimistic. Either way, we'll find ways to outperform the industry. With that, back to you, Aaron.

Aaron H. Jacoby
Vice President of Corporate Development
Great. Thanks, Mike. We can now open the call up for any questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Randy Binner with FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

Just a question for Mike on the comment about the new model in the Property area. You said it would drive loss costs down in hurricane-exposed areas. Do you mean from -- it would be that from a reinsurance perspective?

Michael J. Stone
Director

Well, no. This is Mike Stone, obviously. No. As we model the business, our client, where we basically write primary business, we model that business before we underwrite it and price it. It's going to drive -- basically, drive loss costs down, expected losses down in those CAT-exposed areas. Just like RMS, I think, it was 11. This is going to be RMS 12. RMS 11 drove loss costs up. So they -- as they learn more information to get more data, Sandy's -- a part of this, the impact, they update the model and the model produces a new result. The truth changes, if you will, and it's going to drive costs down, just like it drove loss costs up in the prior model. So net-net, I think if you put 12 and 11 together, our loss costs are still up some 10-plus percent.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And so what is the dynamic, from your view, in RMS 12 now that would cause kind of some loss costs relief, I guess, versus the impact from 11?

Michael J. Stone
Director

Well, I mean, we're going to see -- you're going to see companies starting to write business at lower rates. That's what you're going to see. And as I've said, it's not fully implemented yet. In fact, it's not implemented at all. But everybody knows what the result is already. So you're starting to see brokers push new rates. Brokers know what the results are going to be, roughly. So we're seeing pressure on CAT exposed business, wind business, as a result of that.

Randolph Binner
FBR Capital Markets & Co., Research Division

Right. I guess, I mean, the assumption changes in 12. Does it assume, more or less, inland storms, like tornadoes? Is it assuming that hurricanes are going to go farther inland? I mean, is there kind of a piece of the CAT profile that changes in 12 that leads to a different result?

Michael J. Stone
Director

Again, from our early discussions and analysis of this, it's really looking at lower frequency of events. So that's going to drive lower loss costs.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And then just one more if I could, just jumping into investment income. It was alluded to, I think, in the press release that there was more allocation to munis, but then there's also lower reinvestment yields. Would it be possible to kind of size the impact of those 2 items on the lower investment income in the quarter, just from a modeling perspective to understand how much we might be getting back on the tax side versus how much we're just losing as the portfolio turns over?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Randy, I can kind of give you a couple of thoughts on it. I don't know if I have that exact number, but if you look at first quarter 2013 to 2012, we've moved from an allocation of 21% in municipals to 31%. So now we roughly allocate about 1/3 munis, 2/3 -- or about 1/3, I said 31% munis. If you look at it on an effective rate where you've taken in consideration the effect of tax, it comes out to -- a current market yield of about 2.2%, overall. So I don't know if that really answers your question, but...

Randolph Binner
FBR Capital Markets & Co., Research Division

That's the effective rate on the muni -- just on the muni portfolio. Well, it means -- I guess, I'd ask the question this way. If net investment income was $12.9 million in the first quarter and it was $14.5 million in the fourth quarter, just on a link-to-quarter basis. That's a delta of $1.6 million, right? So like, is it roughly -- it's kind of like half of that shortfall reinvestment and half the allocation in munis? Or is it kind of much more munis or much more reinvestment? I guess that's what I'm trying to get a sense of.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

I would say it's about 2/3 rate, 1/3 munis.

Operator

We'll take our next question from Raymond Iardella with Macquarie.

Raymond Iardella
Macquarie Research

So maybe just touching on the growth in the Casualty segment. I know, Mike, you had mentioned, commercial umbrella, D&O and transportation. Were there any of the other sort of lines of business that saw good growth?

Michael J. Stone
Director

Well, it's Mike Stone. Also, the new products, we have the Medical Malpractice business, our security guard business. Certainly, our professional services, our architects and engineers, continues to grow out from a smaller base, but it's growing out, and we would expect that growth to start to moderate as they expand their footprint in all 50 states, and they're just about there. So the growth really coming from those 3 products I mentioned first and the new products and additionally, the professional services, the architects and engineers.

Raymond Iardella
Macquarie Research

Okay. And then maybe, with that growth, I was a little bit surprised that you didn't get any sort of benefit on the expense ratio side. Are some of those new products carry higher expense ratios? Or do you think, over time, as they build scale, that, that expense ratio might come down a little bit more?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, Ray. As you know, I mean, while we've written $6 million to $7 million of new business, that doesn't turn into earned premium overnight. So those carry -- you have your costs associated with that upfront. So it will start to level out as you get to a kind of a year-over-year run rate on that. So right now, those are carrying kind of an artificially high expense ratio, relative to the earned premium on those new products.

Raymond Iardella
Macquarie Research

Okay. So even with this [indiscernible]. No, go ahead, sir.

Michael J. Stone
Director

This is Mike. So I'll just augment that with we've been building out the footprint on our admitted platform, which is really from our architects and engineers space. That's additional expense. That expense ratio is higher. That will start coming down as we get that implemented. And certainly, these newer products, surplus lines of products, will have less -- a less impact on the expense ratio over time. So we would expect that to help as we start earning that premium.

Raymond Iardella
Macquarie Research

Okay, that's helpful. And then I know it's not a big renewal period for reinsurance in 401, but I think you're -- the surety and some liability lines reinsurance contracts renewed. Any update or major changes to that?

Michael J. Stone
Director

Yes. This is Mike Stone. Surety renewed. We renewed -- we had basically a 10% overall rate reduction on our Surety business and our PSG, our Professional Services Group, which is basically architects and engineers and miscellaneous professionals, also a 10% rate reduction, both expiring structures essentially the same.

Raymond Iardella
Macquarie Research

Okay, that's helpful. And then last one, and maybe just touching on investment income in the tax rate. I mean, what is the tax rate, I guess, just on investment income? I mean, maybe that's another way to look at the impact from munis?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, just put it out, Ray, it's pretty much effectively at 35% on the taxables. It's approximately about a 5% tax rate on the tax exempts.

Operator

Our next question comes from Meyer Shields with KBW.

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

One more tax question, if I can. Were there any savings from dividends to the Employee Stock Ownership Plan in the quarter?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

No. The only real change here -- the effective rate change about 1%, and I would attribute that to the large allocation to munis. That would be about 1%.

Meyer Shields

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

We try and separate that out, so that's helpful. Corporate expenses were up, sort of significant year-over-year. Is that just bonus allocations or general terms, I should say?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, Meyer. It's a function of the bonuses for the employees.

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

Okay. And on a sequential basis, I guess, looking at Casualty lines, taking out the favorable reserve development. They were up sort of -- the loss issue was up somewhat significantly sequentially and I was wondering whether that's just caution on new business lines. Or whether loss costs inflation is starting to get worse.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes. Meyer, if you look at your -- you're talking about the Casualty line, correct?

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

Yes.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, so a little backdrop on that. If you really look back to Q1 of last year, the -- your combined ratio is about 109, so it's actually a point down in our first quarter this year. And I think as you're well aware, we take a long-term view towards the frequency and severity trends in the -- really don't do our first full-blown study until the second half of 2013. And much like last year when we did that, we saw it come down slightly to around 105 for the year.

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

Okay, all right. So -- but you're -- let me ask this more specifically, you're not seeing any changes in loss costs inflation, are you?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Not really. No.

Operator

Our next question comes from Scott Heleniak with RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

I was just wondering if you could first comment on -- I think, you mentioned, E&S was flat for the quarter. And it seemed like -- it seemed that that was getting a little bit better toward the end of last year. Are you seeing a lot more competition there? And if so, what areas? It seems like that market just, from what we've heard, is improving a little bit. Just wonder if you had any comment on that.

Michael J. Stone
Director

When you say E&S, you mean E&S property? That's what I was speaking to, I think.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Yes.

Michael J. Stone
Director

Our Property business -- well, certainly there's quite a bit of competition. And a bit of that business is our DIC business, California earthquake, which is seeing heightened competition as well. I mean, we're a ways off from the last event and underwriters start to have a lapse in memory of what can happen. But we're still being disciplined, so there's competition there, certainly on the hurricane side. I talked a little bit about some changes there, on both from a capital perspective and an impending model change, which is again, putting pressure there. And the -- we haven't seen a lot of pickup from rates because of the tornadic activity that we saw in prior years. We've got a little bit of movement, but not a lot. I mean, the standard lines guys are still running a lot of that business in those areas. So all in all, we continue to try to push a little rate and remain disciplined, but there's quite a bit of competition in that space.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. And then on Surety, you talked about more competitive there. Is that just a couple of bigger players kind of getting more aggressive? Or is that more smaller players kind of getting back into it that's causing that?

Michael J. Stone
Director

I say it's a combination. I mean, the bigger sureties certainly are competitive, certainly competitive in the transactional miscellaneous surety that we have a nice piece of. They're very aggressive there with commissions, and we're seeing new entrants, people that are starting up surety operations. People look at the combined ratios, and it looks pretty attractive. What they don't realize is a lot of cost associated with getting into miscellaneous surety, building out systems, building out distribution networks, and contract surety is always tough. So I would caution the competitors that they'd better be careful.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay, understood. And then the last question I have was just on the equity portfolio, which is about 22% of vested assets right now. Just wondering, is there a certain range where you'd start reducing exposure? I guess, I'm just asking how much further that can go as a percent of your invested assets. Or how do you look at that specifically?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Scott, historically, we keep it pretty much at about an 80% fixed and 20% equity. We might range up north of that depending on how we feel about the portfolio. But you'll look back, historically, it's been in that 20% to 25% range, sometimes lower.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay. So 25%, kind of the upper end is sort of the range you're talking about?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes.

Operator

Our next question comes from John Thomas with William Blair.

John Thomas

I was wondering, where is the favorable development in Casualty coming from this quarter, if there's any large differences between business lines. And then, if you could comment on the difference between this quarter and the first quarter of '12 in that there is a pretty big increase in the Casualty development.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, John, I can break it down a little bit. I'm not sure I can give you a good comparison to the prior year, but we'll do our best. We've seen it across a number of lines, the GL, umbrella, EPG and then CPIC's [ph] contract pack product as well. That's about $10.6 million of the total. This year, we'd say probably GL and EPG are up relative to the quarter last year. I don't know if I can break it down to actual dollars, but I would say those are trending up.

John Thomas

Okay. And so, habitational, you're not seeing any adverse development in that area, like in prior years?

Michael J. Stone
Director

This is Mike Stone. Actually, habitational is kind of leveling off. I mean, it's not performing well, but it's not performing worse. We're getting off quite a bit of that, certainly the large schedules we're exiting from. So we would expect actually to see that improve as the year unfolds. So it's not getting worse.

John Thomas

Okay. And then, just on a profitability basis, where would you say that you can find the greatest improvement in profitability in Casualty and where do you think you're at a pretty good level right now? Or is it just kind of, across-the-board, the same?

Michael J. Stone
Director

We think there is more opportunity in our Primary Liability business, which is -- which we've shrunk over the last 4 or 5 years. So we think there's opportunity there as the market firms a bit. We're well positioned to increase our writings there. We've kind of tread water, given our habitational business that we've re-underwritten. So we think there's certainly opportunity there. Our new businesses, as we grow them out, both the Medical Malpractice, which has a historically, a very nice combined ratio. And we think the security guards, as we build it out, will be a nice business for us. So we -- I mean, we see the Commercial umbrella business that's growing. We think there are nice margins there. We're not going to see a lot of margin for a while, but it's a long-tailed business. But given the rates, given the context of the business that we understand and have been in for a long time, we think there's some nice margins there as well.

Operator

Our next question comes from Kevin Shields with Pine River Capital.

Kevin Shields

I was interested in getting the paid CAT losses for this quarter and last, and if you could provide sort of what percent of your Hurricane Sandy losses have been paid through quarter end.

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Well, let me start with the -- our estimate for Sandy. We put out initial estimate of a range of $15 million to $20 million, and it's remained at the low end of that at $15 million, so we have not seen any movement on that. Not sure I have a breakdown of the actual payments right here at my fingertips, but I would say that our paid -- net paid losses this quarter towards -- compared to the same quarter of 2012 are up about $20 million-plus. We would attribute a fair amount of that to the Sandy claims, as well as some of the crop program. As we all know crop did not have a particularly good year last year, and that's starting to morph into payments in the quarter.

Jonathan E. Michael
Chairman and Chief Executive Officer

Kevin, this is Jon Michael. I will say, however, that we were very aggressive in settling the Sandy claims, aggressive in contacting our insureds, even if they hadn't reported a loss, made advance payments on many of the claims, and we have been on top of that helping our share -- I mean, our insureds get through that.

Operator

And we have a follow-up question from Ray Iardella with Macquarie.

Raymond Iardella
Macquarie Research

Just one question, just looking at stat surplus. It was up over 9% relative to year end. Is there anything sort of driving that increase in surplus, just given book value growth was up a little bit less than that?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Right, Ray, it's Tom Brown. Good question. It's largely a function of recognition and valuation of investments for statutory purposes and a decline in our net or not embedded assets you realize in the statutory world. So they didn't move in lock step. And as you saw, I think it was about a $63 million increase in statutory surplus versus a 4.6% increase in equity.

Raymond Iardella
Macquarie Research

Okay, that's helpful. And one more, if I can squeeze it in. In terms of ProAg, I think last call, you guys had chatted a little bit that some things were not necessarily finalized in the contract. Is there anything changed in terms of expectations for premium for 2013?

Michael J. Stone
Director

This is Mike Stone. No, the contract is finalized. We had a 4% quota share with ProAg. And then we have an additional quota share on a subset of states that will generate additional premium, but it's -- we see a portion of that as well. So it'll be up a bit this year because of the second quota share.

Operator

[Operator Instructions] And we'll take our next question from Meyer Shields with KBW.

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

Just one quick follow-up. If we're seeing, I guess, a modest economic recovery, does that make a divestiture of Maui Jim more or less likely?

Jonathan E. Michael
Chairman and Chief Executive Officer

Jon Michael here, Meyer. I would say, I don't know the answer to that, to be honest. Certainly, if Maui Jim continues to perform well, they'll be an attractive target. They have been an attractive target. And we're very happy with our investment in it at this point, but I don't know what that portends, to be honest with you.

Operator

And there are no further questions. I will now turn the conference back over to Mr. Jonathan Michael for any closing remarks.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you all for joining us this morning. On a micro-level basis, it's raining and raining hard here in Central Illinois. That should -- the farmers should be very happy about that. This quarter was a very, very good quarter for RLI. Premiums were up by double digits. Our combined ratio was mid-80s. Rates across most product lines, in fact, almost all product lines continue to advance. Those are the things that I like to hear. The double-digit decline in investment income means we need more rate on the underwriting side to make up for that investment decline, but this is good for us. We are excellent underwriters and believe we'll outperform and even thrive in this kind of an environment. Thanks for attending, and we'll talk to you again next quarter.

Operator
Ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 1 (888) 203-1112, with a conference ID number of 6578540. This concludes our conference for today. Thank you all for participating and have a nice day. All parties may now disconnect.