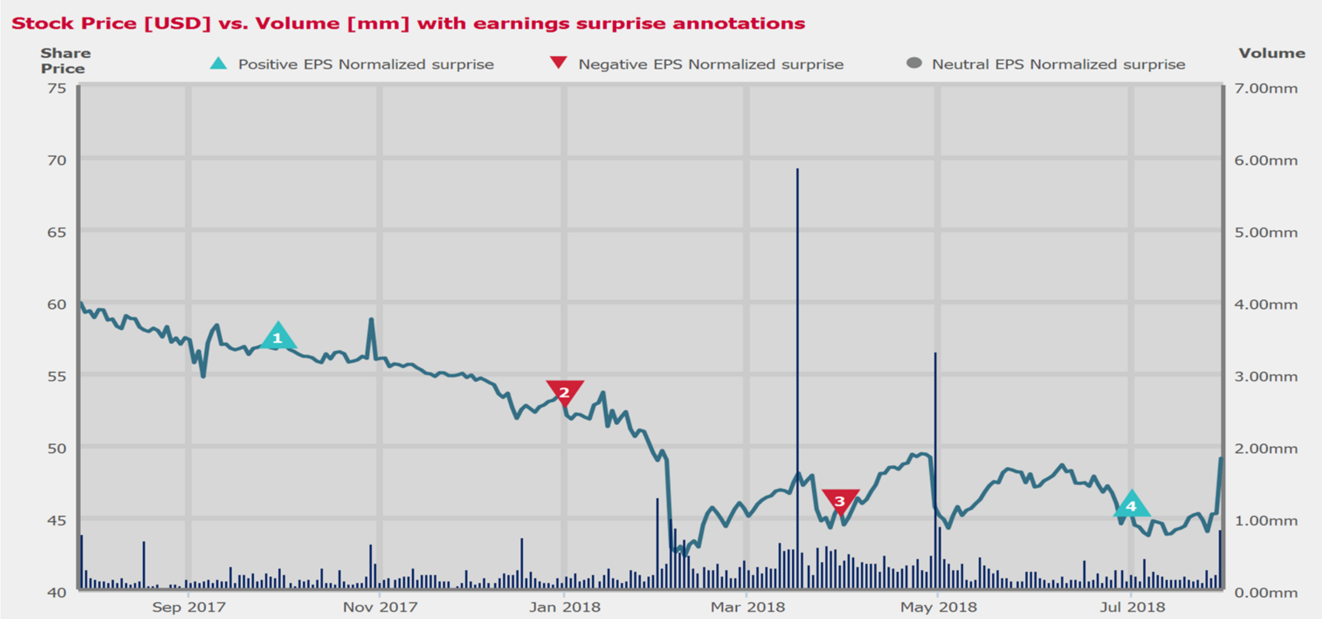
S&P Global
Market Intelligence

Mercury General Corporation NYSE:MCY
FQ3 2018 Earnings Call Transcripts
Monday, October 29, 2018 5:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ3 2018-			-FQ4 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.71	1.11	▲56.34	0.52	2.28	3.26
Revenue (mm)	877.06	905.34	▲3.22	826.00	3442.75	3528.82

Currency: USD
Consensus as of Oct-29-2018 1:25 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2017	0.52	0.60	▲15.38 %
FQ4 2017	0.33	0.15	▼(54.55 %)
FQ1 2018	0.30	0.07	▼(76.67 %)
FQ2 2018	0.55	0.88	▲60.00 %

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Call Participants

EXECUTIVES

Christopher Wadewitz Graves
VP & Chief Investment Officer

Gabriel Tirador
President, CEO & Director

Robert Houlihan
VP & Chief Product Officer

Theodore Robert Stalick
Senior VP & CFO

ANALYSTS

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

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

Presentation

Operator

Good morning. My name is Jamaria, and I will be your conference operator for today. At this time, I would like to welcome everyone to the Mercury General third quarter 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 risk 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, please go ahead.

Gabriel Tirador
President, CEO & 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. I am pleased to report our third quarter operating earnings were $1.11 per share compared to $0.60 per share in the third quarter of 2017. The improvement in operating earnings was primarily due to an improvement in the combined ratio, an increase in after-tax investment income and a lower corporate tax rate. The combined ratio was 95.6% in the third quarter of 2018 compared to 99.3% in the third quarter of 2017. The combined ratio in the quarter was aided by premium rate increases, lower catastrophe losses and a lower expense ratio.

To improve our combined ratio, we have been increasing rates in most states. In California, a 5% personal auto rate increase in Mercury Insurance company went into effect in March. A 6.9% personal auto rate increase from Mercury Insurance Company and California Automobile Insurance company are pending approval with the California Department of Insurance. In addition, a 6.9% rate increase in our California homeowners' line was filed in May. California personal auto and homeowners' premiums represent about 77% of our direct company-wide premiums earned.

Net catastrophe losses were $13 million in the quarter, primarily the result of the car fire in Redding, California. This compares to $19 million of net catastrophe losses in the third quarter of 2017, primarily from Hurricane Harvey in Texas and Hurricane Irma in Florida and Georgia.

During the quarter, we recorded $6 million of unfavorable prior year reserve development, down from both the first and second quarter of 2018. The development in the quarter came primarily from our auto line of business.

The expense ratio was 24% in the third quarter compared to 25% in the third quarter of 2017. The lower expense ratio was primarily due to lower average commissions and a slight reduction in other operating expenses coupled with a large increase in earned premiums.

Advertising expense was $12 million in both the current and third quarter of 2017. Excluding the impact of catastrophe losses, unfavorable reserve development and seated reinstatement premiums earned, the combined ratio was 94.5% for the 9-month period ending September 30, 2018 compared to 96.8% for the 9-month period ending September 30, 2017.

After-tax investment income increased 24% to $33.5 million. The increase in after-tax investment income was primarily due to higher short-term interest rates, an increase in invested assets, a lower corporate tax rate and higher yields obtained on certain classes of investments.

Company-wide private passenger auto new business applications submitted to the company increased approximately 8% in the quarter, and company-wide homeowners' applications increased 16% in the quarter.

Earlier this month, Hurricane Michael caused significant damage in Florida as well as in Georgia and Virginia. At this time, based on the information currently available, we believe our ultimate losses from hurricane Michael will be in a range between $4 million and $8 million, which will be recorded as losses in the fourth quarter. Our catastrophe reinsurance treaty provides for $205 million of coverage in excess of our $10 million retention.

Lastly, we generally expect our combined ratio in the fourth quarter, excluding catastrophes, to be higher than the rest of the year due to increased loss frequency and higher severities caused by seasonal driving in weather. That said, it is hard to predict with certainty whether the underlying 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] And your first question will come from Greg Peters with Raymond James.

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

Based on what I see here, it looks like this third quarter result is the lowest combined ratio that you guys have produced in something like the last 10 years. Is that a right read?

Gabriel Tirador
President, CEO & Director

Yes. I believe that's right, Greg.

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

Congratulations.

Gabriel Tirador
President, CEO & Director

Thank you.

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

I know it's been a hard-fought battle. So I know you mentioned in your opening comments about some pending rate increases that are -- 2 are in the auto and 1 is in the homeowners line, I believe. Given that the underlying and reported results are trending favorably, do you believe there's less possibility that those rates are going to be approved?

Gabriel Tirador
President, CEO & Director

No. We still think that they will be approved. I think the indications show that we need the rates. In Cal Auto, I think in the last quarter, we talked about the fact that we were expecting approval. Additional questions came in from the Department, not necessarily really based on whether or not we needed the rate, but just some additional questions. And I believe we've answered those questions in Cal Auto, and we do expect to have approval sometime in the near future in Cal Auto. In MIC, again, the rates have pledged from the Department of Insurance suggest that we do need the rate based on the trend, and -- although we don't expect that rate to go into effect until 2019, probably spring or mid of 2019 is our best guess right now. And same really with the homeowners rate filing that we filed earlier this year. When you take a look at the rate templates that we filed, it clearly shows that, based on the trends, that we need the rate. I don't know if, Robert, you want to add anything?

Robert Houlihan
VP & Chief Product Officer

No. I really would -- don't have much to add to that commentary.

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

Okay. Well, that's good color. On the prior year development, obviously, it's been -- you talked in the earlier conference calls about some of the trends that were popping up, that were causing this year's adverse development to -- at least through the 9 months, to be worse than last year's results through the

9 months, but the trend is improving. There's less unfavorable development. Can you talk about where we are with that? And I know the fourth quarter has some volatility around it, but should we look at this improving trend and think that maybe you got the reserve issues resolved?

Theodore Robert Stalick
Senior VP & CFO

Well, we definitely are baking the trends into our selections, our ultimate selections. We've gone through a period over the last several quarters, maybe 4 to 6 quarters, where the underlying development was more than expected, and that did moderate in the third quarter, which gives us some hope that this will be the end of adverse development going forward. But it's hard to tell because things change and we look at fast track data and it looked like the industry in California was moderating a bit in the last quarter or 2. So that's also a good sign.

Gabriel Tirador
President, CEO & Director

Yes. It was definitely better this quarter. But as I think we mentioned last quarter, our historical trends, when we were forecasting forward, they were coming in higher. The selections on the linked factors that we were selecting were coming in higher. But it appears, to me at least, that, that's starting to stabilize, which is why you saw, in the third quarter, less development. Whether or not that continues in the future, we don't know.

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

Right. Well, I know, Gabe, you've talked for several years about your stated objective of a [95%] combined ratio, and I assume, as part of that stated objective, you assumed that there's not going to be negative or adverse reserve development. You assumed that reserves are going to be adequately set. Is that the right read? So...

Gabriel Tirador
President, CEO & Director

We do not assume any development, one way or the other.

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

So where -- at some -- if you're catching up on the reported side, maybe you're catching up on the reserve side too, or maybe that would be what I would infer from your results. Can I -- can we spend a little bit talking about the operating expenses and they were down a little bit in the third quarter? Were there some discretionary items that you just withheld -- held back on? Or just talk to us a little bit about what -- the ebb and flow of the underwriting expenses in the quarter.

Theodore Robert Stalick
Senior VP & CFO

Our operating expenses were fairly -- I think they were flat compared to last year's third quarter. One of the things I think that's really helping the ratio is really our growth earned premium. We're growing now at a lot faster rate than we are in the operating expenses. Our ad spend, I think, was the same, third quarters this year compared to last year.

Gabriel Tirador
President, CEO & Director

Yes. And our effective commission rate is down. That's up -- and that's variable. So if the effective commission rate is down, that's going to help. And we've been monitoring our expenses, making sure our -- from an expense standpoint, that we're tight with the budget. So I think it's a combination of all those factors that are helping the expense ratio.

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

And can you just expand for a second on commission rates being down? I'm just surprised by that comment. Usually, agents are reluctant to give up commission.

Gabriel Tirador
President, CEO & Director

Well, we're talking about, maybe, I think, and overall, maybe, 0.2 or 0.3 of a point down year-over-year is my recollection, and our commissions in California are variable, and they're based on the possibility of the book of business and it's a 3-year trading number that we use. So that has been trending down a little bit. We've also made some changes to our commission structure where we're paying for certain type of business more and other types of business less. So a combination of all those factors have driven down the expense ratio or the commission rate here in California a little bit. I'm not talking about a lot. I think it's 0.2, 0.3 of a point here in California.

Theodore Robert Stalick
Senior VP & CFO

And we make our annual commission rate adjustments, that is effective with the July 1 for all of our agents. So if the commission rates typically go down, you would expect to see that in the second half of the year.

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

Right. One more underwriting question, and then I have a question for Chris. On the non-California business, can you comment about -- is Florida still a shrinking auto market for you? Or has that stabilized in a position to start growing again? And talk about the other states as well.

Gabriel Tirador
President, CEO & Director

Florida was down in the quarter, was still down in the quarter. Posted a very good combined ratio in Florida in the quarter, but the top line was down. Overall, outside of California, our premiums were up about 2% for private passenger auto, and about 5% up in the homeowners outside of California on the top line. And I think as I mentioned earlier, from an application count standpoint, in the third quarter, we were up 7.9% in applications for private passenger auto for the entire quarter, about 8% up in California and about 7.2% up outside of California in the quarter. So some of the states that are growing, Texas is growing on the top line and the app count, New York, Oklahoma. The states that are down are -- the 2 primary states that are down are Florida and Virginia.

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

Great. And I know you, in your prepared remarks, talked a little bit about investment income, but it really was a whopper of a quarter for you. Maybe you could give us more details about that. Is the $38 million a new run rate to expect going forward, et cetera? Chris, this should be a good opportunity for you to chime in as well.

Gabriel Tirador
President, CEO & Director

Yes. Go ahead, Chris.

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes, Greg. Well, going back several years, we're sort of positioning the portfolio to be more sensitive to LIBOR rates. We're definitely seeing the benefits of those positions, particularly through our CLO investment. We've been putting more capital towards investment-grade CLOs, and so that helps. And then, obviously, just tighter rates in general. We've seen quite a big move this year, which is allowing us to see more and more opportunities to buy fixed income that's accretive to our book yield, which has not been the case for some time. We've been challenged to maintain where we were, and that's no longer the case. We can actually add some pretty good bonds now and see a pickup in yield. And we're not having to stretch for anything either. We can get pretty good credits and not have to take a lot of risk. And then, dividends, we're seeing more dividend bumps come through. The equity investments have helped. So all of that combined has put some good wins to our back this year. I really can't speak towards the run rate. It's hard to say, but I'm certainly feeling pretty good about where we are right now.

Gabriel Tirador
President, CEO & Director

The only thing I would add to that, is our investment balances have also grown, which has helped as well.

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes. That's something else. That's a good point, Gabe. Mercury's business, when it does well, doesn't put any strain on me. And as you can see, our investment balances have really picked up, and that's translated into investment income pickup. And if you go back over the history, we are approaching investment -- annualized investment income numbers that we haven't seen in 10 years, but on a much higher balance. So I think you can -- as rates normalize, I think you can start to speculate that the investment income's going to continue to do better.

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

Well it -- certainly, the last 2 quarters have been particularly noteworthy, so -- and the third quarter was a blockbuster, no doubt.

Operator

[Operator Instructions] Your next question is from Christopher Campbell from KBW.

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

I guess my first question is on the premium growth. So it looks like, maybe, like 250 bps was from the other growth this quarter. Year-over-year was from the 12-month policy reintroduction. But if you back that out, you're still seeing 7% growth. So I guess like if you're decomposing that, how much of that would be exposure versus rate? Because I noticed the auto and the home PIP were picking up this quarter.

Christopher Wadewitz Graves
VP & Chief Investment Officer

It's probably about 2% on the policy growth, the rest are rate.

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

Okay. So 2% would be exposure, and then the other 5%, excluding the policy introduction, would be rate?

Christopher Wadewitz Graves
VP & Chief Investment Officer

Yes. In that ballpark.

Gabriel Tirador
President, CEO & Director

Yes.

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

Okay. Got it. That's really helpful. And I guess, just kind of another question on the reserves. I think Greg asked a few. Just looking at the reserves the last few years, it looks like the adverse reserve development seems to be the lowest in the third quarter, and kind of heavier in the other 3 quarters of the year. Is there anything seasonal in terms of your review process that would kind of bias the third quarter to be lower than the other quarters of the year?

Theodore Robert Stalick
Senior VP & CFO

We follow the same process every quarter. So that's an interesting observation, but I don't think there's anything biasing it one way or the other.

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

Okay. And there's no, like, different, like, data that you use per quarter depending -- or is it just, you have the same inputs every quarter?

Theodore Robert Stalick
Senior VP & CFO

Same input, same process.

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

Okay, got it. And then, just kind of -- finally, like a high-level one, on the regulatory environment in California. So I guess as Mercury gets more profitable, does this kind of create a heightened risk that regulators might order the rate rollbacks that I think were like -- that were rumored a few months ago? And then, just secondary one on that, is like how could the November elections kind of shape California's regulatory environment going forward?

Gabriel Tirador
President, CEO & Director

Well, I'll let Robert talk about the prescribed formula that we have here in California with respect to rates. And then, I can shift on timing on the election.

Robert Houlihan
VP & Chief Product Officer

Yes. On the rate filings, it's subject to a return on surplus formula. So only to the extent that, that formula would yield a decrease can the department force a reduction in rates. And right now, as we discussed earlier, we have 2 pending increases, which we think are supported. The department -- if a company hasn't filed in a period of time, the department has the right to come in and request a filing. But other than that, there's no mechanisms for a rate rollback.

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

Okay. Got it. Because I thought like the Commissioner was like ordering like his staff to review all of the rates. Now like when would that be a risk, like I guess? Or does that vary by line? So I think you guys are catching up in homeowners. But if auto is becoming more profitable, does it become more of a risk for auto versus homeowners?

Gabriel Tirador
President, CEO & Director

Go ahead.

Robert Houlihan
VP & Chief Product Officer

I was going to say, the department can request a filing to be reviewed for a potential decrease, but we already have pending filings going through the process right now. So there's nothing above and beyond that.

Gabriel Tirador
President, CEO & Director

The only thing I can think of is, that there was some kind of -- a notice went out, maybe what you're referring to is when the taxes went down.

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

Yes. That's it.

Gabriel Tirador
President, CEO & Director

That's what I think you're referring to, but we've already incorporated the lower tax rate into our filings. So I think that's what you're referring to, is that the Commissioner came out and said, "Hey, we're going to look at the rates, a lower tax rate." But those lower tax rates are in the formula that we're -- that we have for our filings.

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

Okay. So that's already baked into the 6.9% you have going in Mercury and then in Cal Auto? So that's already got the lower tax rate? And you're still [asking] for 6.9%, correct?

Robert Houlihan
VP & Chief Product Officer

Yes. Those filings already reflect the lower tax rate, yes.

Gabriel Tirador
President, CEO & Director

And as far as the election, I'll just make the comment that we don't think whoever gets elected will be any more adverse than what we have today. That's my feeling.

Operator

And at this time, there are no further questions. I would now like to turn it back over to the panel for any closing remarks at this time.

Gabriel Tirador
President, CEO & Director

Well, I'd like to thank you for joining us for the third quarter, and we hope to bring you some good news as well in the fourth quarter.

Thank you very much.

Operator

This concludes today's conference call.
You may now disconnect.