S&P Capital IQ

CONTENTS

RLI Corp. NYSE:RLI

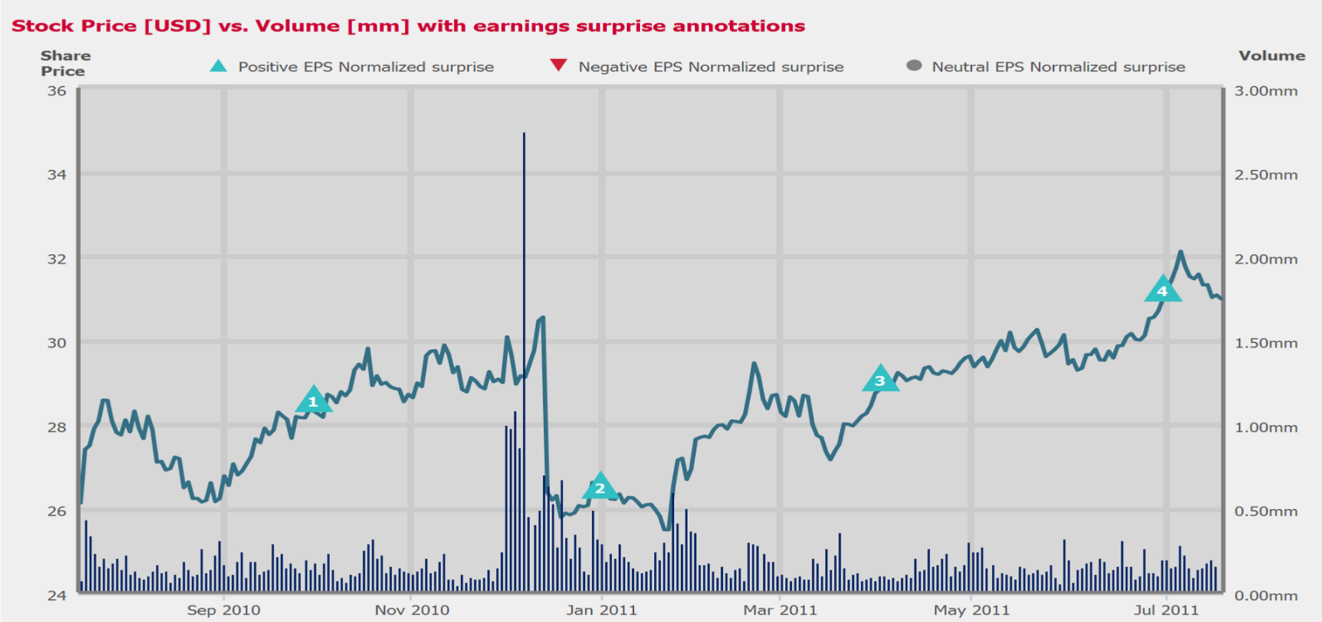
FQ3 2011 Earnings Call Transcripts

Wednesday, October 19, 2011 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2011-			-FQ4 2011-	-FY 2011-	-FY 2012-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.49	0.62	26.53	0.53	2.56	2.16
Revenue (mm)	144.96	162.33	11.98	150.88	575.34	617.26

Currency: USD
Consensus as of Oct-19-2011 3:24 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2010	0.48	0.60	1 25.00 %
FQ4 2010	0.49	0.83	2 69.39 %
FQ1 2011	0.46	0.56	3 21.74 %
FQ2 2011	0.53	0.96	4 81.13 %

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

Adam Klauber
William Blair & Company L.L.C., Research Division

Christine Amanda Worley
JMP Securities LLC, Research Division

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Randolph Binner
FBR Capital Markets & Co., Research Division

Ronald David Bobman
Capital Returns Management, LLC

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. Third Quarter Earnings Call. At this time, I would like to inform you that this conference is being recorded and that all participants are in a listen-only mode. At the request of the company, we will open the conference up for questions and answers after the presentation.

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 in 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 the press release announcing second 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 believe 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 8-K contains reconciliation between operating earnings and net earnings. The Form 8-K and press release are available at the company's website at www.rlicorp.com.

I will now turn the conference over to RLI's Chairman and CEO, Mr. Jonathan Michael. Please go ahead, sir.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thanks. Good morning, everyone, and welcome to the RLI teleconference for the third quarter of 2011. Back in August, we announced the retirement of Joe Dondanville, our long-time CFO, and the appointment of Tom Brown into that position. I just wanted to take a minute to thank Joe for his 27 years of service to RLI.

RLI has benefited greatly from Joe's outstanding leadership. During Joe's tenure, RLI has put up an enviable track record that includes posting combined ratios below 100 in 24 of those 27 years. It's also a period of time that saw our stock advance at greater-than-a-15% annual rate, resulting in a 5,000%-plus gain over that span.

Although we will miss Joe, we're pleased to have Tom Brown on-board and participating in today's call. Tom joined us last month from PricewaterhouseCoopers, following a 31-year career within the insurance audit practice.

I'll now turn the call over to our Vice President of Corporate Development and Head of Investor Relations, Aaron Jacoby. Aaron?

Aaron H. Jacoby
Vice President of Corporate Development

Thanks, Jon. I'm going to give some brief opening comments on the quarter, then I'll turn the call over to Mike Stone, President and Chief Operating Officer, to talk about the quarter's operations and market conditions. Then, we will open the call to questions, and Jon will finish up with some closing comments.

Operating income came in at $1.23 per share in the quarter, up from $1.19 last year. Results were positively influenced by favorable development in prior year's loss reserves of $28 million or $0.85 per share. This was primarily in our casualty segment. In the quarter, we also took $6 million of losses related to Hurricane Irene, or $0.18 per share.

The combined ratio for the quarter was 83, matching that of the previous year's third quarter. Year-to-date, the combined ratio stands at 77.

Gross premium in the quarter was up 17%. This quarter represents the first full quarter's worth of results from Contractors Bonding, the acquisition we closed in April. It contributed gross premium of $14 million. Excluding this impact, gross premium growth was 8%, driven by continued positive momentum in some of our newer product initiatives.

Within the investment portfolio, investment income was down 5% on both the quarterly and the year-to-date basis. As Jon noted in the earnings release, our ability to deliver superior underwriting results is particularly important in today's low interest rate environment. Between the positive underwriting and investment returns achieved year-to-date, book value per share has advanced 9% during the first 9 months.

And with that, I'll turn the call over to Mike.

Michael J. Stone
Director

Thanks, Aaron. Good morning, everybody. I'll make a few brief comments on the market and our performance.

A good, if not terrific, quarter. Our underwriters are remained diligent and disciplined, and we are being rewarded as a result. Market rates are moving in the right direction, they stands [ph] the D&O market. We are seeing rate increases in our casualty business on the order of some 1% to 5% of property, around 10% in property driven, to some large degree, by the model change, the RMS 11.

But the weak economy continues to challenge as the exposure base stagnates. And the construction industry is weak, and that industry drives a significant portion of our business, both the E&S business and some of our other businesses, surety, for example, architectural engineers, another example. What we have decided is to be not overly influenced by the amplitude of the market cycle or the state of the economy but rather find ways to thrive, even when external forces are less than helpful, and we are thriving.

We find new avenues for growth, profit. New products represented some 25% of our gross written premium in the quarter. And CBIC is now online and being efficiently and effectively integrated. We have underwriting teams integrated and are now pushing forward, working to grow the small surety book and the package policy for contractors. And CBIC represented some 9% of the gross written premium for the quarter.

As I mentioned a little bit ago, one product that continues to defy underwriting logic is the D&O business where rates continue to decline, even as losses accumulate, and we are being very careful in this arena.

Let's look at the segments. Casualty gross written premiums, up 10% for the quarter. Growth is the function of the acquisition of CBIC as our E&S business is off some 10% and transportation, down as well.

But probably the best current commentary comes from our E&S segments and our transportation. Both groups report improving rates with E&S rates up some 3% to 5% in the quarter. While transportation is flat, that's a significant improvement over the past number of quarters in that business. And as I think I've said before, transportation tends to be the canary in the mine in our business, so as transportation starts to at least feel some improvement, that sort of bodes well as we go forward. So I'd say we're cautiously optimistic, going forward, about the rate.

Still a fragile economy, and that produces a headwind, but we are well positioned for a tailwind. Our new products, for example, professional services, the architects and engineers, professional and miscellaneous professional liability products are growing nicely.

If you look at our property business, it continues to be a significant growth area as pricing allows for a reasonable rate of return. Gross written premium, up some 20% for the quarter, 16% for the year. And as I indicated, the model change has moved rates up, but it also means that it moved exposures up, so there's a sort of a dual edge there.

Our crop reinsurance business is in this segment. As we recorded last quarter, the crop year was under pressure, given the drought and excess moisture, the 2 extremes. We now expect the year to produce a combined ratio north of 100, probably somewhere in the area of 105, though we'll say that, over the 2 years we've been in the business, it has produced a profit for us.

Surety. Our surety segment, gross written premium, up some 42% for the quarter, 21% for the year, CBIC a big driver of this growth. But our organic surety business is up about 5% in the quarter, even though our contract surety was down slightly. Contract surety represents about 25% of our surety gross written premium, so we are well diversified in this space with miscellaneous, oil and gas and commercial representing the other 75%. And the transactional miscellaneous, very low volatility, about 1/3 of the overall surety business.

We have seen some loss activity in our contract book as the economy continues to make it difficult for small contractors. We are managing closely. Our book still looks good. Our model shows that our underwriting is on track, but we need some help from the economy to keep this business going well forward. CBIC's contract book is performing as expected, performing well.

Again, a very good quarter, a testament to all of our associates who remain disciplined and provide world-class service to our customers, agents, brokers and policyholders.

Aaron, back to you.

Aaron H. Jacoby
Vice President of Corporate Development

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Great. Thanks, Mike. We can now open the call up for some questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Mike Grasher with Piper Jaffray.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Mike Stone, I wanted to follow up with you around the -- I think you mentioned the loss activity concerning in the contract books. Are there other loss cost trends or any other lines maybe that are concerning in terms of the trends that are developing?

Michael J. Stone
Director

In the surety book, Mike?

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Not specific to the surety book. Your business overall.

Michael J. Stone
Director

No, I don't think so. I think we have a segment of our E&S business, some habitational business that's been difficult over the past couple of 3 quarters, 4 quarters, and we've been working diligently on that. I think that's starting to show a bit of improvement. Our marine book has had some difficulty. Again, we're seeing improvement there, but difficulty there. The -- certainly, the contract surety, as I indicated, has -- while still doing okay, it's -- we've seen a little bit of bump-up. I think the economy is an issue there. So all in all, I think we're pretty comfortable with where things are, relative to the economy and to the state of the market. Always a few areas we have to work on, Mike.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

And then, you mentioned surety. And aside from the economy, what's the outlook for the business both from organic as well as potential acquisition pipeline?

Michael J. Stone
Director

This is Mike Stone again. I guess, on the acquisition, we certainly don't have anything on the forefront. I mean, we're always looking for new people, new geographies where we don't have much penetration. Obviously, the CBIC acquisition has given us a much, much stronger footprint in the west, particularly the northwest, but the west overall. And we expect to continue to enhance that footprint, if you will. So I think, overall, it's -- the state of the surety markets is pretty good. Contract surety, obviously, always at this stage of the economy, is difficult. We've been through this before, and we went through this before not so good. So we're being particularly vigilant here, and we're watching it closely. We have very seasoned underwriters there, so we'll get through this. And the rest of that surety business is performing very well. So overall, we like our surety business.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Okay. And then final question. Just you brought up the crop reinsurance, and I think that business maybe is up for renewal at year end. Is that right?

Michael J. Stone

Director

That is correct.

Michael Fitzgerald Grasher
Piper Jaffray Companies, Research Division

Okay, and then -- so I mean, you've spoken about the combined ratio there. The government, also making some noise about cutting subsidies around this. How does that impact your thinking around renewing or not renewing this business?

Michael J. Stone
Director

Well, we're obviously talking to those people fairly consistently. And obviously, the amplitude of that will increase as we move towards renewal. But I think we still like the business. Obviously, the economics aren't as good as they once were and, given the noise out of Washington, gives us a little cause for pause. But I think, all in all, we're interested in trying to renew that and trying to renew that on at least as good a terms as we had. So we believe we can still make money in crop going forward. So -- but like I said, it's not what it was 5 years ago. And noise in Washington -- there's always noise in Washington. They got more important things to deal with than crop reinsurance.

Operator

Our next question will come from Randy Binner with FBR Capital Markets.

Randolph Binner
FBR Capital Markets & Co., Research Division

Just a question on the investment yield, trying to get color on how you factor that into underwriting, how that's communicated to your underwriters and how they price product. And if the current pricing in your portfolio of products is kind of adjusted for the current rate environment or if it's lagging and how you plan to address the reinvestment risk.

Michael J. Stone
Director

This is Mike Stone. I mean, I’ll deal with the underwriting side of that, and I’ll let somebody a hell of a lot more knowledgeable deal with the investment side of that. But we look at underwriting, and we're not unmindful of the economics. We're not unmindful of the reserves and the investment returns of that. But we look at underwriting on the basis of straight underwriting profit. What are -- what's our combined ratio going to be? How do we -- how are we going to price that business to enable us to make an underwriting profit, make a risk-adjusted rate of return on our capital applied to that business, that makes sense without regard to the investment income? Now, clearly, with investment rates where they are today, that makes even more sense. Obviously, with interest rates higher, like I said, we're not unmindful of the economics, but we try to do that in all cycles and all economies. And we think we've done pretty well. It certainly serves us well with interest rates where it is today -- where they are today.

Randolph Binner
FBR Capital Markets & Co., Research Division

It's interesting, if I may, I mean, it seems like some of your larger -- some larger insurance companies seem to guide us to believe that there's a more active interaction between underwriting and investment yield. So is your -- do you feel that, when you're out in the market, that, that's affecting your competitors’ pricing? Or is that too hard to tell?

Michael J. Stone
Director

I don't know if that's the reason. But we do know that our competitors, in some instance, are pretty aggressive.

Randolph Binner
FBR Capital Markets & Co., Research Division

Yes, fair enough. And I guess, on the -- I mean, I guess then from a holding company perspective or wherever the investment decision is made, is -- I mean, is there any change in the investment philosophy to deal with the low rate environment?

Jonathan E. Michael
Chairman and Chief Executive Officer

That's -- this is Jon Michael. That's done at the holding company level. And sure, we make tweaks to our investment strategy, but we haven't done anything dramatic for some time to our strategy. The last thing we did that was of any consequence was really moving out of southern and municipals and really reducing our exposure to that municipal portfolio and adding to our corporate portfolio, really.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. So from a modeling perspective, we should just make an assumption of how much the portfolio turns over and just kind of take what the market is giving us on rate?

Jonathan E. Michael
Chairman and Chief Executive Officer

Yes, that's up to you, how you model it. But you can talk to Aaron offline on that, but yes.

Operator

Next, we'll go to Doug Mewhirter with RBC Capital Markets.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

I wanted to, I guess, explore a little bit more into your sources of growth in the quarter. Property was up pretty nicely, and it looks like maybe even 1/2 of that could've been from rate increases. And you also said because of the model -- if the model changes that you’d increase exposure units. Are you saying that, that would increase exposure units from your customers too? So would that add on again to the premium growth figure? Or is that sort of exposure that you would be taking on, even though you're basically selling the same amount of products, so to speak?

Michael J. Stone
Director

This is Mike Stone. I think I -- what the model change did was increase the amount of exposure in various places. We were able to get more rate against that exposure because of that. We didn't grow units in the quarter. So overall, I mean, again, if the unit was 1, we're still at 1 even that the model would look at it as being 2. So -- but we didn't grow policies, so our -- so you could say, most of it is rate from an E&S property standpoint. Our marine business is in that segment as well, and we had a little growth there.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Okay, and that actually answers the question I was trying to ask. And you said you had -- 25% of your gross written premiums a quarter was due to "new products." Is that inclusive of the CBIC portion?

Michael J. Stone
Director

Yes.

Douglas Robert Mewhirter
RBC Capital Markets, LLC, Research Division

Okay. My second question deals more with your source to favorable development. Can you give an idea of where -- accident years and maybe product lines that the majority of that development came from this quarter?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, Doug, it's Tom Brown, happy to do that. As you can see, it's largely from casualty, pretty much accident years 2006 through 2010 coming largely from general liability, umbrella and transportation.

Operator

Our next question will come from Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

In the E&S market, you're obviously -- sounded like the environment is better. Are you seeing the standard carriers being more conservative, and as a result, are you seeing submissions come up?

Michael J. Stone
Director

It's Mike Stone again. I think we've been so pounded by the standard guys over the last couple of 3 years that it doesn't feel like they've gone away. I think that we're starting to see a little recognition of the losses, so I would suspect we'll start to feel that more in the coming quarters. But I don't think we really felt it this quarter. Again, if you ask our underwriters, almost in any product, E&S product, who their biggest competitor is, almost all of them would name a couple of the standard line companies.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. Okay, so that suggests that, if the standard lines do become more conservative going forward, that the environment would actually improve more than it is today. Is that right?

Michael J. Stone
Director

Yes. I think your logic is right. Whether or not that happens is another question.

Adam Klauber
William Blair & Company L.L.C., Research Division

Sure, sure. Sure, but there's a ways to go if they do become more conservative.

Michael J. Stone
Director

No question about that. There are certainly opportunities -- let me back up. Certainly, there's plenty of competition just from just the E&S guys. So we'd love to see the standard guys go back to -- stick to their knitting back in the standard line space. There'd still be plenty of competition. There'd still be plenty of capacity, but I don't suspect they're going to completely pull out. But maybe they'll start to see that they've been a little too aggressive and will pull back.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. Overall, I mean, definitely, it seems like growth is up over the last couple of quarters. As you think about your capital positioning, potential capital return, last year, you obviously had a big dividend. Does that change your view that you have more growth potential now? Does that change your view on potential capital return in the near term?

Jonathan E. Michael
Chairman and Chief Executive Officer

Jon Michael here. We're constantly monitoring net capital position. And certainly, when we have -- our attitude has always been that we want to use the capital ourselves. And we look for opportunities, and if that -- if those opportunities come from organic growth or growth in our business through acquisition or other new business, then that's where we would want to use it as opposed to returning it. But on the other hand, if we find that we don't have those opportunities, then we'll return it. So obviously, having 2 quarters in a row with -- of sizable growth and good growth, we're happy for that. And that will come into our thinking on capital.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. Also, on the property loss ratio, even excluding Irene, looks like the accident year’s up maybe 600, 700 basis points. Was that some of that factors you mentioned earlier as far marine and some of the other losses ticking up during the quarter? Or I guess, what's driving that higher property loss ratio, x Irene?

Michael J. Stone
Director

Yes, it's Mike Stone. We've -- our business, probably up a little bit, and RLI Re, our facultative reinsurance business, and crop is also in there.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay, okay, that makes sense. And then finally, I'm sorry I missed the answer to the last question. On the Federal Reserve development, which underwriting years did that come from?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

It's Tom Brown. We could -- I'd say it's coming in casualty from all -- spread across all accident years, but you'll see it a little more significant in the 2006-through-2010 accident years.

Operator

We'll now go to our next question from Ron Bobman with Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I had a question just about surety, contract surety in particular. It's sort of clear you're communicating, I don't know, some greater degree of carefulness and just a watchful eye. I'm curious to know, if you strip out CBIC and you look at the contract surety book and its size currently, how does that compare in size to, I don't know, 2007, which, I would hazard a guess, might have been the peak year? But I'm just curious to know, volume-wise, have you been dialing it back?

Michael J. Stone
Director

Well, I think, if we look at our surety business, I think it's fairly consistent, within the surety business, the size of our contract surety. Our contract surety has been probably anywhere from 15% to 25% of our overall -- even up maybe 30% at one point in time of our overall surety segment, never a dominant force. But I wouldn't say dialing it back. I think we've been pretty careful. We've added quite a bit of geography over the last 3 or 4 years. So we've added underwriters in places where they've got a following and a track record. So I think we have increased a bit the size of surety bond that we'll write at RLI, just a little bit larger. We're still a fairly small contract surety underwriter from that perspective. So we -- long-term, we still like contract surety. It's -- this is the state, time of the market, you got to be awfully, awfully careful where the economy is, and we think we’re being that.

Ronald David Bobman
Capital Returns Management, LLC

What are you doing on the lost picks? Are you keeping them the same? Again, for that contract surety book, what is your current lost pick for that segment? And has it changed?

Michael J. Stone
Director

It hasn't really changed, no.

Ronald David Bobman
Capital Returns Management, LLC

And would you provide us a number?

Michael J. Stone
Director

For contract?

Ronald David Bobman
Capital Returns Management, LLC

Yes.

Michael J. Stone
Director

We don't break -- we don't provide those kinds of numbers. I mean, we're not afraid of it, but we don't -- we're not getting down a little too granular on loss picks. Our overall surety loss pick is 15.

Ronald David Bobman
Capital Returns Management, LLC

Including miscellaneous and the whole book? Okay, I would imagine.

Michael J. Stone
Director

Including all [ph].

Operator

[Operator Instructions] We'll now go to Vincent DeAugustino with Stifel, Nicolaus.

Vincent M. DeAugustino
Stifel, Nicolaus & Company, Incorporated, Research Division

Just one question. Just help us out with modeling the casualty reserve releases since they've been a source of much stronger earnings than at least what we've been looking for in the last 2 quarters. I'm just curious, are the actual adjustments driving those releases more of a series of unrelated onetime adjustments? Or as it stays as long as the status quo environment remains unchanged, we should expect similar type of releases going forward?

Jonathan E. Michael
Chairman and Chief Executive Officer

Vincent, Jon Michael here. It was hard to hear your question, but I think you were once again asking about the reserve releases and trying to get a bit more granular on the reserve releases and whether or not they were onetime reserve releases or a pattern. I think we always think of reserve releases as onetime occurrences. But obviously, when we look back, we have had a pattern of reserve releases, and you can take that for what it's worth. But our best effort each quarter when we -- when our actuaries come to us and provide us with the actuarial estimates for all the various accident years in all the various lines of business is to be right on with where we believe our loss reserves ought to be. So looking forward, I can't really give you any advice looking forward, other than to say it is what it is.

Operator

And we'll now move to our next question from Matt Carletti with JMP Securities.

Christine Amanda Worley
JMP Securities LLC, Research Division

It's actually Christine Worley. I just had a question. If you have any further disclosure as far as other losses that affected you in the quarter from something like Texas wildfires or any creep from prior-2011 events?

Michael J. Stone
Director

It's Mike Stone. No.

Christine Amanda Worley
JMP Securities LLC, Research Division

You didn't have any other losses?

Michael J. Stone
Director

We didn't have anything from Texas wildfires of any consequence. And I don't think there's any creep as well from prior catastrophes.

Operator

And with that, gentlemen, there are no further questions. I will now turn the conference back to Mr. Jonathan Michael.

Jonathan E. Michael
Chairman and Chief Executive Officer

Thank you very much.

And another good quarter is in the books. Premiums were up 17% for the quarter. Our combined ratio for the quarter was 83. Our acquisition of CBIC and its integration have gone very smoothly. Book value per share continues to increase and stands at over $41, a 9% increase since the beginning of the year.

We're a highly respected company in the industry with a diversified product portfolio. We're not everything to everybody. We are different. While not absolute, our business is specialty. It's domestic. And it's underwritten by our own employed and highly motivated underwriters. That does make us different. I think, when you see the respect we get in the industry, you can see where it's coming from. It's coming from our associates and our underwriters and what they do for our customers.

I want to thank everybody for joining us again today and welcome to Tom Brown and thank Joe Dondanville for all his years of service. And we'll talk to you again next quarter. Thank you.

Operator
And ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 1 (888) 203-1112 with an ID number of 4692689. This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.