S&P Capital IQ

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Mercury General Corporation NYSE:MCY

FQ3 2016 Earnings Call Transcripts

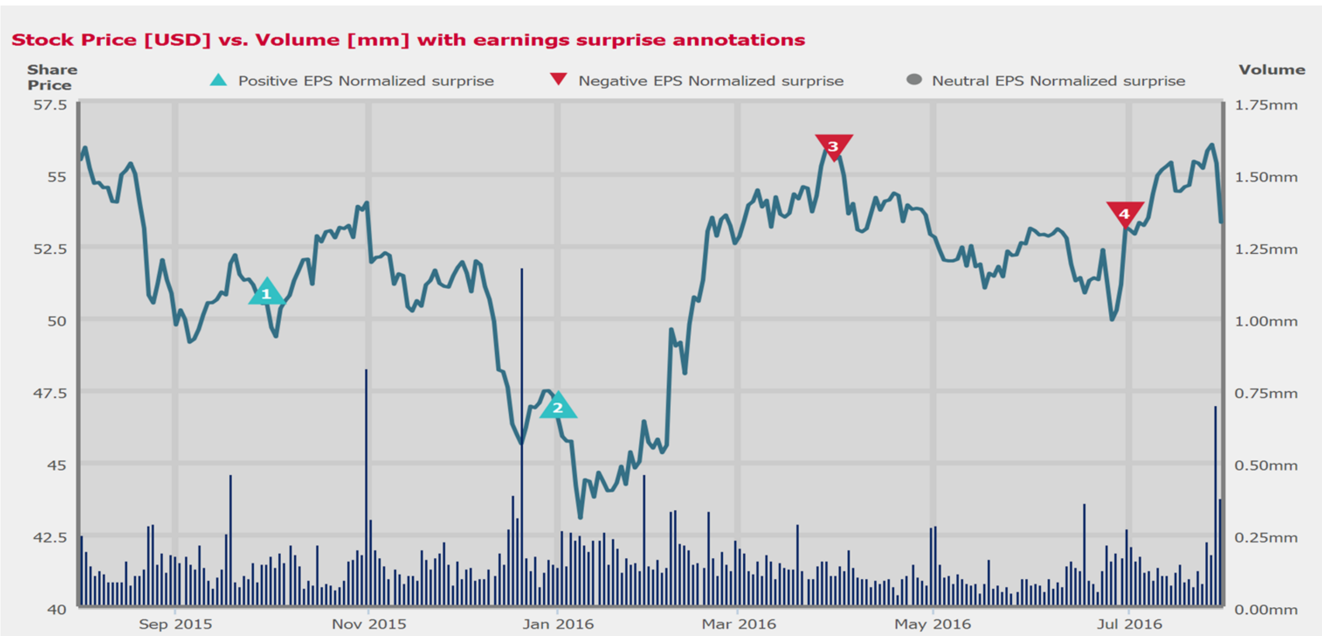
Monday, October 31, 2016 5:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2016-			-FQ4 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.54	0.67	▲24.07	0.42	1.44	2.48
Revenue (mm)	826.45	808.38	▼(2.19 %)	784.23	3190.00	3345.00

Currency: USD

Consensus as of Oct-19-2016 6:51 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2015	0.58	0.59	▲1.72 %
FQ4 2015	0.45	0.52	▲15.56 %
FQ1 2016	0.68	0.13	▼(80.88 %)
FQ2 2016	0.59	0.35	▼(40.68 %)

Call Participants

EXECUTIVES

Christopher Graves
Chief Investment Officer and Vice President

Gabriel Tirador
Chief Executive Officer, President and Director

Robert Houlihan
Chief Product Officer and Vice President

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

ANALYSTS

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

Jay Adam Cohen
BofA Merrill Lynch, Research Division

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

Ronald David Bobman
Capital Returns Management, LLC

Presentation

Operator

Good morning or afternoon. My name is Michelle, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General Quarterly Conference Call. [Operator Instructions]

This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial and industry trends, which may affect Mercury General's future operating results and financial position. Such statements involve risks and uncertainties, which cannot be predicted or quantified and which may cause future activities and results of operations to differ materially from those discussed here today.

I would now like to turn the call over to Mr. Gabriel Tirador. Sir, please go ahead.

Gabriel Tirador
Chief Executive Officer, President and Director

Thank you very much. I would like to welcome everyone to Mercury's Third Quarter Conference Call. I'm Gabe Tirador, President and CEO. In the room with me is Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; Chris Graves, Vice President and Chief Investment Officer; and Robert Houlihan, Vice President and Chief Product Officer.

Before we take questions, we will make a few comments regarding the quarter. Our third quarter operating earnings were $0.67 per share compared to $0.59 per share in the third quarter of 2015. The improvement in operating earnings was primarily due to an improvement in the combined ratio from 99.2% in the third quarter of 2015 to 98.1% in the third quarter of 2016.

In California, we recorded an increase in personal auto severity in the mid-single-digit range for the 2016 accident year and an increase in frequency in the low single digits.

Industry trends reflect frequency in California increased about 3% and severity about 6% for the 12-month period ending June 2016. To help offset the increase in loss trends, we have been increasing rates in California. This year, for our personal auto business in California, we implemented a 5% rate increase in late March 2016 for Mercury Insurance Company and a 6.9% rate increase in June 2016 for California Automobile Insurance Company.

Personal auto premiums in Mercury Insurance Company represent about half of our company-wide premiums and earned and California Automobile Insurance Company represents about 15% of our company-wide premiums earned.

We have observed a significant number of our competitors also file for rate increases in California.

Outside of California, increasing loss cost trends and higher loss ratios that come with an increase in new business have negatively impacted our results. To address profitability outside of California, we have been increasing rates and tightening our underwriting.

The expense ratio in the quarter declined to 25.2% from 26% in the third quarter of 2015. The decrease in the expense ratio was primarily due to lower profitability-related accruals. Net advertising expense in the quarter was $10 million compared to $11 million in the third quarter of 2015.

Premiums written grew 3.8% in the quarter primarily due to higher-average premiums per policy. Company-wide, private passenger auto new business applications submitted to the company decreased approximately 15% in the third quarter of 2016, as we focus on improving profitability in our private passenger auto line.

Company-wide homeowners applications increased about 1% in the third quarter of 2016. In California, we posted premiums written growth of 5.7%; outside of California, premiums written decreased by 4.4% in the quarter.

We are pleased to report the Superior Court of California ruled in our favor vacating the commissioner's 2015 order that had imposed a penalty of $27.6 million against the company. The principal findings of the Superior Court order were: that the broker fees at issue were not premium and the charging of such fees did not result in any violation of insurance code rate regulation provisions; the $27.6 million penalty imposed violated Mercury's right to fair notice and due process; and there was an unreasonable delay by the department in issuing the notice of noncompliance in 2004, which resulted in a manifest injustice to the company. The financial statement recognition of the reversal of the $27.6 million penalty, plus any related interest, is yet to be determined as the Superior Court's order is subject to appeal.

Lastly, we generally expect our accident quarter combined ratio for the fourth quarter to be higher than the rest of the year due to increased loss frequency and higher severities caused by seasonal driving and weather. That said, it is hard to predict with certainty whether the combined ratio will be higher as there are many factors currently unknown or beyond our control.
With that brief background, we will now take questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Greg Peters from Raymond James.

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

Just a couple of questions for you on the severity commentary. I think last quarter, you said it was high single digits, so now we're reverting back to a mid-single-digit. Is there anything sequentially in the trend that looks a little bit better in the third quarter versus the second quarter or the first half of the year?

Gabriel Tirador
Chief Executive Officer, President and Director

Really here, we're talking about maybe a 1 point difference. I mean, it's all [indiscernible]. Ted, you want to elaborate?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes. I mean, Greg, the difference between the mid and high maybe is the matter of instead of a 7 or 8, it's a 6 or a 7. So -- and that may just have to do with our picks more than anything, so [indiscernible].

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

That's perfectly understandable. So can you just step back for a second? And I note your commentary on the expense ratio and the profitability accruals. Maybe you can sort of walk us through the logistics behind that, especially considering the possibility that going forward, your results may begin to improve a little bit as all the rate increases continue to flow through your book of business.

Gabriel Tirador
Chief Executive Officer, President and Director

It's primarily related to bonus accruals. And because of the poor underwriting results this year, we're not really accruing for a bonus accrual this year. So that amounts maybe 0.6 of a point. Half of that or maybe a little bit more than half of that is loss adjustment expenses and the other half is underwriting expense.

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

I see. And so if the underwriting results improve next year at this time, we could expect a reversal where the bonus accrual trend might move against the company, is that correct?

Gabriel Tirador
Chief Executive Officer, President and Director

That is correct. And I think a full bonus accrual maybe in the neighborhood of $20 million.

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

And for the full year, that is, right, or for the quarter?

Gabriel Tirador
Chief Executive Officer, President and Director

For the full year, Greg, for the full year.

Charles Gregory Peters

Raymond James & Associates, Inc., Research Division

And where do you think it's going to come up this year?

Gabriel Tirador
Chief Executive Officer, President and Director

0.

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

0. Oh, okay. So just reverting back to the severity, the commentary upon the current quarter and frequency, I know I've asked you this on previous calls and it always is worth asking again. Where do you think you are in the possibility of filing for additional rate increases as both severity and frequency trends continue to march forward in the context of your California book of business?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, in Cal Auto, we have a 6.9% rate pending with the Department of Insurance, so that's already in there. And that's California Automobile Insurance Company. In Mercury Insurance Company, I believe there's a pretty good likelihood that within the next, I would say, 90 days, that we will file a class plan that will include some sort of rate increase.

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

For Cal Auto, the 6.9% is pending? That's on top of the 6.9% that was effective in June?

Gabriel Tirador
Chief Executive Officer, President and Director

That is correct.

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

Yes, okay. On the non-California business, is there any one state of the remaining states that are in that business that are more problematic than others? Or perhaps you could just provide some additional color around what's going on in your business outside of California.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, the biggest 2 states outside of California are Florida and Texas. And the results have been poor in those states as a result of what I mentioned earlier. We had a lot of new business growth. In addition to that, the trends were high in those 2 states. But we feel that with the rate changes that we've made, some other procedural changes, that we're going to be much better positioned going into 2017. So some of the smaller states in the Northeast with respect to New York and New Jersey, we've made improvements in those 2 states, and we continue to make improvements in those 2 states. But the 2 bigger states outside of California, Florida and Texas, we feel that we have made the changes and are continuing to make the changes to basically get us well positioned for 2017.

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

And by well positioned, do you mean positioned to start growing again or positioned for profitability to hit your hurdles or both?

Gabriel Tirador
Chief Executive Officer, President and Director

Profitability, profitability. Yes, I think next year, the growth is going to be outside of California down as a result of the rate changes and other revenues that we've taken to improve profitability. So I think it's more of a profitability play outside of California right now.

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

Okay. So I just want to -- kind of just to clarify your last comment. Is it policy count that's going to be down outside of Florida or premium, total premium or both?

Gabriel Tirador
Chief Executive Officer, President and Director

I anticipate that both will probably be down next year.

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

Okay. Probably one final clean-up area. Perhaps Chris could comment on the investment portfolio. I was looking at both pretax and after-tax income is down year-over-year and the average invested assets is up. Perhaps you could give us commentary on how we think that's going to look going forward.

Christopher Graves
Chief Investment Officer and Vice President

Yes, Greg. Well, a lot of that I think, as you'd understand, is interest-rate related. We've got it on the books with much higher book yields than current market rate, they're being reinvested perhaps a point or more less than what they were on the book. So even with increased cash flows coming into the portfolio, current rates don't allow for us to fully offset what we're losing. So it's a bit of a battle, but I think in the past 2 years, we've provided some reasonable growth. This year is a bigger challenge, but I think that we should be able to at least maintain where we currently are especially with rates at these levels. And then we'll just see what the company does with these rate increases and what they allow me to reinvest.

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

So just to close the loop on that commentary. If the interest rate environment stabilizes at this point or is stable from this point going forward, when would the yield on your total portfolio start to bottom out? Does that happen next year, or is it happening right now, or do we still have some more runway?

Gabriel Tirador
Chief Executive Officer, President and Director

No, it would still take a little bit more for rates to move higher before I think we'd see what you can call a bottoming. But it could easily be eclipsed with reasonable cash flows coming into the portfolio.

Operator

Your next question comes from Ken Billingsley from Compass Point.

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

Question for you on just following up on your commentary earlier, and I think, Gabe, you answered some accrual questions for him, but maybe I just wrote this down wrong. You said the lower expense ratio and I wrote down lower property-related accruals. Did I hear that wrong?

Gabriel Tirador
Chief Executive Officer, President and Director

Possibility, they're basically bonus.

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

Yes, okay. That makes a lot more sense. And then I got the commentary that you answered earlier for Greg here. So then let me just move on to this just a couple of follow -- fill-in questions. The mix of the business for what, I guess, in the market generally considers standard versus nonstandard mix of business. Could you give me what your percentage is today and maybe how that's changed over the last year?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, I think that's hard to measure nowadays. Those lines are blurred, but let's talk about our biggest state in California where we consider Mercury Insurance, our biggest state obviously and our biggest company here in California. We consider that our preferred company, and that represents about -- I said earlier, about 50% of our company-wide premiums. And then we have Cal Auto, which is what we refer to as kind of mid-market, nonstandard, and that represents about 15%. So that's about 65% of the business. Outside of California, we are more towards the nonstandard arena as far as risk classifications go. Robert, would you have any other comments on that?

Robert Houlihan
Chief Product Officer and Vice President

Certainly, in terms of new business and in terms of our portfolio, I think it starts to skew more renewal books gets more towards standard, even outside of California.

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

So the renewal book, in general, is shifting more towards standard, you said?

Robert Houlihan
Chief Product Officer and Vice President

No, I'm just saying the new business probably skews more standard, but because of the lower policy life expectancy, when you look at the renewal book, it actually skews more standard.

Gabriel Tirador
Chief Executive Officer, President and Director

Renewal is by definition, if they renew it long enough, they're more standard generally, is the point. But as far as new business goes, I would say we skew more nonstandard outside of California.

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

Okay. And then within California, obviously, I know it's a big state, but is there any specific geographic concentrations above the, I guess, 65% of your premium that's in the state? Is it concentrated 50% in certain county or 2?

Gabriel Tirador
Chief Executive Officer, President and Director

Southern California represents the majority. I would have to say off the top of my head, Robert, maybe 70% of the business down here in Southern California versus Northern California. That's off the top of my head and…

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

[indiscernible].

Gabriel Tirador
Chief Executive Officer, President and Director

Yes, that's where all the people are at.

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

Sure. Okay, pretty broad. And then, the last question I have is, could you just update on ad spending? I mean, if you're looking -- expecting to write maybe less outside of California, can you talk about your ad budget and ad spending plans and how that may be affecting the expense ratio now and going forward?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we haven't decided yet for 2017. Our best expectation right now is that it would probably remain flat, but that has not been finalized yet for 2017.

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

Would you -- I understand your answer here, but would you be considering staying with the national campaign as opposed to being focused? And does that cover California for you as well? Or do you have a specific ad plan in California?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, we advertise locally in California as well besides the national. So we do that already. And we still haven't evaluated whether or not we're going to still continue with the national, that's something still under evaluation. But we have always advertised here locally as well, even though we have some national ad spend.

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

Okay. And can -- do you have, off the top of your head, what the national ad campaign was on an annual basis? What the cost was?

Gabriel Tirador
Chief Executive Officer, President and Director

Ted, do you have how much total advertising expense?

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Our total is about $40 million, $42 million, I think, but…

Gabriel Tirador
Chief Executive Officer, President and Director

In the neighborhood of $40 million, yes.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes, but just like Gabe mentioned, the national is one component of that. I think it's maybe even less than half of that, because we do a lot of digital advertising, sports advertising.

Gabriel Tirador
Chief Executive Officer, President and Director

And he's talking just about the national substantially.

Theodore R. Stalick
Chief Financial Officer and Senior Vice President

Yes.

Gabriel Tirador
Chief Executive Officer, President and Director

Robert, do you have any?

Robert Houlihan
Chief Product Officer and Vice President

Yes, it's a little less than half.

Operator

Your next question comes from Jay Cohen from Bank of America.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

A couple of questions. For the fourth quarter, do you have any sense yet what Hurricane Matthew will do to the results?

Gabriel Tirador
Chief Executive Officer, President and Director

We think at this point, it's not going to be material, Jay. Maybe $1 million to $2 million is our best estimate right now from the data that we have.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Great. That's helpful. And then secondly, I guess, outside of California, as your shrink, obviously, the goal is to improve the loss ratio. But at some point, would you have a scale issue? It's going to be lack of scale, whether it's with the agents, more from a claims standpoint. How do you deal with that balance, guys?

Gabriel Tirador
Chief Executive Officer, President and Director

Well, one of the things that we did, I guess, the last year sometime where we centralized our hubs so that we can get more scale. And now we have basically some central hubs in Florida and Texas and in California. And we closed down a lot of the other hubs that we had so that we can get some more scale and efficiencies. So -- that -- we've tried to deal it with that so that we can basically centralize our operations and get more leverage. With the top line declining, it does put added pressure. There's no question about that. It's something that we will have to take a look at it and see how much added pressure it's going to be adding.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Got it. But you've to build in, I guess, some -- at least some flexibility to the system there?

Gabriel Tirador
Chief Executive Officer, President and Director

Yes. We did that, when did we do that?

Robert Houlihan
Chief Product Officer and Vice President

2 years.

Gabriel Tirador
Chief Executive Officer, President and Director

Two years ago, I guess we did that, Jay, where we centralized our operations outside of California. We have major hubs now that basically service many states.

Jay Adam Cohen
BofA Merrill Lynch, Research Division

Yes, I do remember you guys doing that. That's helpful.

Operator

[Operator Instructions] Your next question comes from Ron Bobman from Capital Returns.

Ronald David Bobman
Capital Returns Management, LLC

I had a question on rates. Obviously, it sure seems like everybody in the business is pushing rate. And I'm wondering if you'd talk a little bit about retention, maybe regionally, but also, are you seeing less shopping and thus better retention? Maybe all companies are doing so by virtue of the common lift in rates that all carriers are pushing. I'm curious to get your thoughts and your view.

Gabriel Tirador
Chief Executive Officer, President and Director

I'm going to let -- Robert, why don't you talk about retention, because it is better than we expected actually.

Robert Houlihan
Chief Product Officer and Vice President

Yes. Certainly, in California, as you say, a turbo-rising tide, we're seeing rate increases and underwriting actions from all of our competitors. And with the rate increases, our new business application counts have held steadier, perhaps moved up slightly and our retention is only down a point-or-so despite all the rate that we've taken.

Gabriel Tirador
Chief Executive Officer, President and Director

I mean to give you an idea of some of the rate action, you have a lot of rate activity that has already occurred. In addition to that, you have a lot of rate funds that are pending. You got GEICO, Allstate, Farmers, Infinity, 21st Century, [indiscernible] Progressive, State Farm, the Northern Club, all with pending 6.9% or thereabout rate increases pending.

Ronald David Bobman
Capital Returns Management, LLC

And I'd be curious to know whether the state's taking any different approach, I guess, time line-wise as far us approving the 6.9s%. And I think the 6.9% is sort of a typical threshold without having a hearing, but correct me if I'm wrong. And then could you comment about other states? And what's going on retention and rate-wise, sort of the same question, but at you look at your other states?

Gabriel Tirador
Chief Executive Officer, President and Director

Robert?

Robert Houlihan
Chief Product Officer and Vice President

Yes. So there's a couple of questions there. Time wise, the reviews with the Department of Action have actually been quicker than historical time lines. So that hasn't been an issue. Outside of California, it's a little bit of mixed bag. There are some states where the rate increases are moving us into a less competitive position, thus some of Gabe's comments about the slowdown in growth or actually decline in premium because we are becoming less competitive in a few states and we have seen some decline in retention in a few states as our rates have become a little bit uncompetitive.

Ronald David Bobman
Capital Returns Management, LLC

I would have thought it would be more common. We hear from so many auto companies that are pushing rate, but I guess, it's -- it varies by state and so you're seeing the differential.

Operator

I have no further questions at this time. I turn the call back over to the presenters for closing remarks.

Gabriel Tirador
Chief Executive Officer, President and Director

Well, thank you very much for joining us this quarter. We look forward to talking to you again next quarter. Thank you.

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