# Mercury General Corporation NYSE:MCY

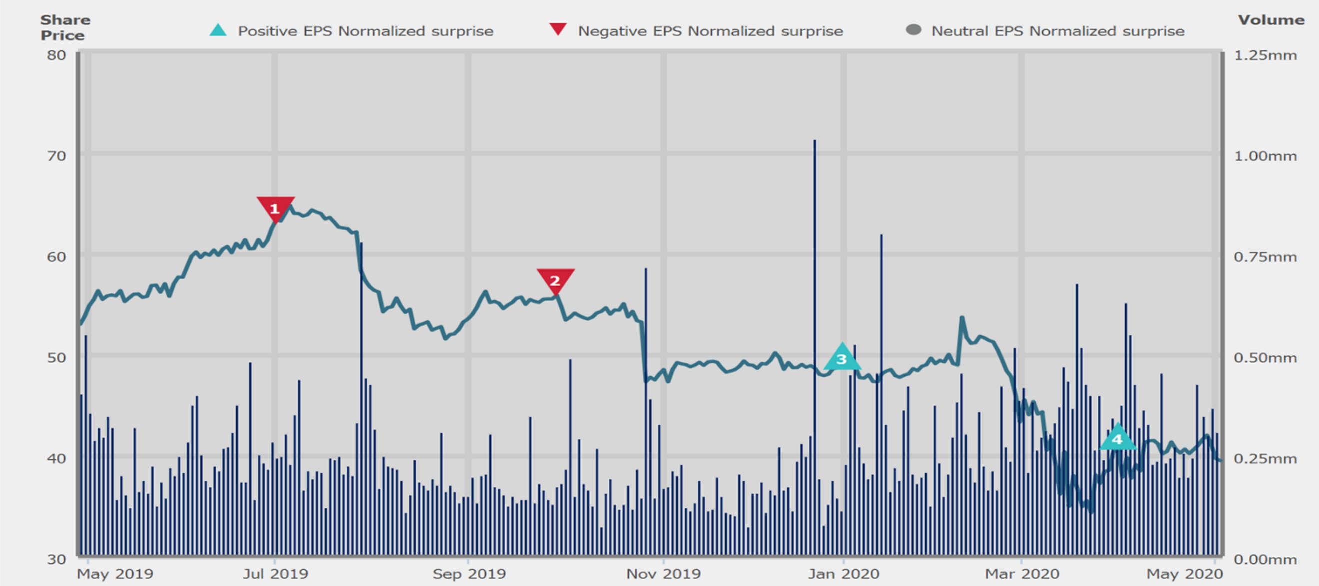
# FQ1 2020 Earnings Call Transcripts

## Monday, May 04, 2020 5:00 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ1 2020- | | | -FQ2 2020- | -FY 2020- | -FY 2021- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| EPS Normalized | 0.84 | 1.07 | ▲25.88 | 0.94 | 3.28 | 3.42 |
| Revenue (mm) | 927.89 | 954.22 | ▲2.84 | 915.37 | 3734.61 | 3837.13 |

Currency: USD
Consensus as of Apr-13-2020 10:29 PM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| FQ2 2019 | 1.03 | 0.74 | ▼1 (28.16 %) |
| FQ3 2019 | 1.08 | 0.78 | ▼2 (27.78 %) |
| FQ4 2019 | 0.18 | 0.21 | ▲3 16.67 % |
| FQ1 2020 | 0.84 | 1.07 | ▲4 25.88 % |

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# Call Participants

## EXECUTIVES

**Christopher Wadewitz Graves**
*VP & Chief Investment Officer*

**Gabriel Tirador**
*President, CEO & Director*

**Jeff Schroeder**
*Chief Product Officer & VP*

**Theodore Robert Stalick**
*Senior VP & CFO*

## ANALYSTS

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

# Presentation

**Operator**

Good afternoon. My name is Jason, 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**
*President, CEO & Director*

Thank you very much. I would like to welcome, everyone, to Mercury's First Quarter Conference Call. I'm Gabe Tirador, President and CEO. On the phone, we have Mr. George Joseph, Chairman; Ted Stalick, Senior Vice President and CFO; Jeff Schroeder, 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. The impact COVID-19 is having on the world is unprecedented. Our hearts and prayers go out to everyone affected by this crisis. I'd like to thank our 4,000-plus team members for their efforts and resilience during this time. Our investments in technology over the past few years allowed us to smoothly transition our team members to work from home. We are fully functional in serving our customers and agents well.

In the first quarter of 2020, the company lost $139.2 million or $2.51 per share, which includes $198.5 million of after-tax losses on our investment portfolio. Pretax investment losses represent 6% of the portfolio value at December 2019. The majority of those investments are mark-to-market adjustments on securities that continue to be held by the company. Our first quarter operating earnings were $1.07 per share compared to $0.87 per share in the first quarter of 2019. The improvement in operating earnings was primarily due to a reduction in the combined ratio from 97.3% in the first quarter of 2019 to 95.9% in the first quarter of 2020.

Catastrophe losses in the quarter were $2 million compared to $5 million in the first quarter of 2019. The company recorded $15 million in unfavorable reserve development in the quarter compared to $1 million in the first quarter of 2019. Excluding the impact of catastrophe losses and unfavorable reserve development, the combined ratio was 93.8% in the quarter compared to 95.9% in the first quarter of 2019. Our private passenger auto combined ratio was approximately 93.6% in the first quarter of 2020 compared to 96.8% in the first quarter of 2019. The improvement in the private passenger auto combined ratio was primarily due to higher average premiums from rate increases taken during 2019, less unfavorable reserve development and a reduction in frequency, partially offset by an increase in severity. The company recorded $3 million of unfavorable reserve development in our private passenger auto line of business in the quarter compared to $10 million of unfavorable reserve development in the first quarter of 2019.

Our homeowners combined ratio was 101% in the first quarter of 2020 compared to 102% in the first quarter of 2019. Our homeowners results were negatively impacted in the quarter by $6 million of unfavorable reserve development compared to $8 million of favorable reserve development in the first quarter of 2019. Homeowners catastrophe losses in the quarter were less than $1 million compared to $3 million in the first quarter of 2019. Excluding the impact of reserve development and catastrophe losses, the homeowners combined ratio was 95.3% in the quarter compared to 100.6% in the first quarter of 2019. To improve our homeowners' results, a 6.99% rate increase in our California homeowners line went into effect on April 21. This rate increase is on top of a 6.99% California homeowners' rate increase implemented in August of 2019. California homeowners' premiums earned represent about 87% of company-wide direct homeowners premiums earned and 14% of direct company-wide premiums earned.

Our commercial auto business posted a combined ratio of approximately 100% in the first quarter of 2020 compared to 102% in the first quarter of 2019. Those results included approximately $5 million of unfavorable prior year reserve development in both the first quarter of 2020 and 2019. Excluding the impact of reserve development, the combined ratio was 91% in both the first quarter of 2020 and 2019.

The expense ratio was 25.3% in the first quarter of 2020 compared to 24.8% in the first quarter of 2019. The higher expense ratio is primarily due to a $7 million increase in the company's bad debt provision. The increase in the bad debt provision was made in anticipation of a higher number of premium balance write-off as payment due dates are being extended to customers facing financial difficulties due to COVID-19.

Premiums written grew 4.1% in the quarter, primarily due to higher average premiums per policy and an increase in homeowners policies written. Private passenger auto and homeowners new business applications are down over 20% and 10%, respectively, as compared to the weeks prior to the coronavirus outbreak.

As previously announced, we are giving back 15% of monthly auto insurance premiums to personal auto customers for 2 months as less driving during the COVID-19 pandemic has resulted in fewer accidents and claims. Accordingly, we expect second quarter premiums written and earned to be reduced by approximately $78 million as a result of the giveback. We will continue to monitor the extent and duration of the economic impact related to COVID-19 and make further adjustments as necessary.

We expect our underwriting and loss adjustment expense ratios to increase in future quarters as premiums decline without a proportionate reduction in expenses. Agent compensation will not be reduced for the premiums we are giving back. With that brief background, we will now take questions.

# Question and Answer

**Operator**

[Operator Instructions]

Your first question comes from the line of Greg Peters from Raymond James.

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

My first question would be for you to explain what the difference is in your 15% of 2-month refunds to private passenger customers. What's the difference between that plan and what the California Insurance Commissioner has ordered, if there is any difference?

**Gabriel Tirador**
*President, CEO & Director*

Well, there -- the California Commissioner did not order any specific type of percentage giveback. He just ordered companies to give back premium, but did not order any type of specific giveback. He did say was for a certain duration starting in March and April as well, and that he would further update any order going forward as he felt necessary. I don't know, Jeff, do you want to add anything else to that?

**Jeff Schroeder**
*Chief Product Officer & VP*

No, Gabe, you said it correctly. I would just reiterate the point that we have been consistent with the time frame that the Commissioner set out.

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

Great. And your -- for your 2 months, I thought your -- so none of the refunds were effect -- in effect for the March quarter. So I assume you're going to sort of retroactively refund for March and then also April in the next 2 -- next month or 2.

**Gabriel Tirador**
*President, CEO & Director*

Yes. That's correct. From March 18, I think, it is to May 17, will impact the second quarter. And that's the approximately $70 million that I mentioned in my prepared remarks.

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

And Gabe, did you guys go -- did you get approval from -- did you notify the Commissioner you're doing this? Did they sign off on it? Did they give you a seal of approval on it?

**Gabriel Tirador**
*President, CEO & Director*

The order basically gave -- didn't require any kind of formal approval -- his order did not require a formal approval. He just asked companies to do it, and there is no formal approval required.

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

Great. And so in your comments, you said that the underwriting expense wouldn't -- the ratio would go up because the underlying expense hadn't changed. I suppose there's some prevailing wins with the loss ratio too, right? Lower accident frequency drives the loss ratio down, but you're getting a lower premium. So is that a net-net push? Or how's -- what's your view on that?

**Gabriel Tirador**
*President, CEO & Director*

Well, yes, we're going to be giving back premium as a result of the lower frequency, as we mentioned. And we're going to have to just evaluate going forward what that means with respect to how long this continues and make determinations at that time. So there are some offsetting things going on as you -- for example, severity could be going up for both BI and material damage. It was going up -- before pre-COVID, it was going up. And there's evidence of increasing speeds associated with less congested roads and highways, which leads to more serious accidents. There's potential for cost pressures on parts that -- due to potential supply chain issues. So there's a lot of uncertainty right now, I would say. On the top line, our top line is going to go down. We have the premium giveback. We have a little bit lower new business volume as well.

On the loss side, losses are down, but we also have higher bad debt provision. How this nets out, we're going to have to see in future months, and we're basically monitoring it very closely.

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

Got it. Actually, it's good color. Can you just update us -- I think there was a couple of active rate filings in the pipeline. Have those been sidelined for the time being?

**Gabriel Tirador**
*President, CEO & Director*

Yes. I'll have Jeff answer that.

**Jeff Schroeder**
*Chief Product Officer & VP*

Yes. Greg, prior to the pandemic, we were seeing severity increases in California personal auto, still outpaced the frequency declines. And hence, the rate filings that we had here in California, they remain outstanding with the California Department of Insurance, but we don't expect the department to act on our applications during the state of emergency. So you can say that they're on hold right now.

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

Got it. Can we pivot to just the reinsurance structure? Can you talk about your reinsurance structure for the homeowners business for the 2020 calendar year? And how, if at all, it's going to change relative to the structure last year? And I'm thinking about things like in terms of retentions, et cetera.

**Gabriel Tirador**
*President, CEO & Director*

Ted, do you want to go ahead and handle that?

**Theodore Robert Stalick**
*Senior VP & CFO*

Yes. Yes, Greg. So just to remind the audience, our current treaty has a $600 million of limit in excess of our $40 million retention. And there are some small slivers that exclude wildfire, but for the most part, wildfire is in there. We're currently in the process or getting into the process for the July 1 renewal. As a reminder, we paid around $38 million for our current coverage. We plan to buy a comparable amount this July 1. We're seeing how the market is, but we plan to buy a comparable amount. As far as rates, right now, I think our anticipation is some maybe, modest increases. But we're -- that's our plan. We need to get into the process and meeting with the reinsurers before we can really know exactly where that's all going to shake out.

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

Got it. I guess that's going to happen virtually these days. Do you anticipate that your retention, the $40 million retention that you had last year is going to stick through this year? Or is it possible that could change?

**Theodore Robert Stalick**
*Senior VP & CFO*

It's possible it could change. Right now our desire is to keep it right around where it was in the current treaty.

**Gabriel Tirador**
*President, CEO & Director*

A lot of that will depend, Greg, on pricing, right? I mean it depends -- it will depend on pricing. So -- but our intention right now is to keep it where it's at, but with a caveat of what's the pricing look like at that lower level.

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

Great. My last question, just will focus on the investment results. And I realize that a portion of the realized investment gain was just a mark-to-market adjustment. I was hoping that we could get 2 things: first of all, how reinvestment yields are looking today versus they were before this crisis hit; and then secondly, just to give us some idea within the realized investment, how much of that is the investment loss? How much of that is just the valuation versus actual sale?

**Christopher Wadewitz Graves**
*VP & Chief Investment Officer*

Greg, yes. So as far as reinvestment levels go, I mean, during March, when the height of the crisis unfolded, the levels that you could get, especially on municipal bonds, were just incredible. And we pushed a lot of capital into the market at that point in time. But once the government stepped in and started all of these different phases of the bailouts, all the markets really normalized quite quickly to a large degree. We still see bifurcation on the municipal side. Clearly, there are states or certain sectors of revenue bonds that are under pressure, like an airport bond or hospitals, or certain states, Illinois, particularly, would be under pressure. Those bonds still trade fairly cheaply. But other bonds that have good support for, either sales tax revenues or income tax revenues, that are still holding up, those bonds are still trading at really good spreads -- well, very competitive spreads. So it's surprising how quickly this market has looked through the current economic problems.

As far as the mark-to-market levels go, we did take losses in the quarter. I think they amounted to something in the neighborhood of just $10 million. So most of it that you saw -- because we passed everything through, most of what you saw is simply mark-to-market losses. Just like back in '08, '09, we were on the same methodology. Everything gets pushed through in '08 with tremendous unrealized losses that we label as realized. And then in 2009, the market came back, and all of those unrealized shifts were labeled as realized on the income statement.

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

I guess the -- considering the snapback in the market, we'll see a reversal of part of that mark-to-market adjustment in the second quarter.

**Operator**

There are no further questions at this time. I'll turn the call back to the presenters.

**Gabriel Tirador**
*President, CEO & Director*

Well, I'd like to thank everyone for joining us this quarter and we look forward to joining you next quarter. Thank you very much.

**Operator**
That concludes today's conference call. Thank you, everybody, for joining today. You may now disconnect.