S&P Capital IQ

CONTENTS



# Mercury General Corporation NYSE:MCY

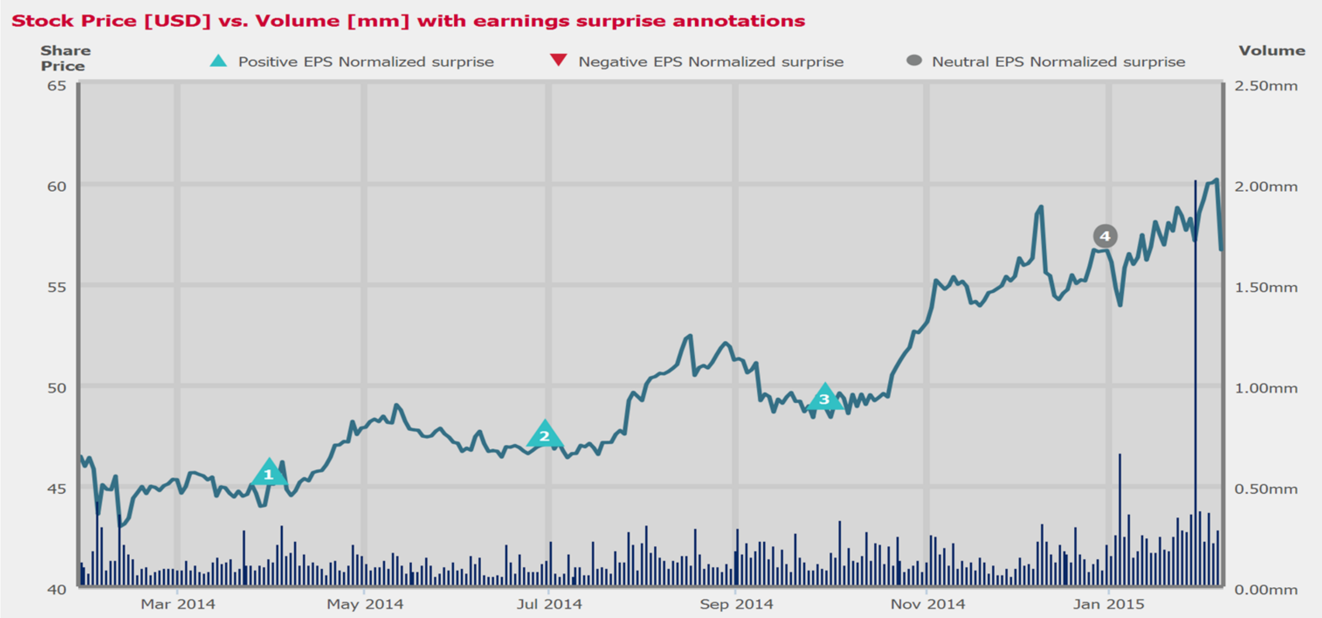
*FQ1 2015 Earnings Call Transcripts*

Monday, April 27, 2015 5:00 PM GMT

## S&P Capital IQ Estimates

| | -FQ1 2015- | | | -FQ2 2015- | -FY 2015- | -FY 2016- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS Normalized** | 0.73 | 0.59 | (19.18 %) | 0.72 | 2.60 | 2.74 |
| **Revenue (mm)** | 758.93 | 740.49 | (2.43 %) | 730.90 | 2971.50 | 3090.55 |

Currency: USD
Consensus as of Apr-27-2015 2:02 PM GMT




- EPS NORMALIZED -

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ1 2014** | 0.61 | 0.77 | 26.23 % |
| **FQ2 2014** | 0.70 | 0.83 | 18.57 % |
| **FQ3 2014** | 0.61 | 0.81 | 32.79 % |
| **FQ4 2014** | (0.01) | (0.13) | NM |

# Call Participants

## EXECUTIVES

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

## ANALYSTS

**Alison Marnie Jacobowitz**
*BofA Merrill Lynch, Research Division*

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

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

**Ronald David Bobman**
*Capital Returns Management, LLC*

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

# Presentation

**Operator**

Good afternoon. My name is Laurel, and I will be your conference operator today. At this time, I would like to welcome everyone to the Mercury General First Quarter Conference Call. [Operator Instructions] This conference call may contain comments and forward-looking statements based on current plans, expectations, events and financial 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 First Quarter Conference Call. I'm Gabe Tirador, President and CEO. In the room with me is: Mr. George Joseph, Chairman; Robert Houlihan, Vice President and Chief Product Officer; and Chris Graves, Vice President and Chief Investment Officer. On the phone, we have Ted Stalick, Senior Vice President and CFO.

Before we take questions, we will make a few comments regarding the quarter. Our first quarter operating earnings were $0.59 per share compared to $0.77 per share in the first quarter of 2014. Excluding the impact of catastrophes and favorable reserve development, the combined ratio was 99.2% in the quarter compared to 96.6% in the first quarter of 2014.

The deterioration in the combined ratio was primarily due to an increase in frequency and severity in our private passenger auto business and higher advertising expenses.

In addition, the recently acquired Workmen's Auto added 0.4 points to the combined ratio.

Premiums written grew 2.2% in the quarter, primarily due to higher-average premiums per policy, the acquisition of Workmen's Auto and an increase in new business policy sales. Workmen's Auto premiums written of $6.9 million added 1 point to the quarter's premium growth.

In the first quarter of 2015, California Private Passenger Auto Frequency increased by about 8% and severity increased in the mid-single digits. We believe there are a few factors contributing to the elevated frequency level this quarter. Although California remains in a severe drought, the winter of 2015 had more precipitation than in 2014.

In addition, total vehicle miles driven have increased due to lower gasoline prices and an improving economy.

Higher-average premiums from rate increases taken in 2014 partially offset the increase in frequency and severity in the quarter.

To further address the increase in loss cost, a 6.4% rate increase was recently approved by the California Department of Insurance for Mercury Insurance Company, representing about half of our company-wide premiums written. A 6.9% rate increase in California Automobile Insurance Company, representing about 15% of our company-wide premiums, is pending approval. We expect to implement the 6.4% rate increase for Mercury Insurance Company in late May.

Results outside of California were mixed. For Florida and Texas, our 2 largest states other than California, prior passenger auto results were good with combined ratios below 100%. Both of these states also had positive premium growth. However, our results in our Northeastern states were not good with combined ratios well above 100%.

Winter storms had an impact on the results. Also, for New York and New Jersey, we continue to evaluate reserves. And the impact of changes in claims procedures, which include the speeding up of claims settlement and case reserving, have added an element of uncertainty to the estimates.

For New York and New Jersey combined, the company recorded $1 million of adverse loss reserve development. We implemented rate increases of 3% in New York in January of 2015 and 2% in New Jersey in February 2015.

Our expense ratio in the quarter increased to 27.7% from 26.9% in the first quarter of 2014. The increase in expense ratio was primarily due to higher advertising expenses from our national advertising campaign launched in January, partially offset by lower profitability-related accruals.

Net advertising expense in the quarter was $16 million compared to $6.4 million in the first quarter of 2014. Our 2015 annual advertising budget of $48 million is heavily weighted toward the first quarter spend. The advertising spend will be lower for the remaining 3 quarters of 2015.

We evaluate the effectiveness of our advertising by comparing the lifetime acquisition cost built into our pricing to actual acquisition cost, while also giving some consideration to the long-term value of increasing brand awareness. However, for accounting purposes, the cost of advertising is expense when incurred and is not amortized over the life of the policy.

Based on our first quarter results, we expect to recover the vast majority of our advertising expenses over the lives of the policies sold. We are currently evaluating changes to improve the results going forward with the objective of recovering the entire advertising spend over the lives of the policies.

Company-wide, private passenger auto new business applications submitted to the company increased 11% in the first quarter of 2015 and homeowners new business submissions were up 29%.

In California, we've posted premiums written growth of 4.4%. Outside of California and excluding our mechanical breakdown product, premiums written were down 1.2% in the quarter. This compares to negative growth of 3.9% and 7.6% for 2014 and '13, respectively.
With that brief background, we will now take questions.

# Question and Answer

**Operator**

[Operator Instructions] Your first question comes from the line of Vincent DeAugustino with KBW.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Just looking at the first one here. So some of the industry [indiscernible] data that came out last week, it looks like California property damage and then collision severity both may be ticking up decently, and so you went through some of frequency drivers here and then mentioned severity as well. So I just wanted to see on these particular coverages or severity, what you might be seeing in the state as well.

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Yes, we're seeing about anywhere from 3% to 5% in the physical damage lines with respect to severity here in California. We had -- in the first quarter -- we had an increase in total losses in the first quarter year-over-year, and that contributed to the increase in severity. We're also seeing some small increases, obviously, in parts and labor.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. On the parts and labors, is there anything for some of the old -- or now old yellow form stuff on the OEM parts? Is that any driver there?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

I don't think so. We not attributing any of that. That -- I think that the new regulation was in March of 2013, it's my recollection, Vincent. We're not attributing the cost increase to that regulation at this point.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, great. And then on the total losses, I mean, is that pretty much an anomaly? Or do you think there is anything there that you've mentioned some and just a little bit more rainfall and that kind of stuff that would slow down somebody's braking ability and that type of thing, but is that just type of activity? Or is there anything else that would be kind of underlying there?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

I don't know of anything else. We're going to have to wait and see in the next several quarters to see what occurs, but I can't attribute it to anything else.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. And then on Google Compare. I know it's something we've talked about over the last few quarters. What I'm trying to understand is, on the commission and expense structure side, how do you think that, that's going to play out versus the traditional business? And then on the loss ratio side, one of the things we've talked about is the benefit of frontline agent underwriting. So what I'm trying to get to all the gives and takes, perhaps, maybe between the loss and expense ratio where we may have some shifting on some of that business that comes through on the Google side.

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, first, I'll say that the Google Compare is relatively new, so it hasn't been live very long. The sales from the program at this point are not significant. I think we've been doing it maybe a couple months now, 1.5 months, something like that, so they're not very significant. From an acquisition standpoint, cost of acquisition, it's favorable to us. I'll just say that the cost of acquiring a Google customer is favorable. We're paying on a per sale basis, and we believe that the cost is very reasonable. On the loss ratio side, we actually compare the loss ratio that we have on our buy button compared to our agent business, and the loss ratios are not that significantly different.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay, very good. And then sorry I was trying to write this down, I think I missed it. It's around new business submission activity and then just linking that to the national advertising campaign, so could we just revisit how -- I guess, how that's performing relative to your expectations on it?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, our initial hope was to recover the entire advertising spend of the $48 million that we're budgeting. And we're recovering the vast majority of that spend, so but we're learning from it. We're making some adjustments with respect to the advertising. There is -- the advertising campaign is composed of PD. You have digital, you have media aggregators that we have in that $48 million, so it's comprised of various avenues, for us to try to get some growth. And what we're doing is we're learning from this first quarter and we're going to probably be making some adjustments. There are certain states, for example, that aren't closing as well as other states. So we'll probably be moving some money that we're spending in some states and moving them to other states, things of that nature. But I would say that over 90% of the advertising spend, we're recovering at this point or we plan on recovering over the lives of the policies. The new business submissions that I mentioned in the -- at the beginning of the call, 11% increase in private passenger auto and about 29% in homeowners.

**Vincent M. DeAugustino**
*Keefe, Bruyette, & Woods, Inc., Research Division*

Okay. And last question would be on the preferred rate approval, could you see that come through? I guess, in the course of historical precedent here, should we expect you to, kind of, in a pretty short order, come back with another rate increase there in light of some of the California loss cost trends?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

That's something we're going to evaluate. That's something we're evaluating. We'll do our indication after this first quarter, and it's something we'll definitely evaluate.

**Operator**

[Operator Instructions] Your next question comes from the line of Alison Jacobowitz with Bank of America Merrill Lynch.

**Alison Marnie Jacobowitz**
*BofA Merrill Lynch, Research Division*

First, a favor please. It just went by me too fast. I believe you gave the frequency and severity numbers for private passenger auto in California. If you could repeat those. And then if you could talk some about the frequency outside of California.

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Sure. In California, the frequency increased about 8% and severity in the mid-single digit area.

**Alison Marnie Jacobowitz**

*BofA Merrill Lynch, Research Division*

Okay. And then frequency outside of California?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Outside of California, in the Northeast region, we certainly saw an increase in -- as a group of the companies that we write in the Northeast region, we saw an increase in frequency up there, primarily probably related to the winter that the Northeast had. And it varies by state somewhat, but generally speaking, I would say that as a whole, we're seeing an increase in the frequency.

**Alison Marnie Jacobowitz**
*BofA Merrill Lynch, Research Division*

And then another question. I was wondering if you could talk some about just your ongoing reviews of your loss reserves. If there's anything in particular you're watching more than others or how you're feeling about that going forward.

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, I mean, we feel good about our loss reserves. Obviously, there's 2 states that I mentioned in my prepared remarks, New York and New Jersey, which we continue to evaluate in light of the claims procedure changes that we've made there, which have basically sped up our claim settlement and case reserving, and that's added an element of uncertainty to the estimates for those 2 states. So those are the 2 states that I would say that we're watching. But overall, we feel good with our reserve position. And in fact, I think that we recorded $3 million this quarter of positive or favorable reserve development on a consolidated basis.

**Operator**

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

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

I had just a couple of questions. You talked briefly about your participation in the Google venture. And I was wondering if you could comment on whether you're participating in the comparative raters with independent agencies. And if so, which states?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

We are participating with independent agents through comparative raters in pretty much every state that we're in.

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

I see. And is there -- I guess in the context of your advertising budget where you laid out some $48 million that you expect to spend this year, how are you skewing that advertising expense in the context? Because most of your business, obviously, is California-oriented. Would -- should we assume that the advertising expense is modeled after your market share? Or is it pushed in a different direction?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, on the TV spend, which is a significant portion, maybe half, maybe not quite half of the spend, it's national cable, primarily. So we're spending on a national basis, and we're doing some local buys in California in addition to that. And then we -- and then the rest of the spend is in digital as well as lead aggregators. And we're spending more money in California, as you would assume, as compared to outside of California. But I will say that outside of California, the growth was quite a bit more from a count standpoint. I think outside of California, our new business submissions in the quarter were up like 26%. I mean, in California, they were up in the mid-single digits, so that's how the spend is allocated.

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

Okay. In the context of the $48 million, is it assumed that you're going to spread that out pretty evenly throughout the year? Or is it going to be front-end loaded? Or any color there?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

No, no. As I mentioned in my prepared remarks, it's front-end loaded. The first quarter, historically, has been our biggest sales quarter, and we front-loaded it in the first quarter. So it was $16 million in the first quarter. I think you'll see for the next several quarters $2 million or $3 million reduction there for the next several quarters. And then in our fourth quarter, we drop quite a bit. So it -- the first quarter is going to be the highest spend.

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

Okay. Just circle back on the 26% increase in submissions, is that bound business, new business? Or -- I'm trying to understand how you're defining submissions.

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, we define submissions as how many applications were submitted to us either through the agent or through our buy button process for us to issue. We may not have issued these, but these are ones that have been submitted to us for issuance, that's how I'm defining it. By and large, we pretty much issue what's submitted to us. The vast majority of what's submitted, we issue.

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

Okay, perfect. One last question. Just as we think about any unusual litigation or regulatory expense, I know you highlighted the recent rate increase you got approved for California, is there any additional expense either with litigation or regulatory that you might anticipate in the balance of the year that is unusual?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Not that I'm anticipating.

**Operator**

[Operator Instructions] Your next question comes from the line of Ken Billingsley with Compass Point.

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

Just two follow-up questions. On the reserve release -- on the net basis, are the -- did you mention what years it is coming from?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

I didn't mention the years, but they're most recent accident years, maybe 2 or 3 back.

**Kenneth G. Billingsley**

*Compass Point Research & Trading, LLC, Research Division*

And from looking at the reserve tables, and again, this is coming from more the year-end table that you reported, it seems that you tend to release early on and then add slowly after that. Do you see a change in that? Or is that likely to continue? Are you seeing net additions to later years still?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Not significant to later years. I mean, most of the additions are in the most recent 2 to 3 years. We try to book the most accurate reserve number possible. We have over $1 billion of reserves up, so you're going to be off a little bit, $3 million, one way or the other is not -- in the whole scheme of things is not significant when you're taking a look at that big of a reserve balance. Our intention is not -- I guess, to answer your question, our intention is not to release positive development in the first quarter and then slowly over the next several quarters reduce that. That's not the intention. So in a perfect world, we would have no development from here on out, but that's not going to occur. We're going to have some development one way or the other typically.

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

All right. The -- and then on the Policies-in-Force, looking at personal auto, the decline is slowing. Obviously, I'm assuming some of that is from the increased advertising spending. Can you just break down -- I believe you said it was 26% increase in submissions outside, but can you talk about the Policies-in-Force? Are they continuing to shrink in California and growing a lot faster outside? Or can you talk about the mix?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, as far as California, I think from year end, California -- from 12/31/14, California is up slightly from year end. You have states like Texas, Florida, Georgia, Virginia, where they are up. And then we have some states -- a lot of the states are stabilizing now. We have states like New Jersey where that have been declining significantly for some time. And now since year end, I would say that the [ph] pick is stabilized now. So it varies. But in California, up slightly. Outside of California and some of the states I mentioned, Texas Florida, Georgia, Virginia, up. And in some of the states where we've had large declines, they're starting to stabilize.

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

And then on the homeowners side, the growth still looks -- at least comparatively, is much stronger there in Policies-in-Force? Where is that coming from? Is that mostly California?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

That is mostly from California. That -- we introduced a new product back in October of '14. That new product has been well received here in California and coupled with the advertising that we're doing, I think that most of that is in California.

**Operator**

Your next question comes from the line of Ron Bobman with Capital Returns.

**Ronald David Bobman**
*Capital Returns Management, LLC*

I have a question about the Google initiative. I recognize it's early days. I was curious, are your rate plans the same whether a like risk makes it to your, sort of, underwriting desk by way of an independent agent or comes in via Google's website?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Yes, they're the same.

**Ronald David Bobman**
*Capital Returns Management, LLC*

Okay. And what -- I assume you've reached the conclusion that, sort of, channel conflict and what I'm really getting at, sort of, your agents relationships that you can, sort of, temper any concerns that they have of, sort of, alienation and challenge going forward. Would you just talk about that as this, sort of, plays itself out in the years to come?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Yes. I think we've been selling online now for sometime in California, and our agents are involved in that process. We basically assign those sales to an agent for a cost. On the Google Compare, it's a very new program. And currently, our agents are not participating, and we've informed this through our agents. The way the program is currently structured, it makes it difficult to involve them at this point. But it's -- as the program evolves, it's something that we're taking a look at.

**Ronald David Bobman**
*Capital Returns Management, LLC*

And for consumers that use the Google Compare website, is it sort of straight through binding? Or do you -- do your systems and/or people, sort of, play catcher and, sort of, make underwriting decisions and pricing decisions? Or is it sort of -- is there an automated binding element to it?

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, there's an automated binding element. In addition to -- if someone needs to talk to someone for -- to finalize the sale, we have auto insurance specialist, AIS, who we own to finalize the sale.

**Ronald David Bobman**
*Capital Returns Management, LLC*

That's an if, I think you said -- you used the word "if."

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Yes, there are some sales that are coming in directly. They bind online and they're done. Then there are some sales that come through Google that they don't want to bind online. They want to talk to somebody and that's when we pick up that piece, so it's a combination.

**Operator**

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

**Gabriel Tirador**
*Chief Executive Officer, President and Director*

Well, I'd like to thank everyone for participating this quarter. And we hope to bring you better results in the second quarter. Thank you very much.

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