S&P Capital IQ

CONTENTS

RLI Corp. NYSE:RLI

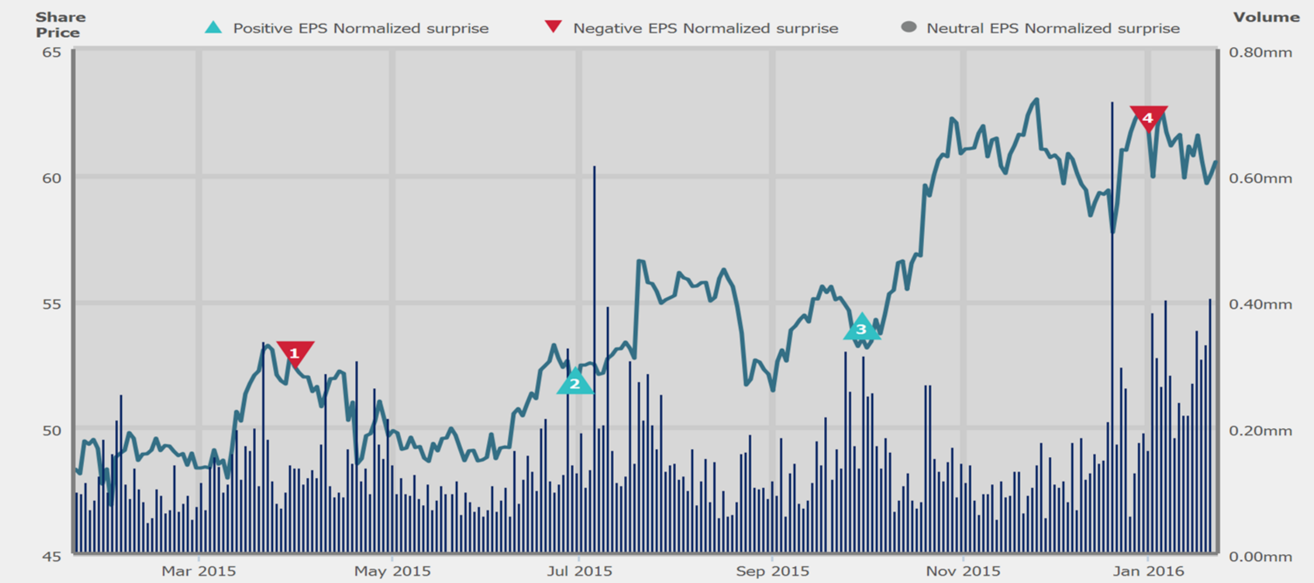
FQ1 2016 Earnings Call Transcripts

Thursday, April 21, 2016 3:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2016-			-FQ2 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.49	0.54	▲10.20	0.60	2.27	2.25
Revenue (mm)	194.04	201.69	▲3.94	193.54	774.19	761.03

Currency: USD
Consensus as of Apr-21-2016 5:15 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2015	0.52	0.50	▼1 (3.85 %)
FQ2 2015	0.54	0.77	▲2 42.59 %
FQ3 2015	0.58	0.70	▲3 20.69 %
FQ4 2015	0.64	0.56	▼4 (12.50 %)

Call Participants

EXECUTIVES

Aaron H. Jacoby
Vice President of Corporate Development

Craig William Kliethermes
President and Chief Operating Officer

Jonathan E. Michael
Chairman and Chief Executive Officer

Thomas L. Brown
Chief Financial Officer and Senior Vice President

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Jeff Schmitt

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Michael Zaremski

Randolph Binner
FBR Capital Markets & Co., Research Division

Presentation

Operator

Good morning, and welcome, ladies and gentlemen, to the RLI Corp. First Quarter Earnings Teleconference. At this time, I would like to inform you that this conference is being recorded. [Operator Instructions]

Before we get started, let me remind everyone that through the course of this 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 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 first 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 believes 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 Vice President, Corporate Development, Mr. Aaron Jacoby. Please go ahead, sir.

Aaron H. Jacoby
Vice President of Corporate Development

Thank you. Good morning to everyone. Welcome to the RLI earnings call for the first quarter of 2016. Joining me on today's call are Jon Michael, Chairman and CEO; Craig Kliethermes, President and Chief Operating Officer; and Tom Brown, Vice President and Chief Financial Officer.

I'm going to turn the call over to Tom first to give some brief opening comments on the quarter's financial results. Then Craig will talk about operations and market conditions. Next, we'll open the call to questions. And Jon will finish up with some closing comments.

Tom?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Thanks, Aaron, and good morning, everyone. I feel a bit like a broken record with these opening comments, which speaks to our consistency, but nonetheless, we are pleased to report a good start to the year with these first quarter results. Start with the combined ratio, we achieved an 88 in the quarter, modestly better than last year. Underwriting income was positively impacted from favorable loss reserve development. In this case, $11 million coming out of the Casualty segment. As a reminder, during the first quarter, we do not perform a full actuarial loss reserve study.

Total gross written premiums was up 3% in the quarter. Casualty, our largest segment, turned in an impressive 9% growth rate on the strength of a number of different products, including some recent product launches. Surety was up 7%, continuing a very nice run of growth over the last several years. Property, however, was down 13%. Excluding the discontinued crop and facultative reinsurance business that we previously reported, the segment was down 7%, which is attributable mostly to continued soft market conditions in catastrophe-exposed areas. Each segment turned in attractive combined ratios:

Casualty at a 92; Property at an 84; and Surety at an 80 combined ratio. Again, a pretty good result, leading to the aforementioned 88 overall combined ratio.

Turning to investments. The first quarter was a good one, with a 3.2% total return. Our equity portfolio was a strong contributor, it was up 5.7%, a result helped by our overweight utility stocks. The bond portfolio also posted a positive total return, up 2.6% in the quarter. And although pretax investment income was down a slight 1%, it was actually up 0.6% on an after-tax basis, as our allocation to municipal bonds increased compared to the same period last year.

With regard to our minority investments, Maui Jim turned in a slightly lower earnings, while net sales continue to grow modestly, foreign exchange impacts and ramp up in marketing expenditures served to depress earnings slightly. Our other minority investment, Prime Insurance, was basically flat in the quarter compared to first quarter of 2015.

All in all, with strong underwriting and investment performance driving our results, book value per share was up 7% in the first quarter, inclusive of dividends.

And now with that, I'll turn the call over to Craig Kliethermes. Craig?

Craig William Kliethermes
President and Chief Operating Officer

Thanks, Tom, and good morning, everyone. As Tom mentioned, we're off to a very solid start to 2016, gross and net written premium growth both up 3%. Removing the impact of crop and the facultative reinsurance business that we exited last year, we were up 5%. So our core portfolio is on a good trajectory in a challenging market. At the same time, we were able to deliver another sub-90 combined ratio quarter. It is not getting easier, but there's still opportunities for the skilled fisherman who know where to cast their line.

Let me provide some more detail by segment. In Casualty, gross written premium was up 9% in the quarter and posted 92 combined ratio. We continue to find opportunities both in our established products and within many that we have started in the last several years. Our excess liability, transportation and package businesses continue to grow at a double-digit pace. Transportation and excess liability continue to be a supply-side phenomenon, with many companies suffering very poor results and retrenching or pulling MGA contracts. Most of our package growth has come from expansion of distribution and share of wallet initiatives.

The opportunities are not across the board. There are differences both geographically and within subclass. In this market, it takes seasoned underwriting and outstanding claim people to differentiate selection, pick the right spots and weather the storm. We continue to invest in new people and new products across our Casualty segment, and we are working hard to get more products online and to scale.

Rate increases are very difficult to come by, and we see casualty rates as flat overall, but we continue to see positive rate on most wheels-based business and in a smaller-count professional liability space. However, we are having to give back a fair amount of rate in primary general liability and larger D&O risk to remain competitive.

Our Property segment was down 13%, while reporting an 84 combined ratio. As Tom mentioned, after taking out the impact of exited products, we were still down 7%. A lot of this is price driven, as we see rates in CAT exposed business is continue to slide at a double-digit pace.

Rate levels are about 60% of what they were in 2013 for CAT business. We've lost out on many accounts, as rates we believed to be priced at or below expected loss cost, so the margins in these businesses have gotten much thinner. Declining reinsurance rates and a better spread of risk have helped us take some of the pressure off our returns in the bottom line, but this is not a growth business for us until the underlying economics change.

Meanwhile, we will continue to provide capacity to our best accounts and brokers where we still have an opportunity to make a profit.

Also putting pressure on the top line for the quarter was marine and our recreational vehicle products. We have been able to achieve some positive rate in both of these businesses, but growth has been elusive as a result. The declining top line in Property has caused some deterioration in the margins and resulted in higher expense ratios for this segment.

Our Surety segment continues to grow profitably. We were up 7% in premium and posted an 80 combined ratio. Our long-term presence, relationships and consistent, predictable risk appetite are a big advantage for us in this segment. Surety was led by our miscellaneous product, which grew at a double-digit pace. These are typically very small bonds, where ease of doing business is a critical differentiator.

On the larger surety risks, we see an abundance of less refined competition. Although results have been good for the industry, we see storms on the horizon for those who view this as loss-free business. Surety is very specialized. Hope and luck are not a good long-term strategy. The odds will eventually catch up with those offering up loose credit and other terms. Our narrow and deep surety expertise and hallmark discipline should serve us well in the short and long term.

Overall, we had a very solid quarter. I want to thank and congratulate the RLI associates for being different. Their drive, their discipline and our diversified portfolio of products delivered again this quarter.

I'll turn it back to Aaron, who'll open it up for questions.

Aaron H. Jacoby
Vice President of Corporate Development
Thanks, Craig. We can now open the call for questions.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Quick couple of questions here. So I know you said the growth within Casualty, part of that was from some new products. Can you talk about -- did any of that growth come from new teams that you were able to bring on from any of the industry fallout?

Craig William Kliethermes
President and Chief Operating Officer

Yes, this is Craig Kliethermes, Arash. We've added probably about a half a dozen products or so that have generated premium to date. And a few of those have been smaller teams, or smaller -- mostly individuals as opposed to teams, that have started up products, whether it be in health care, miscellaneous professional, in our D&O space, we've added quite a few in our E&S space, but we really haven't gotten those products up online quite yet.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And my next question, in terms of -- you said you're getting rate in wheels-based business, as you've said in the past. So can you just clarify, are you getting more rate there than you think you would, I guess, actuarially need? Because the industry is in pain and is raising rates, that kind of paves the way for you to get more than you would otherwise need. Is that a fair way to look at it?

Craig William Kliethermes
President and Chief Operating Officer

So I think it's both. I think there are some places where we were getting rate where it is needed. And I think that's a probably true of a good part of the industry because I know the commercial auto and personal auto space, in particular, you guys all have seen, results have not been that good. So some of that rate is needed. And then I think we've also found some opportunity where rate was, I'll say, just available, or available to us in a specialized niche. And today, that's probably more true of our transportation business for us in particular.

Operator

And we'll go next to Randy Binner of FBR Capital Markets.

Randolph Binner
FBR Capital Markets & Co., Research Division

I have a question about commercial auto and kind of how industry reserve trends are coming along. Our view, kind of -- statutory data, which isolates commercial auto as a class. Is that -- it seems like reserve elements continues to be poor through action year '14. And so I guess my question is, is commercial auto ever going to get better? This is a really long time to see a class have poor performance. I know you've done better. And I'm asking the question in a way to understand kind of how continuous this opportunity might be for you all. But are you feeling like rate adequacy is better in accident years '13 and '14 than it was in '10 to '12? Or is it just as bad now as it was before?

Craig William Kliethermes
President and Chief Operating Officer

Randy, this is Craig again. So I think that we would say, and our underwriters would say, that during 2011, '12, '13, maybe a lot of our competitors lost their way in regards to price. They dropped price to either maintain market share or to grow market share. At that time, at least in our early part of those years, we were pretty steadfast in regards to what we're willing to charge for a given risk. So we weren't growing much in the '11, '12 timeframe, and we have been able to take opportunity in '13, '14, '15. In regards to current price adequacy, I think, again, it varies risk by risk and I'll say class by class. In the classes that we particularly participate in, in transportation, we feel good about, at least, certainly the risks that are in our portfolio, that they're priced well. But there's still a lot more room, we think, out there for pricing action in that space.

Randolph Binner
FBR Capital Markets & Co., Research Division

Do you think -- is competition more rational in kind of '14, '15 than they were in, call it, '11 to '13?

Craig William Kliethermes
President and Chief Operating Officer

Well, I think it's definitely more rational because we have people either exiting, leaving, pulling MGA contracts or getting substantial price. I think the people in that, in the transportation space, particularly in public transportation space, a lot of people have -- their results have been very, very poor, and I think they're not fooling themselves anymore. And they're getting significant price, probably double-digit increases. And they're willing to let the business walk away. Now they're letting the business walk away if they're not able to get the price.

Randolph Binner
FBR Capital Markets & Co., Research Division

So now we're in the pain, kind of that pain trade, and this happens in the industry. So what inning would you say that pain trade is in, where people are abandoning books or significantly increasing price? Where do you think that process is in an inning basis?

Craig William Kliethermes
President and Chief Operating Officer

I mean, it's difficult for us to say. We hope, we hope it's going to continue for a while. These will create opportunity for us.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. Yes, it just seems like the data, the reserve data is not getting as better as I would have thought it was. On Property, you mentioned you had significant competition, and I think I ask this question a lot on these calls. Is it -- can you characterize where that competition's coming from? Is it kind of new, alternative providers? Or is it more just your brand-name guys just continuing to be more competitive on property?

Craig William Kliethermes
President and Chief Operating Officer

A lot of it is the same competitors that we've had in the past, it's just that they backed it with alternative capital or they backed it with the reinsurers who are laying it off to alternative capital and are willing to take a lower return. The one thing we have seen more recently, which is more even concerning, I think, is the -- we've even started seeing some packaging within the E&S space of the CAT risk and liability for us. So we're well -- or we knew this was happening, and it happens quite frequently in the admitted space, when we run to admitted competition, but now we've seen a few on the E&S side starting to package the liability and the CAT risk as a package.

Randolph Binner
FBR Capital Markets & Co., Research Division

Wait. So just to be clear there, so they package -- it's a...

Craig William Kliethermes
President and Chief Operating Officer

Well, they're offering both covered.

Randolph Binner
FBR Capital Markets & Co., Research Division

Package all that's in non-admitted? Or is it someone -- who they package, a non-admitted piece with an admitted piece?

Craig William Kliethermes
President and Chief Operating Officer

In many, it's both. They're doing it through an MGA. So the MGA might have admitted paper as well, but they're selling both products to the same customer base.

Randolph Binner
FBR Capital Markets & Co., Research Division

So, basically leakage into the non-admitted space, is what's happening?

Craig William Kliethermes
President and Chief Operating Officer

Right. Right.

Operator

And we'll go next to Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Not to make this into the transportation call, but that's kind of where I had my questions as well. Are you able to be a little bit more specific in terms of the rate improvement across some of the different subcategories of wheels-based business? Which to say, trucking versus delivery versus taxis and limos, et cetera?

Craig William Kliethermes
President and Chief Operating Officer

Well, we don't write a lot of those stuff. For us, it's very specialized. And I mean, we're seeing rate pretty much across the board in that space.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

And just, I guess, in terms of the -- what size business do you guys typically write there? Or what sort of limits are kind of your -- in the middle of your wheelhouse?

Craig William Kliethermes
President and Chief Operating Officer

For transportation, typically -- I mean, we prefer to write the $1 million primary, but we write excess as well, up to $5 million, $6 million, I believe, for bus -- most trucks buy $2 million worth of coverage. So there's both a primary policy and usually some type of umbrella or excess policy attached to it.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And so when you were referring to, at the beginning, growth in both excess liability as well as transportation, when you put that growth together, is that -- both of those things together kind of in the same transportation category? Or were you seeing excess growth in the excess business apart from transportation?

Craig William Kliethermes
President and Chief Operating Officer

Apart from transportation. Obviously, we're seeing growth in the excess liability for the transportation segment as well the primary. But we also sell an excess liability product in our E&S space that -- mostly for contractors, that continues to find opportunity.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. And I guess the last question. Are you seeing any -- I mean, obviously, we know the number of the kind of higher-profile exits from the transportation space. Are you seeing any new entrants that you've not seen as much in the past? Or people with improved appetites, apart from yourselves, that are trying to take up some of the opportunity there? I'm not asking for names, I'm just asking for market color.

Craig William Kliethermes
President and Chief Operating Officer

Right. I mean, we always see competition and new people that come in who think they can be smarter than the last guy that lost money because they think the rates are a little better. But I think you need to be a specialist in that space to make money across all markets. And we see a lot of people that can fool themselves. I don't -- can't tell you why in the wheels-based business because it's not a particularly long tail line for casualty, so it comes back to bite people fairly quickly. But for some reason, people continuously -- they get burned, they get out for a brief period of time and then they find it, and then the MGA finds a new market or they find a new -- we'll find a new entrant to compete with, unfortunately.

Operator

[Operator Instructions] And we'll go next to Mike Zaremski of Balyasny.

Michael Zaremski

Just one question on the Property segment's expense ratio. If I recall correctly, part of the step up in the ratio last year was due to crop coming off the books. This quarter, it increased again, sets up again to about 45%. You talked about the competitive environment. We also talked about some FAC that was not renewed. Just trying to get a sense if this is the appropriate near-term step-up in the ratio. Or are you taking some actions to offset it?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Mike, it's Tom Brown. Yes, your memory is correct from last quarter. We still do have a carryover effect of crop. As we said earlier, that was between the crop and FAC re, that was about half of the decline in the premium for the quarter and I wish those had lower expense ratios. The other, I think as we said last meeting and consistent with last call, was we've kind of gotten entrenched. We like the business, we like our underwriters. And if and when that market turns, as Craig was talking about, we want to be in a vantage point where we can capitalize on that and maintain that. Said differently, you don't want to be going hiring underwriters and miss the opportunity.

Michael Zaremski

Okay, got it. So the crop and FAC, will that stop impacting the year-over-year premium numbers next quarter? Or -- because I thought the crop had ended, it was just a year-over-year...

Thomas L. Brown
Chief Financial Officer and Senior Vice President

No, we -- as we said before, we thought we'd have $8 million to $10 million of crop, and we're currently at about $2 million into it in the first quarter. So we'll see this running through the next couple of quarters. In fact, it will trickle in a little more evenly over that timeframe.

Operator

And we'll go next to Jeff Schmitt of William Blair.

Jeff Schmitt

It looks like other comprehensive earnings of around $22 million was driven by equity returns. Did I hear that right? You had said that it was driven by utilities, is there -- what portion of the portfolio was added and was there anything else that drove that?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Two things, Jeff, you're right. Equities had a pretty significant uptick. Obviously, it was -- first 2 months of the quarter were not so good, as we all know. And March turned around for the quarter. As a component of that, it was the sector, utility sector, helped form that. But the fixed income also had a pretty good run with the decline in the interest rates. So all in, that -- those are the 2 drivers, would be the fixed income as well as the equity, coupled with the earnings for the quarter.

Jeff Schmitt

Right, okay. And could you maybe speak to just kind of broadly to your philosophy around equity allocation? It's around -- it looks like equities made up more than 50% of book value. In '13, that's ticked down to 45%. But how do you think about it? Do you think about it relative to book? Or relative to total investments? And do you have a target over time?

Thomas L. Brown
Chief Financial Officer and Senior Vice President

Yes, Jeff, we do. As we've said before, it's really -- it is relative book. It's -- like you said, it's in the neighborhood of about 50% effectively. If you look at the overall allocation of the investment portfolio, historically, it's been about 80% fixed income, 20% equities. And that will vary between mid-upper teens to low 20% for the equities. It is a very value-oriented strategy, with a kind of a leaning towards dividend-paying positions. And obviously with the value-oriented strategies being a little more favorable in Q1, certainly benefited.

Operator

And if 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 all for joining us this quarter. It was another good quarter for us. 88 combined, 3% top line growth in this market, I'd call that good. And our underwriters, as Craig said, they're good fishermen. So we'll expect to continue to be disciplined as we move forward in this market.

Thanks again, and we'll talk to you again next quarter.

Operator
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 4967961. This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.