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SIGI - Q3 2014 Selective Insurance Group Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone. Welcome to the Selective Insurance Group's third quarter 2014 earnings release conference call.

At this time for the opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Ms. Jennifer DiBerardino.

Jennifer DiBerardino - *Selective Insurance Group, Inc. - SVP, IR & Treasurer*

Thank you. Good morning and welcome to Selective Insurance Group's third quarter 2014 conference call. This call is being simulcast on our website and a replay will be available through September 2, 2014.

A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call is available on the Investors page of our website, at www.Selective.com.

Selective uses operating income, a non-GAAP measure, to analyze trends and operations. Operating income is net income excluding the after-tax impact of net realized investment gains or losses, as well as the after-tax results of discontinued operations. We believe that providing this non-GAAP measure makes it easier for investors to evaluate our insurance business.

As a reminder, some of the statements and projections that will be made during this call are forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties.

We refer you to Selective's annual report on Form 10-K and any subsequent Form 10-Qs filed with the US Securities and Exchange Commission for a detailed discussion of these risks and uncertainties. Please note that Selective undertakes no obligation to update or revise any forward-looking statements.

Joining me today on the call are the following members of Selective's executive management team -- Greg Murphy, CEO; John Marchioni, President and Chief Operating Officer; Dale Thatcher, CFO; and Ron Zaleski, Chief Actuary.

Now I will turn the call over to Dale to review the results.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Thanks, Jen, and good morning. We're very pleased with third quarter results, as our insurance operations posted an excellent quarter. And investment results were in line with our expectations.

Now, three quarters through the year, our ex-CAT statutory combined ratio stands at a solid 91.8%. Operating income per diluted share for the quarter was $0.76, up 81% from $0.42 per diluted share a year ago. Excluding the impact of favorable prior year casualty development and catastrophe losses, operating earnings per diluted share were 40% higher than the third quarter of 2013.

The third quarter statutory combined ratio was 91.5% compared to 96.3% a year ago. And our [underlying] combined ratio, excluding catastrophes and prior year casualty development, improved by 2.4 points. The light quarter for weather led the catastrophe losses of only 1.2 points compared to 2.7 points in the prior year period.

Favorable prior year casualty reserve development in the quarter was $8 million or 1.7 points compared to $3.5 million or 0.8 points a year ago. As has been the case in the recent quarters, general liability was the greatest contributor to the favorable development with $11 million or 2.4 points on the overall combined ratio.

As you analyze our results this quarter, keep in mind that the elevated property losses from the first half of the year were substantially paid in the third quarter, leading to a decline in the reserves on a sequential quarter basis.

On an overall basis, statutory net premiums written were up 0.5% in the quarter, with standard commercial lines flat. While growth moderated compared to the second quarter, the sale of our Self-Insured Group, announced in the first quarter of this year, impacted production numbers, as most of this business had a third quarter renewal base.

Excluding the $27 million in premiums written by this group in the third quarter of last year, standard commercial lines statutory net premiums written increased by 8%. And overall premium increased by 6%.

In the standard commercial lines, we achieved quarterly renewal pure price increases of 5.3%, while retention held steady at 83%. The standard commercial lines statutory combined ratio for the quarter was 90.9% compared to 95.6% a year ago. On an ex-CAT basis, results improved by 5 points.

Workers' compensation generated a combined ratio of [111.2]%, a 7-point improvement over the same period of last year, reflecting our continued efforts to improve the profitability of this challenging line. While there's still more work to do, we're pleased with our early successes.

And for the third consecutive quarter, there was no reserve development in the workers' compensation line, either favorable or unfavorable. All other standard commercial lines of business generated strong profitability in the quarter.

Personal lines net premiums written declined 2% in the quarter as we continue the strategic non-renewal of dwelling fire business and a reduction in monoline homeowners. As a result of these initiatives, retention declined to 81% from 86% in the third quarter of 2013.

The statutory combined ratio of 88.9% including catastrophe losses of 2.2 points, compared with the third quarter of 2013, when the statutory combined ratio was 97.6%, including 11.7 points of catastrophe losses.

Homeowners had a strong quarter with a statutory combined ratio of 86.8% and renewal pure pricing of a strong 9.8%. Year-to-date, homeowners profitability has been impacted by CAT and non-CAT weather, with a statutory combined ratio of 110.8%. While renewal pure pricing achieved is 9.4%.

In personal auto, the statutory combined ratio for the quarter was 100.3%, an improvement from the prior year period of 107.4%. Results also improved on an ex-CAT basis with a 101.2% combined ratio compared to a 105.9% last year.

Personal auto had $2 million of favorable prior year casualty reserve development, reflecting a continuation of positive reserving trends and renewal pure price was 3.8%. While we focus our homeowners strategy on rate and underwriting initiatives, we expect personal auto to continue its improvement through a combination of rate increases and aging of the book.

Net premiums written for our excess and surplus operation grew 11% in the quarter to $40 million, with a statutory combined ratio of 102.9%, including 1.4 points of catastrophe losses. Adverse prior year casualty reserve development of $4 million added 11.1 points to the E&S combined ratio in the quarter.

The unfavorable development is related to updated actuarial assumptions as the book matures and we gather more of our own experience. We remain confident in our path to profitability for this line.

Turning to our investment portfolio, after-tax investment income in the quarter increased 5% from a year ago to $26 million. The year-to-date after-tax yield on the portfolio remained flat compared to a year ago at 2.3%. And invested assets increased 5% from year end to $4.8 billion.

After-tax new money yields of 2.14% in the quarter were slightly below our full year budget of 2.25%, reflecting the backup in rates in the third quarter.

The overall pretax portfolio unrealized gain position increased from $79 million at year-end 2013 to $115 million at the end of the third quarter. Also, the pretax unrecognized gain position in the fixed-income held-to-maturity portfolio was $18 million or $0.21 per share on an after-tax basis.

Our fixed-income portfolio continues to be highly rated at AA-minus credit quality with a duration of 3.6 years, including short-term investments.

Surplus and stockholders equity each ended the quarter at $1.3 billion and book value per share grew 9% from year end to $22.45. Our premium to surplus ratio remained at 1.4 to 1.

Benefiting from strong profitability in the quarter, our annualized operating ROE for the first 9 months of the year was 9.1%. And total ROE was 11.1%, both in excess of our weighted average cost of capital of 8.8%.

Now I will turn the call over to John Marchioni to review insurance operations.

John Marchioni - *Selective Insurance Group, Inc. - President, COO*

Thanks, Dale. I'm very encouraged by our success implementing the underwriting and claims initiatives that have resulted in our underlying profitability improvement. This is in spite of some headwinds we've experienced with price moderation, competition from new business opportunities and continued low interest rates.

The commercial lines market has become increasingly competitive. We have successfully managed the delicate balance between rate and retention over the past 4 years, relying on sophisticated underwriting and pricing tools along with very strong agency relationships.

Moving forward, in addition to underwriting claims improvements, we remain focused on achieving pure rate increases, an amount that meets or exceeds expected loss inflation trends. Our highest quality accounts in the first 9 months of the year, we achieved pure rate of 5% and point of renewal retention of 89%. These accounts comprise 54% of our standard commercial lines renewal book.

Our lower quality accounts, we achieved pure rate of 12% and point of renewal retention of 74%. These accounts represent 8% of our standard commercial lines renewable.

We've taken a number of actions to improve underwriting results over the past few years, which are yielding positive results. We improved the hazard mix on our workers' compensation books of business by focusing on lower hazard accounts.

We've also targeted specific classes of business for re-underwriting. An example of this is a significant reduction in snowplowing exposure in the contractors book.

Most importantly, our underwriters are using a dynamic portfolio manager tool to target the lowest performing business for significant rate increases or reducing retention in order to improve the overall profitability of their individually managed books of business. When taken all together, these actions are having a positive effect on our underlying profitability.

We're very encouraged by the positive claim trends emerging as a result of the enhancements we've made in our claims operations. The impact of these changes will take a while longer to manifest in the results, as more time is required to prove them out from an actuarial perspective.

We believe the stability we're seeing in the workers' compensation reserves over the past three quarters is largely due to our claims initiatives. While we are not ready to declare victory by any stretch, we feel good about the early signs of improvement in workers' comp so far.

The strategic case management unit employs a triage process, which focuses on claims with a potential for high severity. After the claims are directed into the unit, seasoned specialists and expert medical resources work the cases through to settlement. As a result, we're seeing significant improvement in claim outcomes.

Excess and surplus lines statutory net premiums written grew 11% year-to-date to $107 million and achieved renewal pure price increases of 3.8%. Given the unfavorable casualty reserve development this quarter, we no longer expect E&S to be at the same relative profitability level as our standard operations for 2014.

We've successfully converted to a single underwriting guide for the two books of business that we purchased in 2011. And they now benefit from that synergy. The automation enhancements undertaken after the acquisition of our E&S operations have been introduced in pilot and full rollout is expected by year end.

We are working with our retail agents to drive more of their E&S opportunities to our [Mesa] wholesale agents, where we still see significant opportunity to write additional premium. One of the benefits of having an E&S operation is that, based on market dynamics, segments that we are no longer comfortable writing in our standard commercial lines present opportunities for us in E&S.

A good example of this is snowplowing. While we have curtailed this class of business in standard commercial lines, we're writing it in E&S. We continue to feel very good about our E&S growth and profitability prospects moving forward.

Personal lines core profitability improvement is on track despite a decline in net premiums written due to our strategic non-renewal dwelling fire policies, as well as targeted non-renewal actions on underperforming auto and home business.

Personal lines renewal pure price increased 6.8% in the quarter and 6.5% for the 9 months, while retention is 81% year-to-date.

In order to improve the overall growth results of personal lines, we'll be rolling out several product changes in early 2015, which will include the introduction of Selective Edge. We believe that a significant portion of the population shops on overall value and service and not purely on price.

The independent agent channel is best suited to attract and service this customer with a broad range of products and services they can provide. In order to win this market, we will work with our agents on targeted marketing campaigns to attract and retain this consultative buyer, as well as offering a broad array of coverage options that this customer demands.

Now I will turn the call over to Greg Murphy.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

Thank you, John. The strong results for both the quarter and year-to-date reflect the hard work of our 2,100 employees, 1,100 retail agents and 85 wholesale general agents to execute on our strategies in a more competitive market. As a result of the significant efforts over the past 3-year period, we feel confident in our 2014 92 ex-CAT statutory combined ratio target.

We presented this target and our strategies to achieve it, in May 2012, and we've been tracking very closely to our expectations on all fronts -- rate, loss inflation trends, underwriting actions and cost initiatives. While commercial lines renewal pure pricing is under some industry-wide pressure for the first 9 months of 2014, we have successfully achieved renewal pure price increases of 5.8%.

For several years, we've been achieving rate above loss inflation and at levels higher than the industry. While not every competitor discloses their renewal pure price changes on a quarterly basis, against the peers that do, we tend to be one of the top performing companies.

Our expectation for the full year 2014 is to obtain overall renewal pure price increases of approximately 5.5%. We are on track with our overall profitability goals and continue to make progress while monitoring the state of the industry for profitable growth opportunities.

In 2015, we expect to generate new business growth on, one, the expansion of our distribution course and new products; two, increasing our share of wallet for both retail and wholesale agents; and three, obtaining more E&S business from Selective's retail agents.

Another area of focus has been customer experience that promotes loyalty and best-in-class service. While service has been part of our culture since Selective's founding over the past several years, we've been implementing numerous customer experience initiatives including the rollout of a more user-friendly bill, a mobile service app, and driving self-service through our online and mobile offerings.

We're also tracking service levels through surveys that produce net promoter scores. We view this as an opportunity to increase retention and profitability.

In recognition of improving operating results and capital levels, the board of directors declared an 8% quarterly dividend increase to $0.14 per share, effective December 1, 2014, to shareholders of record on November 14, 2014.

As has been our practice, we will release our 2015 expectations with the fourth quarter earnings in January. For 2014, our guidance is as follows. Ex-CAT statutory combined ratio of 92, which includes no additional prior year casualty development; 4 points to 4.5 points of catastrophe losses for the year; after-tax investment income of approximately $105 million; and weighted average shares of 57.4 million.

Now I will turn the call over to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Vincent DeAugustino from KBW.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

I have a couple of quick ones on a nice quarter here. So John, to your point on shifting the focus on the workers' comp side to lower hazard business, I was curious if you might (inaudible) some of the industry's broadly -- and I guess don't want to give away too much competitive information there. But just where you have an increased appetite.

Secondly, maybe for Dale, knowing how you operate on the reserve side, I wouldn't expect your projected development patterns to immediately change there. But conceptually, would you agree that this should be a short-tail segment of the workers' comp business with quicker claims payment? Then what the mix, low hazard versus maybe regular business going forward, might be in a few years.

John Marchioni - *Selective Insurance Group, Inc. - President, COO*

I'll start, Vincent, and Dale can jump in on the reserving side. With regard to appetite and success, the first thing to point out would be, as you know, we've historically been a heavier contractors' market overall. That has come down in terms of mix over the last few years.

That's been a concerted effort on our part. We continue to be in a very strong contractors' market and a very profitable contractors' market. But we've really tried to diversify into other segments.

In terms of the segments, when you think about lower hazard, smaller workers' comp industry verticals that we're talking about here, I'd say you think about that heavily in the retail and the service type business segments, which are generally BOP-based products. And the ability to out and write the workers' comp on those competitively, I'd say, is a big part of our expectation and our strategies going forward.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Vince, on the reserve development side, as you know, with our book of business just in general terms being more small commercial, it already tends to have a little bit shorter tail than the board industry. And clearly, a lower hazard comp book, we'd expect to have a somewhat shorter tail also. But workers' comp is the longest tail line that's out there. So certainly, we'd expect to see some benefit from that, but I can't say that it would be dramatic enough to make large modifications to our schedule P patterns.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay. Got it.

John Marchioni - *Selective Insurance Group, Inc. - President, COO*

Then finally, Vince, we have very specific internal targets. We don't talk about those externally in terms of shifting the mix. And we really think about those on a policy count basis because as you'd expect, your higher severity classes carry higher average premiums. So you're really going to see this.

The shifts start to manifest itself in policy counts first and foremost and then later on, you're going to see it on a premium mix basis. We manage that internally. We hold our production folks accountable to moving those targets, but we just haven't talked about those externally.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

Vince, this is Greg. Also, just to dovetail on that whole comp question, obviously, we have entire conversations with you. We consolidate our comp claims handling down in Charlotte. We feel very confident and good about what we've done there. We have a triage model in place now.

We've got our strategic case management unit fully staffed now. And we're in the process of moving the balance of our inventory out of our five regional offices there. There's a small case remainder [mint] that needs to be pulled at that office.

So we feel really good about how we're going to be handling comp going down the road, specifically around the specialties that we'll be able to create on claim handling. And the level of focus that we'll have now going forward is greatly increased as one centralized unit versus how it was handled previously as five more or less more decentralized units. So we really look forward to some fundamental improvement in our comp book going forward.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay. The color there is actually really helpful and I actually do think the consolidation within Charlotte, right? Makes a lot of sense.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

Yes.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

So John, just on the personal lines product change, when I think about some of the big, call it, agency-focused insurers, mainly you and [SADI] and Hanover. Hanover and [Simpson] both have recently had some new products come to market within the personal lines space. I'm wondering how much does your new Edge product look and feel similar to those?

John Marchioni - *Selective Insurance Group, Inc. - President, COO*

So clearly, when we design product changes, we're looking at the competitor set that we have and most of our agents. We certainly view our product in line, in certain cases, better than that. Honestly, I'd say if you were to survey our agency plan, they would tell you that our home products have historically been very, very good from a coverage perspective relative to the industry.

For us, this is really trying to package up those coverage enhancements on both the home and the auto side in a way that's easier for agents to market that product to this customer base. But we feel very good about how it's positioned in the competitor set that we see typically.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay. Sorry if I missed this; I [ended up] with other calls, joining a little bit late. But on the surety side, did you happen to talk about the reserve faction there? Or I can just grab the transcript afterwards maybe?

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Do you mean excess and surplus as opposed to surety?

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Sorry, not surety, E&S, sorry.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Basically, we had a $4 million adverse development there on the E&S. And again, remember this is a young book and a small book, so we do expect some level of volatility as we gain experience and background with that. We do maintain our commitment to the profitability expectations that we have there, although we don't think that we'll achieve the initial combined ratio that we thought we were going to get for this year, 2014.

But we do think that on an overall basis, we're in good shape. And remember, we do tend to react very quickly to any kind of adverse patterns in our reserves because we like to stay on top of that and maintain a very strong balance sheet.

Vincent DeAugustino - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Talk to you soon. Thank you.

Operator

Mark Dwelle of RBC Capital Markets.

Mark Dwelle - *RBC Capital Markets - Analyst*

This is the quarter we've been watching for for some time, so I don't want to pick on a negative. But when I think about the adverse development charge in the E&S unit, what it implies to me is if you hadn't had that charge, the accident year run rate would've been in the mid-90s.

Is that more of the level that we should think about going forward or is there a factor or mix or something else that might make that number lower than I might otherwise guess?

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Mark, as we have talked about from us even getting into the E&S business, it was with the recognition that on a historic basis, this area within the industry has tended to perform at 6 to 10 points better than the commercial lines space. And it's our full expectation to be able to, over time, achieve that same level of performance.

So I agree with your mathematical assessment that we would've been in the mid-90s with that. And that's clearly what our goal is. We'll lay that out in more detail when we provide guidance for 2015 as to where we think that's going to perform next quarter.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

Mark, just to add to it, I think as we scale up more now, we'll be able to see some expense ratio efficiencies. But I think the core of that expense ratio is pretty solidly based around commissions paid to the wholesale agencies. So like Dale said, I think it's going to take us some time. We feel very comfortable about the quality of the book and what we're doing.

We've made a lot of fine-tuning and we'll continue. You know us, we're pretty aggressive on dealing with issues that manifest themselves. And just take a look at the comp, how everybody was on that. And we feel really good about the comp and that's how we manage our organization overall.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay. A little bit in that same vein then, you talked about some business that you were shifting away from standard and towards E&S. Can you talk about just in general how you're seeing business flows or is business still flowing that direction? Or more generally, are you seeing flows come out of the specialty area and towards the standard lines?

John Marchioni - *Selective Insurance Group, Inc. - President, COO*

I don't think you're seeing a big shift. The one big segment that you did see move from standard to E&S over the last couple of years has been on the habitational side. That's not a place that we played in on the Admitted market with our Admitted product, while we certainly do on the E&S side.

I'd say that's leveled off. And I think on the upper end of E&S, which is not where we really play on the brokerage-type business, the larger accounts, I do think you are starting to see a little bit more of that migrate back to the Admitted market. But I don't think you're seeing a big shift beyond those two areas at this point.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay. That's helpful. Then the last question I had, and maybe this is a question for anybody, Greg, maybe. In general on the mood of customers at this stage, we've been raising rates for 4, 5, 6 years in some cases. I know when I get that many rate increases, I eventually get tired of it. What are you sensing from your agencies? And what are people telling you about how customers are -- where their mood is at this stage of the cycle?

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

I think you said it pretty well. There's a little fatigue out there and that's probably the best word to use. Our sense is that going forward, I think what we need to do -- we've been trying to manage this through our agencies and their customers. But there should be some level of ongoing expectation of rate relative to loss inflation trends.

And I think that's the way we like to talk about it and refer to it. I've heard many of our other competitors use that language. And I think that just reflects that we just can't start these wild cyclical swings where you're reducing rates substantially in some years and then trying to build back rate up over.

But I will say that there's a number of companies that are going to be moving into the 2015 time period that still are going to require some fundamental improvement in their core underwriting results. If you haven't done the heavy lifting that we've done, it's going to be very difficult out there.

Mark Dwelle - *RBC Capital Markets - Analyst*

Okay. Thanks for the color, great quarter.

Operator

(Operator Instructions) Mike Zaremski from Balyasny Asset Management.

Mike Zaremski - *Balyasny Asset Management - Analyst*

In regards to the investment income guidance, I was just curious. Markets have obviously been choppy so far this quarter. Have you [plated] within that guidance the potential for weaker alternative returns?

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

Basically, if you look at where we are through 9 months and work through that, it is clear that our original guidance of $100 million was a little bit short of where we'll ultimately be. That's why we've bumped it to the $105 million. So we haven't included any dramatic expectations for material changes in any of the classes of investments that we're in.

Mike Zaremski - *Balyasny Asset Management - Analyst*

Got it. Okay. Then lastly, on the E&S reserve additions, can you provide any color on actually what drove the additions? Was it casualty, property, a mix of both? That would be helpful. Thank you.

Dale Thatcher - *Selective Insurance Group, Inc. - EVP, CFO*

It was all casualty development. Remember, that book of business is 75% casualty and 25% property. And basically, since that's brand new -- we bought it at the end of 2011 -- it was clearly the 2012 and 2013 accident years.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

The only other thing I would add there from a casualty perspective, we're a GL writer. There's no comp in that book; there's no commercial auto in that book. It's purely GL.

Mike Zaremski - *Balyasny Asset Management - Analyst*

Got it. Thank you.

Operator

Thank you. There are no other questions in the queue at this time.

Greg Murphy - *Selective Insurance Group, Inc. - Chairman, CEO*

All right. Thank you. If you have any follow up matters, please contact Jennifer or Dale. Thank you very much for participating on the call.
