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EDITED TRANSCRIPT

SIGI - Q1 2019 Selective Insurance Group Inc Earnings Call

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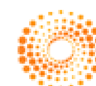

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PRESENTATION

Operator

Good day, everyone. Welcome to Selective Insurance Group's First Quarter 2019 Earnings Call. (Operator Instructions) At this time, for opening remarks and introductions, I would like to turn the call over to Senior Vice President, Investor Relations and Treasurer, Rohan Pai.

Rohan Pai - *Selective Insurance Group, Inc. - Senior VP of IR & Treasurer*

Good morning, and thank you. This call is being simulcast on our website and the replay will be available through June 2, 2019. A supplemental investor package, which includes GAAP reconciliations of non-GAAP financial measures referred to on this call is available on the Investor page of our website www.selective.com.

Certain GAAP financial measures will be stated in the call that also are included in our previously filed Annual Report on Form 10-K and Quarterly Form 10-Q reports. To analyze trends in our operations, we use non-GAAP operating income, which is net income excluding the after-tax impact of net realized gains or losses on investments, unrealized gains or losses on equity securities and, in the current quarter, the debt retirement costs related to the early redemption of debt securities. 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 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-Q's 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 today on the call are the following members of Selective's executive management team; Greg Murphy, Chief Executive Officer; John Marchioni, President and Chief Operating Officer; and Mark Wilcox, Chief Financial Officer.

And, with that, I will turn the call over to Greg.

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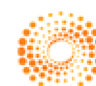

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Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Thank you, Rohan, and good morning. I'll first make some introductory remarks and then focus on some high level themes and initiatives that continue to drive our strategy for profitable growth. Mark then will discuss our financial results, and John will review our insurance operations in more detail, providing additional color on key underwriting initiatives.

Let me start by stating the annualized non-GAAP operating ROE of 11.6% was a strong start to the year and continues to double-digit levels that we've consistently generated since 2013. Our excellent first quarter results reflect the ongoing execution of our strategic initiatives that drives the company's success in a highly competitive insurance marketplace, that include renewal pure pricing that was in line with expected loss trend and net premiums written increased 8%.

Our above industry growth rate reflects in part renewal pure price increases and new business premium written that included the added premium from our five greenfield expansion states. We are now writing commercial lines in 27 states. Our highly talented employees work with sophisticated data and tools that assist our "ivy league" distribution partners with identifying and generating solid new business growth, as well as managing their renewal inventory.

From a profit standpoint, each Insurance segment contributed to our combined ratio of 94.7%, generating 5.7 points of annualized ROE. In addition, results in our insurance segments have been excellent as net investment income after-tax up 15% to $41 million, contributing 8.9 points of annualized ROE. The rise in net investment income after-tax reflected, one, cash flow from operations of 7% of net premium written; two, active management of the core fixed income portfolio; and, three, $106 million of net proceeds from the recent 5.375% senior notes issuance. We continue to actively manage the investment portfolio to optimize after-tax yields, while managing credit, interest rate and liquidity risk. This will become increasingly difficult if interest rates remain at current levels for a prolonged period. Our investment portfolio leverage is $3.24 and the after-tax yield is 2.8% as of the end of the quarter.

Conning's low-to-mid single digit industry-wide forecast for growth in net investment income after-tax reflects the pressure that interest rates are currently under. From year-end 2018, the yield on the 10-year treasury declined almost 30 basis points to %2.40 at March 31, 2019. Although it's recovered somewhat as of today, the Federal Open Market Committee, FOMC, remains under intense pressure to lower rates. At its March 2019 meeting, the FOMC decided to maintain the fed funds rate at the target between 2.25% and 2.50%. The fed has appeared to take it a more dovish and patient approach of monetary policy by backing off its one, one/two 2019 fed funds increase and, two, $50 billion monthly balance sheet runoff as of September of 2019.

I can't say enough about how we love this overall environment, because with only 6 points of industry ROE coming from investments, there is massive pressure for high quality underwriting pricing and risk segmentation, which are capabilities that many of our competitors do not possess. At Selective, given our two times industry underwriting leverage, our outstanding underwriting capabilities and proven track record of effectively managing renewal pure pricing and retention, we should be able to continue to maintain double-digit non-GAAP ROE performance. A.M. Best's industry forecast for 101% combined ratio in 2019 suggest a return on policyholder surplus of about 5%, well short of the industry's cost of capital.

Any return below the weighted average cost of capital is a destruction of shareholder value. Under the theme of "Arithmetic has no mercy" with expected loss trends up in the 3% to 4% range, the only math that improves industry-wide combined ratios is earned rate in the 5% to 6% range. Over time, generating renewal pure price increases over expected loss trend is the only way to maintain and improve profitability.

For the quarter, we achieved renewal pure price increases that on average were in line with expected loss trends. From a top line perspective, we expect to gain disciplined commercial lines market share growth through, one, efforts to increase the amount of business that we write with each distribution partner; two, increasing the number of distribution partners; and, three, the opportunity for us in our five new commercial lines greenfield states.

At Selective, we're 100% focused on customer experience (or CX), which is share experience working with our "ivy league" distribution partners to deliver a high level of customer centricity to our collective insureds. We have a 360 degree view of our customers, which allows us to engage them based on their preferences. As we've been highlighting over the past year, we've also been introducing value-added technologies and services such as, one, Selective Drive; two, proactive messaging; three, the SWIFT claim fast-tracking; four, the EZ claim write, which is a mobile appraisal

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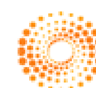

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solution that facilitates claims estimates within hours based on uploaded photographs; and, five, a fully digitally-enabled capabilities of the organization. These initiatives should improve retention and hit ratios and differentiate us in the marketplace.

Turning to 2019 expectations, after one quarter results, we are increasing our full year after-tax net investment income guidance by $5 million to $180 million, mainly due to the $106 million of net proceeds from the recent debt issuance. All other assumptions remain the same. Our full year expectations are as follows: a GAAP combined ratio, excluding catastrophe losses of 92%. This excludes any additional prior year development, catastrophe losses of 3.5 points; after-tax net investment income of $180 million, which includes $8 million of after-tax investment income for alternative investments; and overall effective tax rate of approximately 19%, which includes an effective tax rate of 18% for investment income, reflecting the tax rate of 5.25% on tax-advantaged municipal products and a tax rate of 21% for all other items, and weighted average shares of 60 million on a diluted basis.

Now, I'll turn the call over to Mark to review the results for the quarter.

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Thank you, Greg, and good morning. For the quarter, we reported $1.02 of fully diluted earnings per share and $0.90 of non-GAAP operating earnings per share. Excluded from non-GAAP operating income this quarter was a one-time after tax charge of $3.3 million or $0.06 per share for debt retirement costs on the notes we redeemed after the issuance of our $300 million public debt offering.

For the quarter, our annualized ROE was 13.2%. Our non-GAAP operating ROE was 11.6%, which is just under our 2019 target of 12%. High quality underwriting profitability and investment performance were both contributors to the strong overall results.

Consolidated net premiums written increased 8% for the first quarter with each of our segments contributing to the top line growth. The consolidated combined ratio was a solid 94.7%. On an underlying basis, excluding catastrophe losses and prior casualty reserve development, our combined ratio was 93%. Our ex-CAT combined ratio of 91.4% for the quarter is slightly better than our full year guidance of 92% for 2019.

For the quarter, catastrophe losses added 3.3 points to the combined ratio, which was slightly better than expected. Non-cat property losses, which have an elevated seasonal first quarter bias accounted for 17.1 percentage points on the combined ratio. We are now reporting non-catastrophe property losses after the inclusion of loss expenses, which better reflects the total cost associated with these claims. All prior periods presented have been updated to reflect this change.

In addition, in the first quarter, we experienced $10 million of net favorable prior year casualty reserve development, which lowered the quarter's combined ratio by 1.6 percentage points and was driven by $8 million of favorable development from the workers' compensation line and $2 million from general liability.

Our expense ratio came in at 33.3% for the quarter, which is generally flat relative to 2018, but down 50 basis points from the comparative quarter. Overall, we continue to seek out areas of efficiency in cost savings, while balancing these savings with investments in our operations for the company's long-term success, including investments in talent and in key initiatives such as geographic expansion, our underwriting tools, value-added services and the customer experience.

As we mentioned last quarter, we expect our expense ratio to remain relatively flat this year, assuming we hit our targeted level of underwriting profitability.

Corporate expenses, which are principally comprised of holding company costs and long term stock compensation totaled $12.4 million compared with the $11.3 million in the comparative quarter. As a reminder, our corporate expenses are elevated in the first quarter of each year as newly issued annual long term incentive compensation is fully expensed for retirement eligible employees.

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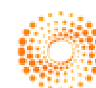

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Interest expense was up relative to prior periods, primarily reflecting the issuance of $300 million of senior notes on March 1st and a one-month overlap of $185 million of debt that was redeemed at the end of March. It also includes $4.2 million of pretax debt retirement costs that are included in net income, but are excluded in the calculation of non-GAAP operating income and the related metrics.

Turning to investments. For the quarter, after-tax net investment income was up 15% to $41 million. The overall after-tax yield on the fixed income portfolio was 2.96% during the quarter compared to 2.68% a year ago. The average new money yield on the fixed income portfolio during the quarter was 3.1% after-tax.

Despite the decrease in interest rates and contraction of credit spreads in the quarter, the pre-tax book yield for our fixed income portfolio edged up 8 basis points. Approximately, 14% of the fixed income portfolio are in floating rate securities, which reset principally based on 90-day LIBOR and these securities benefited from the fourth quarter increase in LIBOR, which was principally reflected in January resets.

We've been tactically managing the investment portfolio, seeking opportunities to increase the after-tax book yield, while maintaining high credit quality and managing duration risk. Our average credit rating remained strong at AA- and the effective duration of our fixed income and short-term investments portfolios down modestly to 3.5 years.

Risk assets, which principally includes high yield fixed income securities, public equities, and our alternative investments portfolio accounted for 8.1% of total invested assets as of the end of the first quarter, which is up modestly from year end, mainly reflecting additions to public and private credit mandates. Our alternative investment portfolio, which includes limited partnerships in private equity, private credit and real asset investments, and reports on a one-quarter lag, generated a pretax gain of $0.6 million for the quarter compared with a $1.6 million gain in the year ago period. The results for all of our alternative investment portfolio reflect the more challenging market conditions for the fourth quarter of 2018, but overall we were pleased with this performance.

As Greg mentioned, we have increased our 2019 after-tax net investment forecast by $5 million to $180 million, principally as a result for the net proceeds related to our recent debt offering.

Turning to capital, our balance sheet remains extremely strong with $1.9 billion of GAAP equity at the end of March, an increase of over 7% from year-end. Strong appreciation in the value of our fixed maturity and equity portfolio has resulted in net realized and unrealized after-tax gains totaling $91 million.

During the first quarter, we launched our inaugural institutional debt transaction raising $300 million of 30-year money, an attractive 5.375% coupon. We used part of the proceeds to extinguish our $185 million, 5.875% senior notes that became callable last year. We plan to maintain the remainder of the proceeds of the holding company for general corporate purposes.

Our debt to capital ratio currently stands at 22.2%, which is still below our longer-term target of approximately 25%. We are targeting the premiums to surplus ratio of approximately 1.4x. We continued to adopt a conservative stance with respect to managing our underwriting risk appetite, investment portfolio, reserving processes, reinsurance buying and catastrophe risk management. This allows us to maintain higher operating leverage than the industry as a whole with each combined ratio pointing to about 111 basis points of ROE.

In addition, our 3.24x investment leverage means that 100 basis points of pre-tax book yield on our investment portfolio results in 266 basis points of ROE. This model positions us well to generate superior returns in today's low interest rate environment.

With that, I'll turn the call over to John to discuss our insurance operations.

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

Thanks, Mark, and good morning. I'll begin with the results of our operations by segment and then provide an overview of some of our strategic initiatives. Our standard commercial line segment, which represented 81% of premiums in the first quarter generated net premiums written growth

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of 7%, driven by stable retention of 84% and renewal pure price increases of 3.4%. The commercial line segment generated a combined ratio of 94.8% or 93.6% on an underlying basis.

This segment has consistently generated excellent results from a growth and profitability perspective over the past few years. For the highest quality standard commercial lines accounts based on future profitability expectations, we achieved renewal pure rate of 2.0% and point of renewal retention of 91.2%. This cohort represented 49% of our commercial lines premium in the quarter.

On the lower quality accounts, which represented 11% of premium in the quarter, we achieved renewal pure rate of 8.2%, while retaining just 76% at point of renewal. Our ability to assess and administer the right price for a given risk at an extremely granular level allows us to achieve additional loss ratio improvement through mix of business changes by maximizing overall retention.

Going down to the results by line for commercial lines, our largest line of business, general liability, achieved an 88.2% combined ratio for the first quarter. Casualty net favorable reserve development totaled $2 million or 1.2 points on the combined ratio. We've achieved renewal pure price increases of approximately 2.4% for this line. While loss trends have been generally benign in recent years, we are closely monitoring loss severities.

Recent events, including the enactment of the Child Victims Act in New York State that extends the statute of limitations for filing claims, has brought the industry's exposure to abuse and molestation risk into the spotlight. At Selective, it has been an area of strong focus for the past couple of years, as we've increased our reserves to reflect this evolving risk and have worked with our agents to better manage our exposure through safety management and underwriting. We are paying close attention to this evolving exposure with a number of other states looking to follow in New York steps. It's an area of increasing risk that the industry needs to comprehend and try to get ahead of through improved pricing and safety management efforts.

Our workers' compensation line generated an 86.4% combined ratio for the quarter. Net favorable reserve development totaled $8 million or 10.2 points on the combined ratio and related to lower than expected severities for accident years 2016 and prior. Renewal pure pricing was down 1.6% in the quarter. Our reported results remained very strong. We managed to book on an accident year combined ratio basis, which for us and the industry have been running in the mid-90% range. This is a line that there is close monitoring as industry pricing has come under sustained pressure and loss cost filings by NCCI and other individual state bureaus continue to be negative. A flattening out or reversal in the trend of favorable frequencies and severities has the potential to significantly increase this lines' combined ratio for the industry.

Commercial auto remains a significant area of focus for both the industry and our company as profitability challenges continue to generate combined ratios that are in excess of targeted levels. To improve profitability in this line, we implemented price increases that averaged 7.3% in the first quarter, which was on top of 7.3% for 2018 and 6.7% for 2017. The first quarter combined ratio was 106.6% and while it's still early we have been observing actual loss frequencies coming in below expected levels for the past couple of quarters. We continue to keep a close watch on trends and bodily injury severities, which remain at elevated levels.

We've been actively managing the new and renewal books in targeted industry segments, which we expect a lot of positive impact on profitability through mix improvement. We are also taking steps to improve the rating and classification inputs. Over the longer term, we expect accounts that adopt our recently introduced Selective Drive program will have greater insight to their auto risks and have the potential to reduce their loss experience.

Our commercial property book generated a 97.8% combined ratio for the quarter. Results for this line continued to experience higher levels of non-CAT losses, driven by adverse weather and large buyers. We have seen some signs of price firming in this class, where we believe that the industry wide increase in loss trends supports additional price increases going forward. Renewal pure price increases for our commercial property business averaged 4.2% in the quarter. In addition to price increases, we are taking steps to address the drivers of the higher loss experience through mix shifts and safety management efforts.

Our personal lines segment, which represented 10% of first quarter premiums, generated 2% growth. This segment produced a combined ratio of 95.9% or 90.6% on an underlying basis. The homeowners generated flat premium volume relative to a year ago in a combined ratio of 98.4%,

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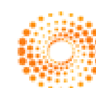

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including 12.6 points of catastrophe losses. Despite some expected volatility and quarterly results, profitability in this line has generally been strong in recent years. Renewal pure price increases averaged 1.9% during the quarter.

In personal auto, net premiums written increased 3%. The combined ratio for the quarter was 100.6%, a substantial improvement relative to the 106.6% a year ago. We are pleased with the trajectory of results for this line and expect continued profitability improvements with earned rate exceeding expected loss trends.

Our E&S segment, which represented 9% of total premiums for the quarter, generated 19% net premiums written growth, primarily reflecting the onboarding of new distribution relationships. The segment generated a 92.1% combined ratio for the quarter, a meaningful improvement relative to a year ago. Over the past few years, we undertook a number of deliberate steps to achieve price adequacy, improve the mix of business and centralize our claims handling processes, which are contributing to the improved combined ratio performance in the segment. E&S is a small segment that can experience quarterly volatility, however we are pleased with the performance in this business and expect to reach our targeted combined ratio in 2020.

I'll switch now to some of the strategic initiatives on which we're focused. We strive to be a market leader that is able to consistently generate best-in-class operating and financial performance. Our ability to execute on our strategy of generating profitable growth is predicated on our core competitive strengths, namely our franchise distribution partner relationships enabled by our unique field underwriting model, our sophisticated underwriting and claims tools, and a superior customer experience we and our agents provide to our policyholders.

First, our franchise distribution model with "ivy league" distribution partners is enabled by our empowered field base underwriting model and remains a true differentiator in the marketplace. We seek to obtain a 3% commercialized market share over time in the states in which we operate, built around appointing partner relationships approximating 25% of their markets and seeking an average share of wallet of 12% across those relationships. We believe that executing on this objective provides us substantial runway for growth in the coming years, representing an additional premium opportunity in excess of $2 billion.

Our current agency market share stands at over 19% and our share of wallet is approximately 8% in our legacy states. During the first quarter, we appointed a total of 24 new distribution partners, excluding consolidations, bringing the total to over 1,330 partnerships and 2,250 store-fronts. Our goal for the year is to appoint slightly over 100 new distribution partners.

Over the past two years, we've opened five new markets, consisting of New Hampshire and a Southwest Hub incorporating the states of Arizona, Colorado, Utah and New Mexico. Our geographic expansion plans have gone extremely well and our operations in the new states are performing in line with our expectations.

Second, we continue to build out and deploy sophisticated underwriting and claims technologies that allow for more efficient decision making, while enhancing overall outcomes. Our tools in commercial lines provide underwriters with model-driven real-time pricing and underwriting insights into each account, also allowing them to understand the impact of each piece of business on the overall portfolio. Our ability to understand the risk characteristics and price each account on a granular basis is best demonstrated by our track record in obtaining strong renewal pure price increases, while maintaining or increasing the retention rate over the past 10 years.

In order to reflect changing customer expectations, we continue to make significant investments to enhance the customer experience, which will position Selective as a leader in this area. Some of our initiatives include building out an omni-channel experience in which customers can engage with us in a 24/7 environment, a full self-service platform offering proactive communications where customers receive relevant information in the manner of their choosing and other value-added technologies and services, such as Selective Drive.

We continue to rollout our Selective Drive product to customers that have commercial vehicle fleets. We provide the product free of charge to business owners, who can leverage features such as logistics management, improved safety guidelines and telematics driven driver scoring. We've seen good take of our products since beginning the rollout late last year and expect to continue to engage our agents and customers about the benefits it brings. We believe value-added services, such as these, will improve retention rates and new business hit ratios, while also leading to better driving behaviors over time.

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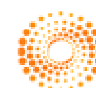

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As we look to the remainder of 2019, we are in an extremely strong financial and strategic position. We are steadfast in our focus on executing our strategies to generate profitable growth. We have the right distribution relationships, tools, technology and people in place to generate consistent financial outperformance.

With that, we'll open the call up for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question is from Mike Zaremski, with Credit Suisse. Please go ahead with your questions.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

First question is on rate versus loss trend. I believe last quarter when we spoke, you expected rate to about equal loss trend. You said that in your -- in the earnings release as well today. Any noticeable changes in either of those two dynamics? You've obviously heard some of your competitors and peers talk about how there's been a -- some momentum upwards on the pricing side. Although, you've also heard some other competitors say that part of that momentum is stemming from an uptick and loss trend as well, so there might be an offset there.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Okay. So, let me start and John too. Again, I've read the smorgasbord of conference calls and I know there is everything in from renewal price to renewal pure price to renewal price excluding comp to renewal price excluding whatever you want to take out of it. And just to get it clear, I mean we are talking about renewal pure price only. If you step back and said, well, Greg, what's your exposure change? It's close to 6% when you hear it from everybody else, but I just don't feel that that's truly representative of what's happening in the cost of goods sold. So let me just state that upfront and I would tell you that we are very confident with our long-term history of cobbling out renewal price increases that are at or about expected loss trend, and then we continue to manage. Again, we're starting with an excellent loss ratio. So -- and then we continue to manage out some of the other things that we do in terms of our inventory to improve that. But, I would say, John had a little bit in his comments too in terms of -- it's too early to be declaring mission accomplished on observed frequency numbers yet. The only thing I will tell you is that, it's better to sit here with a positive view of where you -- on observed trends across every one of our casualty lines relative to expected and rather than to be in the other -- on the other side of that and it's too early in the year to say, is this just an aberration or what's happening, it's too early in the year to say, hey, have we apexed on commercial auto, you got to look at what's happening with miles driven, you've got to look at what's happening with distracted driving and you have to look at what's happening with gas prices. So I would say that within the cost of goods sold area, there is nothing there that are concerning us either way, it's just continuing to be heads down and cobble out enough pure renewal price relative to our expected trend.

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

This is John. Greg answered that pretty holistically. Let me just add a couple of points. And generally speaking, you see our reported rate level and you hear the commentary that it's generally in line with our expectations for trend overall, but you also want to think about how trends move around from one line to another. Trends are influenced not just by your expectations relative to inflation on loss costs, but they are to a certain extent influenced by your historical trend. So when you think about it in those terms, how you think about trend going forward for commercial auto and for commercial property is going to be different than how do you think about it necessarily for workers' comp and for general liability. But, all in, with the rate level we're achieving, it is overall in line with our expectations for trend going forward and at our target combined ratios, which is where we've been writing business for the last few years, that's exactly where we're trying to maintain the level.

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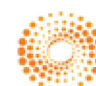

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Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

And then, as a follow-up, to the flattening out and favorable loss trend in comp, you said that could be an issue, but you're not seeing that, right? It would be an issue for the industry if that happened, but that's not the case, correct?

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

Mike, this is John. What I would say on that line is, and we've said this pretty consistently now, our reported results have been very good, but they have been influenced by strong favorable prior year development and that was about 10 points in the quarterly number. We don't spend a lot of time internally focusing on reported results. We focus on the accident year results and strip out that favorable development, but you can't assume it's going to be there forever. So when you think about that line running in the mid-90s, I call it 95 or so on an accident year basis and add to that negative rate level that we and everybody else is experiencing and the fact that you've got individual state bureaus and NCCI continuing to file loss cost reductions, which will continue to earn our way through everybody's books of business. If you see any change in frequency and severity for what's been happening over the last several years, it will have a bigger effect because it's in a negative rate environment. So we like our book of business, we like the way we're writing it and the performance it's giving us, but we're just appropriately cautious relative to that line's ability to continue to generate the kind of results it has into the future.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

Next question is on leverage, probably for Mark. Just curious over time, over the long run, as you guys grow into new states, will the -- your investment leverage profile change or maybe drift downwards or not materially?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

From an investment leverage perspective, that's obviously a function of profitability growth and GAAP equity and cash flow that we generate. It has ticked down a little bit over the last year to 3.24 times as we've had strong profitability and in particular this quarter $91 million of after-tax on net realized and unrealized gains or losses. But I think over the longer run, we would expect it to perhaps come down a little bit from where we are today, but not significantly so. That's fair to state.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

And just to, kind of, dovetail back on that, our sustainable -- the way we look at our sustainable growth rate since we try to keep a dividend payout ratio of approximately 25%, you can view our sustainable growth rate at 75% of our operating ROE with an operating ROE at around 12%, you know, you're talking about non-sustainable growth rate where if you are growing at or [above] (corrected by Company after the call) that you're not really pushing around your underwriting leverage and, as Mark talked about, from your investment leverage, you'll see that maybe be under a little bit of pressure. We always want to make sure we're managing our reserve inventory. We always want to make sure to the extent that we can take the duration of our liability down in a world where you may be consider -- considering inflation, particularly medical, is an area where you would be willing to make that trade. So, again, there is nothing specific there, but that's just a push/pull of running the organization.

Michael David Zaremski - *Crédit Suisse AG, Research Division - Research Analyst*

And then, lastly, on the E&S segment, results have seem to have potentially turned a corner last few quarters, do you expect that growth to remain in potentially double-digit territory going forward?

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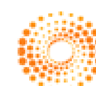

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John Joseph Marchioni - *Selective Insurance Group, Inc. - President & COO*

So we don't prognosticate on premium growth. I think we have stated both in this quarter and prior quarters that we have some newer distribution partner relationships. One significant in particular of that was a reappointment of a prior relationship that after that were spun out from the new owner, we reestablished a relationship. That relationship really kicked off in earnest last April or May. So it's starting to come through our performance in the second and third quarters more materially. So that will start to wind its way down. We'll continue to add agents. We think we can continue to generate good solid growth going forward, but it has been heavily influenced in the last three quarters by that one new big relationship, which will settle into a more normal run rate after we get through the first year.

On the profitability side, we're very proud of the improvement we're showing there. We did mentioned in the prepared comments, it is a smaller segment, so you will have some quarter-to-quarter volatility. And you've also seen, at least in the prior two quarters, this quarter and prior quarter, there has been a significant benefit, because actual property results have come in very favorably, which has contributed to those strong results. So a more normalized version of that is how we would think about that line going forward.

Operator

The next question is from Amit Kumar with Buckingham Research. Please go ahead with your question.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Just a few, two or three quick follow-ups. First of all in your opening remarks, I think you -- there was some discussion on the Child Victims Act, but did you book -- did you adjust reserves for that? It wasn't clear to me if there was any reserve component to that discussion?

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

I would just tell you that this whole exposure and obviously the type of business that you wrote at the time that may open up additional exposure, you've got to be very mindful of. I would just tell you that in our reserving process and what we've done, we've -- we try to be mindful of what this exposure could be and we are constantly working on and improving the process. So I would say that the reserves that we had up at the end of the year reflected a certain amount of that and there's been no changes that have necessitated us to do anything different as of this point in time.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

The second question I had was, you were talking about commercial auto and you also talked about Selective Drive, could you remind us what percent of your commercial auto uses the telematics option?

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

This is John. This is a program that just launched at the very late stage of 2018. So it's fairly new. The take-up is ramping up, but we don't really talk at this point about take-up rates. But I would say, at this point, they're low. It's not enough to influence the overall performance of the book, but we clearly expect as customers take this product on and start to use it and get the advantages of it, their individual experience will improve. And as the take up continues to go higher, it will start to have a better impact on the overall book. But it's early days, but we're pleased with the response we've gotten so far. And it's just now really where we're starting to ramp up the marketing of it now that we've had it fully piloted and tested and know how it works in the market.

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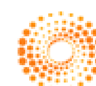

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Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

And Amit, this is Greg. So I just want to assure, it's not as John mentioned in his prepared comments, it's perfectly clear, a moderating tool. This is a tool that will help business owner better -- be a better business person and one of the key elements of it obviously is driving behavior, distracted driving. But, as John mentioned, we are getting way more aggressive working with our agents to distribute this to our renewal book, at point of renewal and increase the level of marketing directly into that and then would expect to be able to better demonstrate to our producing force how this could affect hit ratio at point of sale and these are the things that -- you got to work your way through in terms of demonstrating the value to the customer and the value from a safety standpoint. But in the end, it does make our community safer.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

I guess another way to ask the question I was trying to get to. I was trying to set a link up the dots here and think about how we should think about the underlying loss ratio going forward? So this product take up improves, I think what you've said, generally commercial auto trends are improving overall versus what we had seen in 2018. Is there -- is this premature or should I think about...

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

I would tell you -- Yeah, this is Greg. I'm sorry, I didn't mean to stop you there. But I would agree that this is a tool that we feel will improve the experience going forward, because you get through the Hawthorne effect, every driver in the fleet gets scored, they are scored weekly and from that that should -- and if you believe in the Hawthorne effect that should improve the quality of driving. And the insured will benefit over time through better experience, so our belief is, yes, it will have an impact. It's just that I don't think we'll ever get that comfortable just doing an actual overlay in terms of what it should -- what we should expect from us. So I would say that this will be a benefit as observed frequencies continue to maybe drop down, it could be a benefit based on how it may impact severity overtime, which would be way slower from an actuarial - I mean, our actuaries respond much faster to frequency trends and because you see them earlier and they have a much higher degree of confidence in what they're experiencing from a frequency standpoint, severity is a longer developing story. And that's like in the comp story from before, I mean we are continuing to see drop downs in severity in comp from old years and at some point that can't continue forever.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Yes. That's a fair point. And I think the only other question was, I know you talked about the NCCI discussion and then you talked about comp and I mean net-net, historically, if you look at the past inflection points or cycles, based on your experience, can you just talk about how do you feel about this cycle and its potential inflection point versus the last cycles? Thanks.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

I'm sorry, you're talking about specifically comp or you're talking about...

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Comp, specifically comp.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Let me start. I've got to tell you, so obviously, for me, I've been in the business long time, 39 years, obviously, the entire managed care was absolutely missed in terms of the benefits of managed care, in the pricing, what happened with it, I think you've got pundits on the side of what lower unemployment does to comp versus what higher unemployment does to comp, I don't see those necessarily fully panning out in the numbers either, relative to the quality of worker, people not wanting to go out on comp in different environments. So I can just tell you this, the rating

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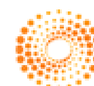

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agencies, the rating bureaus, excuse me, it's more attractive the correct term, are not really looking at forecasted trends, what could happen, what could marijuana do, for instance, in the workplace, what could that do to frequencies, what could recreational -- so in that case, recreational marijuana I'm referring to. They're not really particularly insightful at looking out and saying what may or may not happen, what may happen to trends. Like John told you, look, it's not going to continue to -- severity can't continue to decline, we can't keep giving up in a rate -- in a line where medical is the driver and whether it's RX, hospital services or doctor services. Those are all traditionally under a lot more inflationary pressure than any other part of what we offer as part of the cost of goods sold.

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

This is John. The only other point I would add to that is, I would say, because of the process of the individual state bureaus and NCCI, I think there is a natural lag.

Amit Kumar - *The Buckingham Research Group Incorporated - Analyst*

Yes.

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

There is a lag from the time at which individual companies start to recognize changes in their own frequency and severity patterns between that point and the point at which it starts to make its way into the data and ultimately the loss cost filings, there is a natural lag there and that's why we're so focused on closely managing our own trends and making sure we think about the book in terms of accident year performance as opposed to reported calendar year numbers to be out in front of that.

Operator

The next question is from [Freddie Sleiffer] with KBW. Please go ahead with your question.

Frederique Sleiffer - *Keefe, Bruyette & Woods - Equity Research Associate*

I think you talked a little bit about loss cost inflation within your commercial lines segment already, but within personal lines you had a 5.2% pure rate increase, how does this match up with your current loss cost inflation trends in personal auto and homeowners in particular?

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

I would say our personal lines loss trend expectations are fairly in line with how we talk about trends for the overall organization. So when you look at that, at that earned rate or written rate and earned rate level in personal lines, you want to think about it in the context of our overall trends that we talked about on loss trend expectation.

Frederique Sleiffer - *Keefe, Bruyette & Woods - Equity Research Associate*

And then -- so you had three consecutive pretty solid quarters in E&S now and the rates appear to be strong. And you said, I think that, you hope to achieve your target combined ratio by 2020. Is there anything in the line -- is there anything you're seeing in the line that's making you a little cautious and what combined ratio are you targeting?

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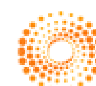

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John Joseph Marchioni - *Selective Insurance Group, Inc. - President & COO*

So we target a combined ratio for E&S that is in line with our overall combined ratio target to generate our 12% overall return on equity. So that continues to be our target there. The only thing I would point to and point back to the earlier comment is, we need to remember, number one, it's a small segment, so you will have some inherent volatility to the fact that it's a small segment. And, second, the segment has benefited at least in particular in the last two quarters from better than expected property losses on both the cat and a non-cat basis and that also could bounce around from quarter-to-quarter. So I wouldn't necessarily -- let's say, that's cautious as much as -- in terms of how we think about the run rate performance of that business. So we're very pleased with the overall rate level. I think on an overall basis, you saw what we reported, there are still some pockets that we're trying to address more aggressively, there are still some pockets we think we've got more room for growth and we'll adjust accordingly, but, overall, everything is pointing in a very positive direction for E&S.

Frederique Sleiffer - *Keefe, Bruyette & Woods - Equity Research Associate*

Okay. Makes sense. And then just quickly on your 2019 guidance, doesn't look too many of reserve development, right now, but you released about $10 million this quarter.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Yeah.

Frederique Sleiffer - *Keefe, Bruyette & Woods - Equity Research Associate*

Those segments had lower core loss ratios year-over-year as well. How much core loss ratio improvement is baked into your current guidance? And at what point would you possibly consider lowering your combined ratio guidance?

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

So we go through a very methodical budgeting process, so I would not look at anything, any fluctuation. Now, what you would see in our liability lines for the most part are what we've got for the year, we have not -- made no alterations to any of our ratios and believe we wouldn't really be that aggressive at changing any of them -- any -- unless they were to the negative in any significant way. So I would tell you that from a development standpoint, that's something that we look at our reserves every quarter, we go through a very disciplined process and we do that consistently side. So that's really all I can tell you about that part of it. But from a cost of goods sold standpoint, we feel good about what we're seeing on the observed trends as we mentioned, but I can't imagine that we would -- it's just too many wildcards out there, what's the overlay of recreational marijuana do to your frequency numbers? What if -- there is so many things that you need to be thinking about in this business that we can't just sit there and go, I've got something and I'm going to prognosticate that to the -- where the numbers are going to settle out at. So, again, I always say as a word a cautious, because that's how we manage our business.

Frederique Sleiffer - *Keefe, Bruyette & Woods - Equity Research Associate*

Okay. And then just lastly, I think you mentioned you will be keeping some of the proceeds from the debt issuance for corporate expenses and the remainder? Is there any more color you can give there or anything else you might consider using the proceeds for?

Mark Alexander Wilcox - *Selective Insurance Group, Inc. - Executive VP & CFO*

Yeah, Freddie. This is Mark here. So what we mentioned was, we've raised the $300 million net of underwriter discount and bringing down the coupon level debt for that net proceeds of, call it, $291 million, we paid back the $185 million of the senior notes we had outstanding. So reduced the overall run rate of interest expense on the $185 million. The net proceeds of, call it, $106 million, those are at the holding company, the parent,

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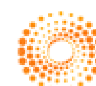

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SIGI, and they're available for general corporate purposes. So, in the past, we've talked about wanting to have cash and liquidity at the parent company at approximately a level that equates to 2 times our annual run rate of expenses of the parent company. That's about $160 million in total to take care of approximately $80 million of run rate of expenses, i.e. common stock dividends and interest expense with the additional proceeds were up to about $258 million at the end of the quarter. And those are available for general corporate purposes. So to the extent that we have good growth opportunities ahead of ourselves, we're generating very strong returns well ahead of our weighted average cost of capital. We would look to deploy that cash and liquidity into the business to continue to drive the growth and maintain our operating leverage ratio at the 1.4x -- a rate that we're comfortable with.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

So, Freddie, this is Greg. I just add to that, I think Mark touched on it. We look at this in the horizon in front of us. When some of these industry issues come to a head, i.e. in terms of companies legitimately trying to improve their profitability and how they work through that, and then our opportunity in our agency plan with a lot of the aggregators with a lot of additional greenfield opportunities look at -- we can get to the point where we want to support growth rates over our sustainable levels and as we talk to you about before, our sustainable growth rate is 75% of ROE and we want to be able to do that by having this capital at the parent company, we can then contribute it on the downstream basis into the insurance subsidiaries on a systematic basis to maintain those leverages, but also to provide the capital to be able to grow the business and I think they're -- in the next two -- in this next time period, I think there's going to be a lot of dislocation whether it's M&A, whether it's companies trying to significantly improve their profitability; when they don't have the tools to do that, I think that will create opportunity for a company like Selective and we want to be well positioned to be able to seize that opportunity.

Operator

The next question is from Matthew Carletti with JMP Securities. Please go ahead with your question.

Matthew John Carletti - *JMP Securities LLC, Research Division - MD and Senior Analyst*

Most of my questions have been answered. Just a couple of small ones. I know it's a small piece of your business. But on E&S, I was hoping you might be able to talk a little bit about the broader environment. We've heard some comments elsewhere about it's really starting to move, just curious what you're seeing in terms of standard market appetite flows, submission flows to you just the broader environment that would be helpful? Thank you.

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

Yeah. This is John. I would say, overall, we look at our pricing levels, we feel pretty good about our ability to generate our targeted pricing levels to improve performance. I would say, growth in our core binding business, new business has come under a little bit of stress, we've seen a couple of segments in the market that are always on the fringe of admitted to non-admitted based on the market cycle start to get some migration back into the standard market, which makes a little bit harder to write. But I would say that's fairly isolated. It's -- when you hear different commentary from different companies about E&S and the pricing environment, it's hard to actually put that all together to understand, because companies play in very different spaces. We're in the contract binding space, which is the very small end of the market, small casualty driven business. So pricing might be running a lot higher on the cat-exposed property markets based on capacity being pulled back and that by they are pulling some companies overall view of the pricing environment. I would say, we think about our E&S business and the casualty pricing environment about similar to how we think about casualty pricing in our standard book, but it's actually been a little bit higher in terms of our ability to capture rate on that line of business.

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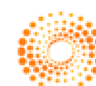

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Matthew John Carletti - *JMP Securities LLC, Research Division - MD and Senior Analyst*

And just quick numbers. I want to apologize, if I missed it, when you kind of ran through the business lines, but was there any development either way in commercial auto in the quarter?

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

No, there was none.

Operator

(Operator Instructions) The next question is from Scott Heleniak with RBC Capital Markets. Please go ahead with your question.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

Just had a question on the personal lines unit, you're getting good rate increases, you have for a while, the margins are good, the premium growth is a little more modest in Q1 relative to what you kind of saw in 2018. So wonder if you could just touch on your appetite for growth there and any significant repositioning going on there, particularly on the homeowners' side. I know you've kind of done that from time to time, but just if you could touch on those?

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

This is John. I'll take the second part of your question first. I would say, there is no significant repositioning. We feel really good about our home book, the profitability has been fairly consistently positive as we mentioned in the prepared comments. There are some quarterly noise because of non-cat property losses in particular, but overall the performance there has been solid and you saw the rate level at just under 2%, reflective of how are we thinking about that book.

On the auto side, we've seen good improvement. We're getting about -- we got about 7.8 points of rate overall on personal auto and when you look at what's happening in the broader market, especially with some of the bigger players, that rate level is higher than what you're seeing broadly, which is -- clearly put pressure on our hit ratios and our ability to grow the personal auto line and because we write a fair amount of companion business, not a package per se but packaged up the home and auto, it's put pressure on new business growth overall in that segment.

So we always respond to that in a way that we're comfortable based on where our profitability is, when our profitability is improving and we still think there's an opportunity on personal auto from an expense standpoint to bring that down a little bit going into the future, which will also help that combined ratio. We look to get ourselves back into an improved competitive position, but I would say that's where the pressure is coming from.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

And then, just want to touch on non-cat weather-related losses, they were -- they are down a little bit year-over-year. It seems like they are still higher than normal really for the industry itself. So, I'm wondering if you could touch on -- just your thoughts on whether this is kind of the new normal for the industry and whether there is anything that you guys have done across your book to be able to see improvements over '19 and '20 as a result of what's happened over the past year or two.

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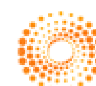

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John Joseph Marchioni - *Selective Insurance Group, Inc. - President & COO*

This is John again and others could add into the commentary. It is certainly down year-over-year, first quarter to first quarter, and I believe Mark referenced in his prepared comments. There is some seasonality to that, I think the non-cat number from a quarterly basis and winter weather certainly affects that. Our view is, the commercial property market overall up until fairly recently has been one of the more competitive pricing price lines in the industry. So even as other pricing started to move in different lines, commercial property remained very competitive and with this increased non-cat property loss experience that we and everybody else is experiencing, our view, this is just a line that needs overall rate level, because target combined ratios in this line are going to be a fair amount lower than overall target combined ratios. When you think about the normal volatility in that line, you need to be running it on a lower target combined ratio to handle those quarters in those years where you're going to have elevated non-cat and cat losses. So, we've been trying to push rate level there and our quarterly number was at 4.2. We think this is primarily a pricing issue. There are some things we're doing on the loss control side certainly to work with our underwriters around normal loss expectancy and fire loads based on building construction and making sure our pricing is as accurate as possible based on different risk characteristics, but I would say overall price level is going to be the biggest driver of improvement for that line.

Scott Gregory Heleniak - *RBC Capital Markets, LLC, Research Division - Associate VP*

Yeah. That's pretty consistent with what people are saying as that the line definitely needs more price, it's just a matter whether it happens and people go forward with that. So, anyway. Thanks a lot.

Operator

At this time, there are no further questions. I would like to hand the call over to Greg Murphy for any closing remarks.

Gregory Edward Murphy - *Selective Insurance Group, Inc. - Chairman & CEO*

Thank you. And if you have any follow-up items, please contact Mark or Rohan. And I thank you for participating in the call today. Thank you very much.

Operator

That concludes Selective Insurance Group First Quarter 2019 Earnings Call. Thank you for your participation. You may now disconnect.

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