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SIGI - Q4 2016 Selective Insurance Group Inc Earnings Call

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PRESENTATION

Operator

Good day, everyone. Welcome to Selective Insurance Group's fourth-quarter 2016 earnings call. 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. Thank you, sir. You may begin.

Rohan Pai - *Selective Insurance Group, Inc. - SVP, IR & Treasurer*

Good morning, everyone and welcome to Selective Insurance Group's fourth-quarter 2016 conference call. My name is Rohan Pai, Senior Vice President of Investor Relations and Treasury. This call is being simulcast on our website and the replay will be available through March 3, 2017. 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, www.selective.com.

Certain GAAP financial measures will be stated during the prepared remarks that will also be included in our annual report on Form 10-K and is in our previously filed Form 10-Q reports. To analyze trends in our operations, we use operating income, which is a non-GAAP measure. Operating income is net income excluding the after-tax impact of both net realized investment gains or losses and 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 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 risk 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 statement.

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; Mark Wilcox, Chief Financial Officer; and Ron Zaleski, Chief Actuary. With that, let me we turn the call over to Greg.

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

Thank you, Rohan and good morning. Before I get into the quarter, I'd like to take the opportunity to welcome Mark Wilcox, our new Chief Financial Officer, to the Selective executive management team. Many of you already know Mark from his prior experience at Renaissance Re. We are extremely



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happy to have him on board. Mark started with us in the new year and while he has had a very busy first month, he has already been adding a lot of value to our organization.

I will begin with introductory remarks and focus on some of the high-level themes from the fourth quarter and the full-year 2016. Mark will then discuss our financial results and John will review our insurance operations in a bit more detail and provide color on some of our underwriting and claim initiatives.

We are very proud of the financial results we reported in 2016. The fourth quarter rounded out another record-setting year in terms of underwriting results and operating earnings driven by excellent results in our standard, commercial and personal lines operations. We reported an overall statutory combined ratio of 91.8% for the year, which was about 9 points better than A.M. Best's industry forecast for 2016. Our stock price hit an all-time high of \$44 in 2016 benefiting from the strong results we continue to generate.

For 2016, our operating return on equity was a solid 11%, reflecting the years of hard work to drive our renewal pure price higher, generate new business and improve the underlying profitability of our book through various underwriting and claim initiatives. It was an impressive result given the prolonged low interest rate environment of recent years.

Our commercial lines net premium written growth of 9% in 2016 was significantly higher than the 1% industry commercial lines net premium written growth rate forecasted by A.M. Best. But none of this would've been accomplished without the hard work, focus and dedication of our best-in-class employees who strive every day to achieve the high targets that we set. A personalized and customer-centric approach has always been the cornerstone of our strategy and remains core to achieving our strategic objectives.

We are not resting on our laurels. As we look to the future, we are positioning ourselves for a more competitive environment with a razor-sharp focus on generating adequate returns for our shareholders. In a period of heightened uncertainty, whether it's tax law changes, interest rates, legislative changes or inflation, Selective is well-positioned.

The Company has also taken a number of strategic initiatives in place to enhance our overall customer experience. With respect to our financial results, there are a couple of areas I would like to highlight. The first is our solid overall net premium written growth of 8%. The main driver of this profitable growth is our strong franchise value and Ivy League distribution partners.

In addition, the growth was aided by the appointment of 110 retail agents in 2016. Approximately 15% of our standard lines commercial lines premium was written by agents appointed in the last three-year period. We are also generating solid overall pure price increases on our renewals, averaging 3.1% across all of our segments while maintaining high retentions. Our E&S segment experienced some new business opportunities as we increased our appetite slightly for new business through our brokerage channel.

In standard commercial lines, renewal pure price for the fourth quarter was a very strong 2.7%, well in excess of the recent market levels reported by Willis Towers Watson commercial lines or CLIPS survey. We are off to a strong start in 2017 with a January commercial lines pure price increase of 2.4%. It is worth noting that we have cumulatively outperformed the CLIPS industry index in terms of paying price increases the past 28 quarters by approximately 1700 basis points while maintaining high retention rates.

As the marketplace gets more competitive for new business, Selective has the tools, processes and people in place to navigate through the market cycles. With the industry expecting a statutory combined ratio of 104.7% for 2016 forecasted by A.M. Best, it will be difficult for companies to generate adequate returns on capital. In addition, with the possibility of rising inflation rates in the near future, it is particularly important to maintain discipline and avoid past industry mistakes.

The second area I would like to highlight is the profitability that Selective has been able to consistently generate in recent years. We reported a record-setting underwriting statutory combined ratio for the full year 2016 of 91.8%. This result was significantly better than the guidance we established in the beginning of the year of 94.5%. In addition to the cumulative price increases we have implemented in our standard commercial lines over the past eight years, Selective's financial results have also benefited from underwriting and claims process enhancements, as well as a



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shift in our business mix towards higher quality accounts. These changes have led to improved commercial lines results that should better position us relative to the industry in the future.

For 2017, we remain committed to maintaining underwriting discipline and executing on our balanced profitable growth strategy while continuing to work with our distribution partners to generate a best-in-class customer experience. It is particularly gratifying looking back on our 90-year history that Selective finds itself today in the strongest position ever from both a financial and a strategic perspective. With that, I will turn to our expectations for 2017. Our guidance for the full year is based on our current view of the marketplace that incorporates a statutory combined ratio, excluding catastrophe losses of 90.5%. This assumes no prior-year development, catastrophe losses of 3.5 points, after-tax investment income of \$110 million and weighted average shares outstanding of \$59.2 million on a diluted basis.

Our guidance for a statutory combined ratio of 94%, including catastrophe losses for 2017, is extremely strong in the context of an estimated breakeven industry combined ratio forecast as per A.M. Best. On an underlying basis, or excluding catastrophe losses and reserve development, we are forecasting a combined ratio improvement of 1.7 points versus A.M. Best's forecast of only 60 basis points for the industry. Now I will turn the call to Mark to review the results for the quarter and the year.

Mark Wilcox - *Selective Insurance Group, Inc. - EVP & CFO*

Thank you, Greg and good morning. I'd like to start by saying that I'm extremely pleased to have joined the Selective team. I look forward to helping the Company execute on its strategic plan and objectives, including continuing to drive disciplined profitable growth over the coming years. I have come to know many of you on the call in my prior role and I look forward to meeting with you over the coming weeks and months.

Moving on to our financial results, I will focus on some key metrics, some trends for the Company as a whole and then we will also touch briefly on our segments, our focus on the quarter, but we will also hit some of our full-year financial highlights. For the quarter, we reported \$0.67 of fully diluted earnings per share and \$0.75 of operating earnings per share. We generated return on equity of 10.1% for the quarter and an operating ROE of 11.4%. For the year, we generated a 10.8% ROE and an 11% operating ROE.

As a reminder, our long-term financial target is to generate an operating ROE that is 300 basis points over our weighted average cost of capital, which we believe will generate solid growth in book value per share and strong shareholder returns over time.

Selective's GAAP combined ratio was a solid 93.6% for the quarter. For the year, we recorded a GAAP combined ratio of 92.9%, which generated \$98.8 million of after-tax underwriting profits. This contributed 6.7 percentage points to the full-year operating ROE. For the year, the investment portfolio generated after-tax net investment income of \$98.4 million and also contributed 6.7 percentage points to our full-year operating ROE. So there was a pretty even split between underwriting and investments in terms of contribution to our ROE for the year.

Focusing on our underwriting results, the combined impact of renewal pure price increases, strong retention rates and new business generated 9% growth in net premiums written for the quarter and 8% for the year. The reported statutory combined ratio of 91.8% in 2016 was a record result for the Company. Excluding 2.8 points of CAT losses, the statutory combined ratio of 89% ended the year a little bit better than the 91% ex-CAT stack combined ratio we had forecast a year ago. Our CAT loss ratio for the year of 2.8 percentage points came in 70 basis points better than our 3.5 percentage point forecast for 2016. As a reminder, due to our 1.4 times statutory premium to surplus ratio, which is about twice the industry average, each combined ratio point equates to about a point of operating ROE. We believe our operating leverage provides us with a competitive advantage because, for the industry to produce the same level of ROE from underwriting performance, it must generate twice the underwriting margin.

For the fourth quarter, our statutory combined ratio of 93.4% was a little bit elevated as we incurred \$27 million or 4.8 points of CAT losses. This was driven by \$12 million or 2.2 points related to Hurricane Matthew and \$14 million or 2.5 points related to the Tennessee wild fires. The Hurricane Matthew losses were right in the middle of the \$10 million to \$14 million range we preannounced on our third-quarter conference call. Our Tennessee wildfire losses came mainly from a handful of large personal lines property losses and you'll see the impact of this in our standard personal lines segment results for the quarter.



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In addition, during the quarter, due to an increased trend in frequency in 2016, principally within our commercial auto book, a trend that we've been monitoring for some time, we raised our 2016 accident year loss picks in the quarter. For the quarter, the impact was 130 basis points of deterioration to our overall combined ratio. For the full year, including actions we took earlier in the year, the impact was about 70 basis points on our overall combined ratio.

Our reserve position remains strong and our results continue to benefit from prior-year favorable casualty reserve development. This past year was our 11th consecutive year of net favorable reserve development. For the quarter, we experienced \$23 million of favorable development, which equates to 4.2 points on the combined ratio. In the current quarter, reserve releases were driven by favorable claims trends in our workers' compensation line of business, which reported \$20 million of favorable development and our general liability line of business, which reported \$12 million of favorable development. Partially offsetting this favorable development was \$5 million of unfavorable prior-year cash early development in commercial auto.

For the year, we experienced \$69 million of total favorable casualty reserve development, which benefited our combined ratio by 3.2 percentage points. It is important to note that this figure is net of adverse reserve development totaling \$25 million in commercial auto and \$6 million in E&S casualty for the year.

Moving on to the segments, our standard commercial lines segment net premiums written were up 10% for the fourth quarter and 9% for the year. The fourth-quarter statutory combined ratio for commercial lines was 89.5%. Results benefited from \$28 million or 6.6 points of favorable prior-year casualty reserve development and were offset in part by \$13.6 million of CAT losses or an addition of 3.2 points for the combined ratio. For the year, our commercial lines statutory combined ratio was 89.9% and our GAAP combined ratio for this segment was 91.2%.

In our standard personal lines segment, premiums were up 3% for the fourth quarter and down 1% for the full year. For the quarter, personal lines generated a statutory combined ratio of 108.5%, which included 16 points or \$11.4 million of CAT losses mainly for the Tennessee wildfires. The combined ratio also included \$2.5 million or 3.5 points of prior-year adverse casualty reserve development from our personal auto book. For the year, our personal lines statutory combined ratio was 95.2% or 95.6% on a GAAP basis.

While our underlying results in homeowners was solid benefiting from various initiatives implemented in recent years, loss trends in personal auto have been challenging across the sector and a number of our competitors have begun to raise prices to address these trends. Flood claims handling fees relating to our participation in the National Flood Insurance Program totaled \$1.6 million in the fourth quarter, primarily related to Hurricane Matthew and as a reminder, these fees are recorded in the personal lines segment.

In our E&S segment, net premiums written increased 6% for the fourth quarter and 11% for the year. For the quarter, the E&S segment generated a statutory combined ratio of 105.5%, which included \$3 million or 5.8 points of unfavorable prior-year casualty reserve development and 3.1 points of CAT losses. For the year, our E&S stat combined ratio was 102.1% or 103.4% on a GAAP basis and although this is not yet where we want it to be, it is down from 2015.

We continue to take meaningful underwriting actions, including targeted price increases and changes to the business mix, to improve underwriting profitability in this segment. While the top-line growth rate has declined as a consequence of these actions, our primary focus is on improving underwriting results to target the levels of profitability.

Moving on to expenses, our overall statutory expense ratio was 35% for the fourth quarter and 34.2% for the year. In part due to our increased profitability, our expense ratio has been under some pressure due to supplemental commission expense paid to our agents, as well as the higher level of incentive compensation paid to employees.

Looking to the future, we are reviewing our major processes and expenditures and looking for opportunities to enhance our operating efficiency. For example, we have restructured our long-term incentive program, which is included in other expenses and expect these expenses to decrease by approximately \$10 million over the next 12 months. While we will continue to invest in technology, our high touch customer experience, underwriting tools to improve profitability and our employee base, we expect our more recent expense initiatives will bring down our expense ratio over time.



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We successfully renewed our 2017 property CAT treaty at 1/1 with the program remaining at \$685 million in excess of a \$40 million retention. We also renewed a treaty that specifically covers catastrophic events outside of our 22 state standard lines footprint. This \$35 million in excess of \$5 million per occurrence treaty reduces potential volatility from CAT events that would be specific to the E&S line's book of business. Pricing on both programs was down modestly on a risk-adjusted basis.

Turning to investments, for the quarter, pretax net investment income was \$35.4 million, which is up 18% from the comparable quarter and for the year, pretax net investment income totaled \$130.8 million, which is up 8% compared to 2015 or up 5% on an after-tax basis. Fixed income, which represents 92% of our portfolio, experienced an 8% increase in pretax net investment income to \$33 million resulting mostly from a higher asset base and a modestly increased allocation to high-yield investments.

New money rates averaged 3% or 2.1% on an after-tax basis during 2016. The pretax yield on the fixed income portfolio at December 31 was 2.72% or 2.03% on an after-tax basis. Alternative investments, which report on a one-quarter lag, reported a pretax gain of \$3 million, up from a loss of \$1 million in the fourth quarter of 2015. We are seeking to diversify our investment portfolio further and modestly increase our risk allocation going forward.

Our focus, however, will be to maintain a highly liquid and conservative investment portfolio that is designed to support our claims-paying ability. Our fixed income portfolio is highly rated with an average credit quality of AA- and a 3.6 year effective duration, including short-term investments. Given the sharp increase in treasury yields during the fourth quarter, the pretax unrealized gain position on our fixed income portfolio decreased \$112 million to \$39 million at the end of 2016. While higher interest rates will hurt the value of our fixed maturity portfolio, our 3.5 times investment leverage means that our run rate net investment income and operating ROE should benefit if interest rates increase in the coming periods.

Our balance sheet remains strong with \$1.6 billion of statutory surplus at year-end and \$1.5 billion of GAAP equity. Book value per share declined 3% during the fourth quarter as the reduction in unrealized gains on our investment portfolio more than offset strong earnings. For the year, book value per share increased 8% to \$26.42.

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

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

Thanks, Mark and good morning. Our results for the year reflected various initiatives we have implemented to balance strong profitability with our strategic objectives around growing the business. We continue to invest in technology to enhance the ease of doing business for our agents, the overall customer experience and our data and analytics platforms. We believe all three will be key success factors in our industry for many years to come.

Our core standard commercial lines results were extremely strong for the year. Solid top-line growth was driven by a stable retention of 83%, new business growth of 5% and renewal pure price increases averaging 2.6% for the full year. In fact, renewal pure price increases averaged 2.7% in the fourth quarter and 2.4% in January of 2017. We closely monitor our pricing based on profitability expectations using our dynamic portfolio management underwriting tool. For the highest quality standard commercial lines accounts, which represent 50% of our premium, we achieved renewal pure rate of 1.5% and point of renewal retention of 91%. On the lower quality accounts, which represent 10% of premium, we achieved pure rate of 7.3% and point of renewal retention of 78%.

Drilling down to the by-line results for commercial lines, our largest line of business, general liability, reported a statutory combined ratio of 83.8% for the full year of 2016, which included \$45 million or 8.5 points of favorable prior-year casualty reserve development. Favorable reserve development relates primarily to lower-than-anticipated claim severities for the 2010 through 2013 accident years, as well as the accident year 2015.

Worker's Compensation continued to benefit from the recent improved loss trends. The steps we have taken in recent years to obtain adequate pricing, improve the business mix and enhance claims outcomes have resulted in solid underwriting margins. This includes initiatives in recent years that shifts towards lower hazard and smaller accounts. For full-year 2016, we achieved an 80.7% statutory combined ratio in worker's compensation, which includes \$56 million or 18.2 points of favorable prior-year casualty reserve development. This development was driven



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primarily by lower severities in accident years 2014 and prior as results benefit from the significant changes in claims handling and outcome management, as well as lower prevailing loss cost inflation.

The commercial property line also had strong results for 2016 with a statutory combined ratio of 84.3%. Commercial auto on the other hand remained a trouble spot and is an area that we are focused on to improve the overall financial results. For the full-year 2016, commercial auto reported a statutory combined ratio of 109.3% that includes \$25 million or 6.3 points of unfavorable prior-year casualty reserve development.

Adverse reserve development in commercial auto liability related mainly to higher severities in accident year 2014. Higher frequencies initially experienced in the 2015 accident year continued into the 2016 accident year. We continue to push for and achieve rate increases in this line. For the full-year 2016, renewal pure price across the commercial auto line averaged 4.9%. In particularly challenging commercial auto classes such as paratransit, motor freight transport and certain wholesale classes, we have reduced our appetite for new business significantly and have implemented meaningfully higher price increases.

Switching to personal lines, the overall underlying results continue to demonstrate the aggressive underwriting actions we have been taking to improve the profitability of the homeowners book. Within homeowners, underwriting results were hurt by an elevated level of catastrophe losses in the quarter, but the statutory combined ratio was a profitable 91.7% for the full year of 2016. We continue to target a 90% combined ratio in a normal catastrophe year. We assume 14 points of catastrophe losses for this line on an annual basis and are very close to achieving our margin goals. Renewal pure price increases across our homeowners book averaged 6.1% in 2016 and we are targeting 2% renewal price increases in 2017.

In personal auto, the statutory combined ratio was 109.3% for the full year. The industry continues to grapple with increased frequency and severity trends in this class. We have seen higher-than-expected frequencies in the 2016 accident year and in response have increased our booked loss ratio over our original expectations. The industry's quest for rate adequacy should provide us with opportunities to grow the book while improving margins.

For the full-year 2016, renewal pure price increases on our book averaged 3.2% for personal auto liability and 3.9% for personal auto physical damage. Our plans for 2017 incorporate rate filings averaging 5.8% in order to address profitability. Over the past few quarters, the underlying benefits of recent underwriting actions and price increases implemented in our E&S business have begun flowing through; although this has hurt the top-line growth rate. We have made the deliberate decision to walk away from business that does not meet our profit hurdles.

Renewal price increases averaged 6.1% in 2016. Price increases in particularly troubled E&S classes, such as habitational in Florida, New Jersey and Connecticut, were significantly higher. We continue to see opportunities for growth in the E&S segment by targeting specific classes where market pricing is in line with our targets. Finally, we expect to see improvements in loss outcomes and loss adjustment expenses through changes made to our claims operation.

Looking across our overall business, we are as focused as ever on seeking out additional growth opportunities while balancing this goal with our profit targets. We are proud of the strong top-line growth over the past few years that has significantly exceeded the industry's growth rate while at the same time generating underwriting performance that is better than that of the industry.

Our longer-term target is to achieve a 3% commercial lines market share in the 22 states in which we currently operate. We are targeting a 12% agency share of wallet as we continue to leverage our agency franchise model by offering our distribution partners superior technology solutions and a great customer experience. Our plan is to increase our agency appointments over time to represent approximately 25% market share in their respective states.

Selective's relationships with its distribution partners are among the strongest in the industry and underpin our success. During 2016, Selective appointed 110 new agents and we are planning for an additional 85 new agency appointments in 2017.

Our plans are well on track to expand into two new states, Arizona and New Hampshire, in the latter half of 2017. We have already identified most of the agents that will partner with us in opening both states. Selective's approach to entering new states is extremely well-planned and thought



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out and is consistent with our current operating model, which is built around our field-based underwriting, franchise distribution model and excellent customer service. With that, we will open the call up for questions. Operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Newsome, Sandler O'Neill.

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

Good morning, Paul. How are you today?

Paul Newsome - Sandler O'Neill - Analyst

I'm doing very well. Probably not as good as you given the quarter's results. Very good quarter. I wanted to focus on the guidance of the combined ratio and that 1.7% improvement that you expect over the course of the year, which I think is remarkable (technical difficulty) competitive market out there (technical difficulty). So I wanted to focus on the 1.7% improvement and if you could walk me and us through the components of that. Is that simply improving the profitability on personal lines in E&S, or does it include a much broader improvement in underwriting performance for the year?

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

I will start with it and then I will kick it over to the rest of the team to add more color to it. If I were to break it into its core [sets], the 1.7 points of improvement, I would say, about a third of that is expense-driven as a result of some of the initiatives we have and two-thirds of it is on the underwriting side and that's really -- it gets back to the three legs of the stool that we've always discussed on the underwriting side. One is rate versus trend, earned rate versus loss trend. The second is claim improvement and the third is underwriting improvement. So when you think about that, I would say it's two-thirds core underwriting improvement, one-third expense improvement.

Paul Newsome - Sandler O'Neill - Analyst

Should we see that in a particular segment or is it broadly-based?

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

So what Greg gave you is on an overall basis, but as we have talked about and gone through the results, we gave you the rate expectations specifically for personal auto rolling forward. Personal auto and E&S we would expect to see more significant margin improvement from rate over trend and underwriting and mix improvements, but we also have some targeted improvement for our standard commercial lines as well. So all three we expect to see improvement, but the bigger improvement should be on E&S and personal lines.

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

So Paul, the only other thing I would add to that, just remember you always ground our commercial lines for an account underwriter. So obviously the goal is to drive commercial auto rates higher and lower GL, so -- because you are just kidding yourself if you do that, so we are trying to also



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fundamentally improve our commercial auto line of business. So I think you are going to see more improvement maybe in that specific line relative to the commercial lines overall, but just remember we are always an account underwriter and we are looking for performance holistically.

Paul Newsome - *Sandler O'Neill - Analyst*

Great. Fantastic. Thank you very much.

Operator

Arash Soleimani, KBW.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

So on the guidance, just to be -- so if I look at the 90.5% guidance for 2017, it's ex-CAT, ex-catastrophe. 2016, it looks like ex-CAT, ex-catastrophe, was 92.2%. So is that 1.7 points of improvement you are referring to, the difference in those two?

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

Yes.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

Okay.

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

Let me make sure I've got this right. So when you look at how we roll forward our combined ratio ex-CATs to ex-CATs, yes, that's where it is.

Arash Soleimani - *Keefe, Bruyette & Woods - Analyst*

Okay, okay. And in 4Q 2016, was the -- I guess there was the core combined ratio uptick, so was that mainly a commercial auto issue? Is that the way to think of it?

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

I'm sorry, can you repeat the (multiple speakers)?

Mark Wilcox - *Selective Insurance Group, Inc. - EVP & CFO*

Yes, that's exactly right and you have the numbers correct. When you are looking at the guidance for 2017, the 90.5%, it's on a stat basis ex-CAT and on an accident year basis and that compares to the 92.2% for the full-year 2016, and as Greg mentioned, he, on the prior question, walked through the 170 basis point improvement.



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In the current quarter, we did see a little bit of a deterioration in the underlying loss ratio on an accident year basis, excluding CATs and that related to the increase in the loss picks that I mentioned for the 2016 year related principally to commercial auto and that was about a 130 basis point deterioration on the overall loss ratio for the fourth quarter.

Arash Soleimani - Keefe, Bruyette & Woods - Analyst

Okay. Thanks. And the two-thirds/one-third, I guess, split that you just gave Paul earlier, can you just remind me that the two-thirds was from claims and underwriting initiatives?

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

So the two-thirds that come out -- all right, there's always three legs to that stool that we talk about. The first is earned rate versus trend and then there's underwriting improvement and claim improvement. Collectively, those three things together will account for about two-thirds of the 1.7 point improvement.

Arash Soleimani - Keefe, Bruyette & Woods - Analyst

Okay.

Mark Wilcox - Selective Insurance Group, Inc. - EVP & CFO

Let me just address the expense ratio very quickly, add a little bit more color on that to follow onto Greg's comments. When you take a look at our expense ratio on a stat basis, it has been a little bit elevated, a little bit under pressure as I mentioned in my prepared comments in part driven by the strong profitability that has resulted in higher supplemental agent commissions, as well as incentive compensation. But expenses are an area that we are highly focused on going into 2017 and our goal is to bring our expense ratio down over the next couple of years. So we have some existing initiatives in place, as well as the restructuring of our long-term incentive program that I mentioned, which should result in about a \$10 million benefit to expenses in 2017 versus 2016. But, again, as I mentioned, that \$10 million benefit actually does not come through the loss ratio. That's in other expenses at the holding company, but overall included in our improved margin forecast for 2017, about a third of the 170 basis points is from a reduction in the expense expectation for a reduction in expense ratio.

Arash Soleimani - Keefe, Bruyette & Woods - Analyst

Thanks. And I guess in terms of looking by segment, that 170 basis points of improvement, is that largely going to come from E&S (inaudible) standard commercial?

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

I think it gets back to what John mentioned. Obviously, the expense ratio is coming through universally. The underwriting improvements where you get into the conversation that John had relative to personal auto or E&S, obviously, where rate is well over trend, you are going to see more improvement weighted to that line versus where we are. Now, remember, our long-term goal for E&S is to generate somewhere between 4 and 6 points better than our commercial lines performance. I will tell you that we are still working on that and we feel very comfortable about it.

So over the long term, you should expect to see the E&S operation improve faster than any other area and as we've always told you on the personal lines segmentation, we've been very, very aggressive on the home side of the equation. Auto, we always told you guys that we were going to lay into that over a longer period of time and the comments that John had was that we feel that the market has really started to move. There will be



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a number of rate increases coming through. We will not be so out of touch with the market relative to our rate structure and actually will have an opportunity to drive more rate on that side of the equation.

Arash Soleimani - Keefe, Bruyette & Woods - Analyst

Okay, thank you. And on the standard commercial lines for that segment specifically looking at ex-CAT, ex-prior-period development, loss rate, do you expect that ratio to improve in 2017?

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

A little bit, yes. It's not a tremendous amount, but, of the relative improvement, is there some improvement in commercial lines? Yes, because the auto line, as I talked earlier, we've got a lot of focus on that auto line, the commercial auto line, excuse me and no, you are going to see some improvement in that line, but what we are saying is proportionately you are going to see more improvement in E&S.

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

And the other point I would also add is it's not just about the lines from a claims perspective that are performing above our target; we've got some very focused initiatives that are rolling out relative to property claims handling that we would expect to benefit us both on the commercial property and the homeowners lines. So as you know us over the years, we are focused on improvement across the board and we think there are opportunities even in lines that are performing better than our target returns at this point to continue to drive improvement on both the underwriting and the claims side.

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

And if I could, obviously, I think the sense of the question, if I could step back a little bit broader, and when I look at the industry and I look at the CLIPS survey and I understand that you guys are looking at our relative underlying performance relative to what you are hearing from our peers and I guess what I would point you guys to the most is the fact that John mentioned, hey, we had a 270 basis point increase in pure price in commercial lines in the fourth quarter and that is up against an industry that's probably, on CLIPS, about 50 basis points and from some of our competitors to the extent that they report it is around 50 or 60 basis points as well.

And then when you look at our January -- and January, just remember that our two biggest inventory renewal months of the year, one is January and one is July, so that is -- in terms of inventory, there's a lot of inventory that renews for us in the month of January and for us to print a 240 on that says a lot and so when you think about the things that John mentioned around -- I don't want to say around the edges because I don't think that's giving it nearly enough weight, but there's enough there in core price to help offset trend and then the things that we are doing on underwriting and claims end up coming through more in terms of profitability and I think that's why you are seeing our core ratio drop 170 basis points versus Best's estimate of only 60 basis points and maybe what you are hearing out in the community relative to principally commercial lines writers.

So I just want to make sure that that all hangs together for you guys when you look at our performance and where our earned rate -- most of the earned rate for 2017 has already been written. So that's the way you guys have got to think about it. What you work on for 2017 in rate affects more 2018, but what we are going to earn in 2016 has already been written.

Arash Soleimani - Keefe, Bruyette & Woods - Analyst

All right. Thank you very much for the answers. That's very helpful.



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Operator

Scott Heleniak, RBC Capital Markets.

Scott Heleniak - RBC Capital Markets - Analyst

First, I want to touch on commercial auto, if you could talk a little bit more about what you are seeing there. I know you mentioned some of the severity that you have seen throughout the year in Q4. If you could just talk about the appetite for that book. You are obviously getting rate increases and we hear mixed pictures from different insurers where they feel like they are getting enough rate or they are not getting enough rate. I know you guys gave some detail on some areas that you are pulling back on, but if you could give just a little more detail on how you are viewing that line and if you feel like rates are where they need to be.

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

I will start and others can fill in. So we have been getting higher average rate on that line of business than we have in other lines and we do think that's sustainable because the market -- as you have seen the results come out, the market continues to struggle on that line and in many cases, because it is probably driven more by macroeconomic forces, overall rate level is a big driver of that need.

For us, we continue to be an account underwriter. I think that's an important part to think about. We don't write very much if any monoline auto and we write it as an overall package. So our focus is on making sure that as we try to bring it higher on the auto line, it's not getting subsidized by lowering rates on other lines of business. It's got to be viewed in the overall context of the account pricing and we think at the rate levels that we have and the targeted underwriting and mix improvements that we have, we can continue to hit our overall new business targets on a packaged basis.

The other point I do want to clarify, you referenced frequency and severity trends. What we have seen in recent times that have driven our results and some of the development has been much more of a frequency-driven issue than a severity-driven issue and again, we view that in large part being driven by some of the macro forces that are impacting higher frequencies than you have heard us talk about in the past.

Scott Heleniak - RBC Capital Markets - Analyst

Okay. Just next on -- you guys mentioned the expansion into Arizona, New Hampshire. Is that going to be in both commercial lines and personal lines and if you could just talk about the opportunities and how you decided on those states?

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

I will start on that as well. So we are opening both Arizona and New Hampshire for commercial lines only at this point. We will evaluate going forward whether it makes sense for us to open up in personal lines, but at this point we are on target to open them in the second half of this year for commercial lines only. We will use our same approach in terms of how we open states; and we last opened new states in the 2007 and 2008 timeframe when we opened Massachusetts and Tennessee and we will take a franchise value approach, which means fewer agency partners and deeper relationships with fewer agency partners. We will take the same approach to underwriting and pricing discipline, the same appetite and product portfolio that we offer.

So we don't have aggressive growth plans in those states. We have plans to grow based on where the market is and where the opportunities are that are in line with our pricing and underwriting expectations. So we don't expect you will see a significant impact in 2017 or 2018 in terms of the overall top line of the organization, but as we build that out, we think those are two very good opportunities for us.

New Hampshire is as much about that state as it is about being able to have a broader share of wallet with our agency partners in Massachusetts and Rhode Island and Eastern New York State where they write a lot of cross-over business and then for us New Hampshire, we are looking at as



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the start of opening up over a several year period a full Southwestern region, which we think gives us a couple of things. One of which is to be in an area of the country that has a little bit higher than average economic growth, but also presents us from a property catastrophe exposure perspective a little bit of diversification and while you have exposure to wildfires, you don't have the same type of wind exposure that we see across our footprint on the East Coast and the Midwestern part of the country.

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

And just remember, that is always a complement. This is adding extra runway for us, but again our driving factors are around share of wallet and market share in our 22 states. We've always told you guys that, for us, share of wallet in our existing states is a \$1 billion opportunity in the 22 states. Additional agency appointments in our 22 states is a \$1.8 billion opportunity and obviously we will be focusing on those, but this is just extra runway to add and to continue to build out an organization that we'd like to see over the long term be 50 state capable from a commercial lines standpoint.

Scott Heleniak - *RBC Capital Markets - Analyst*

Yes, no question about the catastrophe exposure in Arizona too being different and that being an advantage. Greg, you mentioned the 15% in premiums came from agencies appointed in the last three years. It seems like you've been appointing more agencies over the past few years, so is that typically a higher number than you have seen annually over the past 10 years or so?

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

I will tell you, and I will let John weigh in on this a little bit, but, yes, we are getting more disciplined in terms of -- we look at every state and every territory within a state in terms of capacity. What's the premium available in that state and then for our AMSs or field underwriters what do they have to have in terms of suppliers or agents or distribution partners, whatever words you want to put around it, in that geolocation to be able to get the level of premium that we want to have.

So this approach from us in terms of what's the available premium, how do we access that and then the appointment structure around that has been much more disciplined with the state plans and process that we work through that I think is yielding more aggressive appointments than in the past.

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

I will just add to that. The 15% that Greg cited in his prepared comments, I would say over the last two to three years has been fairly consistent in that range because we've been at a similar pace in terms of adding agencies over the last few years, but I do want to reinforce that our franchise value model, which is fewer agency partners and greater share of wallet for each agency partner is still our philosophy. So we've set a target of 25% of that state's marketshare being represented by the agencies that we have appointed and we are not there yet and where our starting point is will vary state to state. So the appointments we are making are in the context of achieving that overall 25% agency representation in each state and that's generally spread geographically across that state. So we would expect that pace to continue as we move into the next couple years.

Scott Heleniak - *RBC Capital Markets - Analyst*

All right. Thanks for all the answers.

Operator

(Operator Instructions). At this time, there are no more questions on the phone.



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

Thank you very much for participating on the call this morning. If you have any follow-ups, you can contact Rohan and Mark and thank you very much for participating today. Thank you.

Operator

Thank you, everyone. That concludes today's conference. Thank you all for joining. You may now disconnect.

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