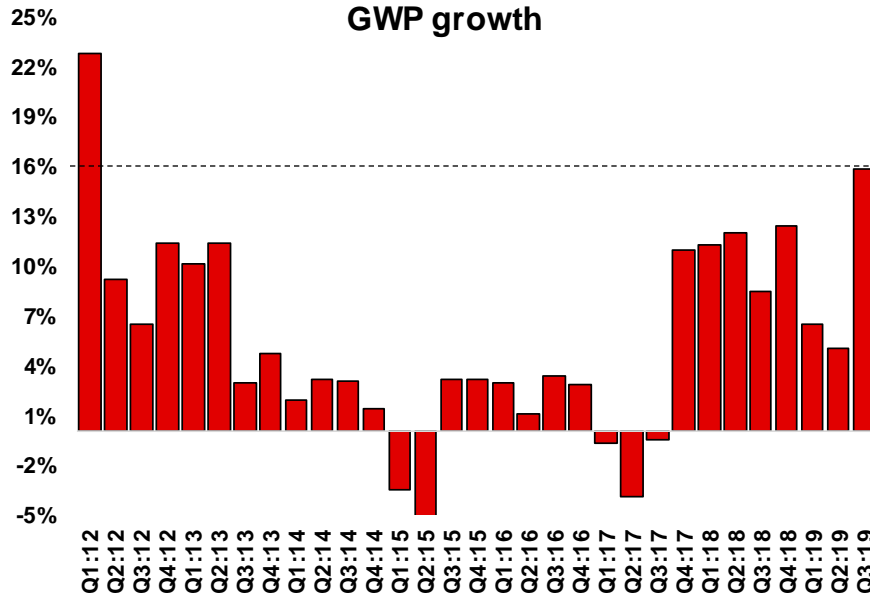


October 17, 2019

RLI TAKES A DEEP BREATH OF PURE OXYGEN**The specialty carrier posts highest growth in eight+ years**

Last quarter in describing the market, RLI's COO Craig Kliethermes said "[disruption is oxygen in this business](#)". Judging on the Q3 results, the entire firm must be feeling light headed.

The firm reported strong third quarter earnings that included 16% GWP growth, the highest since Q1:12 (at the peak of the last hardening cycle). The growth was driven by both casualty (+16% and property (+24%), while surety contracted again as the challenging environment in this business likely persisted in Q3. Notably, the growth was reported despite some material business exits, suggesting underlying growth is even stronger than the headline numbers suggest.

Up to now, the firm has been more circumspect on the market than peers, and even admitted last quarter to somewhat downplaying the production trends it had been seeing. With growth now through the roof, this nuanced stance will likely be harder to maintain on its call with investors (@11AM EST) despite the competitive sensitivity to its disclosures. In many ways, the numbers speak for themselves.

On underwriting, the firm reported an improved combined ratio (93.5% vs. 96.1%) having benefited from a lighter cat quarter, more favorable reserve releases, and an improved accident year loss ratio. [Details and waterfall chart below.](#)

Far from acting as a rising tide that lifted all ships and improve margins, our view has been the transitioning market would likely further [separate winners and losers](#), and provide an opportunity for well positioned and conservatively reserved companies to grow. RLI's Q3 print is an early data point that leans towards confirming this thesis. In this market, [this is what winning looks like.](#)

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Index	QTD	YTD
Large Cap	(3.1)%	23.9%
Regional	(0.5)%	12.3%
Specialty	(3.0)%	24.8%
Personal	(2.7)%	18.5%
Bermuda	(3.2)%	34.2%
Florida	(4.1)%	(20.1)%
Brokers	(1.4)%	25.9%
IPC Select	(2.9)%	11.4%
S&P 500	0.6%	19.5%
S&P Fin.	0.1%	17.7%

Source: S&P Global, Inside P&C

RLI: HIGHEST GWP GROWTH IN OVER EIGHT YEARS

- ❖ **Operating EPS of \$0.57 up 23% and 12% beat to analyst estimates**
- ❖ **Results driven by lower cats, reserve releases and lower AY losses**
- ❖ **Top-line growth of 15.8% is highest since Q1:12 = last hardening cycle**

RLI posted strong third quarter earnings last night, registering a 93.5% combined ratio generating \$13.7m in underwriting income, and reporting a 16% increase in gross premiums written to \$277mn.

- **RLI's operating earnings** rose by 23% to \$0.57 per share in Q3:19, beating analyst estimates of \$0.51. The overall result was driven by lower cat losses, more favorable reserve development and lower accident year losses.
- **Net investment income** was up 8% YoY, coming in at \$17.5m.
- **A lighter cat quarter** than the year-earlier period provided a tailwind that also aided results.
- **Favorable development** of \$12m added to the positive result, comprising the bulk of the current quarter profit.
- **Book value** (including dividends) is up 27% on the year off the back of strong equity returns and a drop in fixed income yields boosting the carrying value of fixed income assets.

EXHIBIT: RLI Q3 EARNINGS RESULTS SUMMARY

Source: Company reports, Inside P&C

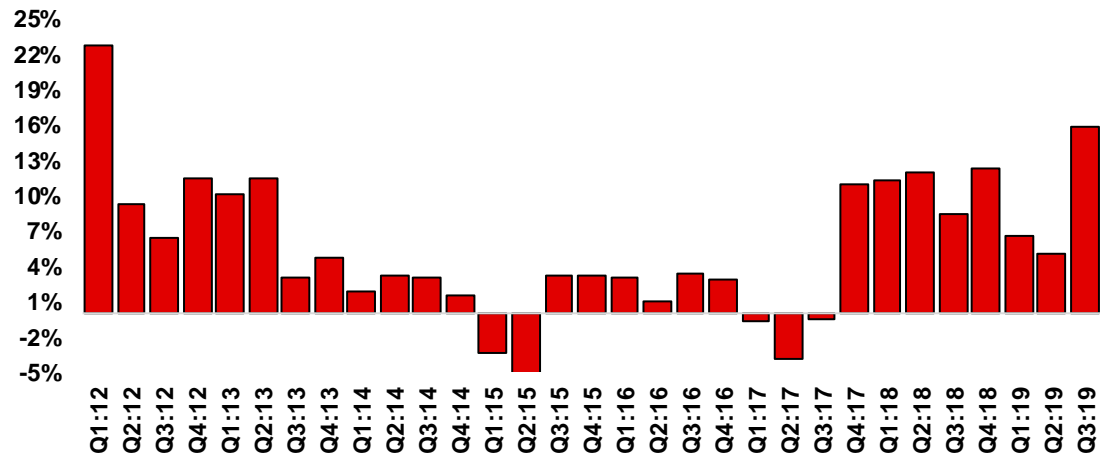
Line Item (\$mn)	EPS Beat: 12.0%					y/y chg
	Q3-18	Q4-18	Q1-19	Q2-19	Q3-19	
Diluted EPS	0.46	0.40	0.71	0.66	0.57	23.4%
Gross written premiums	\$239	\$257	\$231	\$283	\$277	15.8%
Cats	3%	10%	0%	2%	1%	-1.8pts
Prior year	-4.8%	-4.7%	-8.1%	-8.6%	-5.7%	-0.9pts
Ex-cat AY LR	56.5%	55.8%	53.7%	56.7%	55.9%	-0.6pts
Loss ratio	54.9%	60.7%	46.1%	50.1%	51.6%	-3.3pts
Expense ratio	41.2%	38.2%	43.0%	42.7%	41.9%	+0.7pts
Combined ratio	96.1%	98.9%	89.0%	92.8%	93.5%	-2.6pts
Underwriting gain (loss)	\$7.8	\$2.2	\$22.4	\$14.9	\$13.7	76.9%
Net investment income (loss)	\$16.3	\$17.0	\$16.6	\$17.0	\$17.5	7.5%
Book value per share	\$19.60	\$18.13	\$20.08	\$21.43	\$22.30	4.1% q/q
ROE (last four Qs)	16.6%	7.6%	13.8%	14.2%	13.0%	-3.6pts
Casualty gross written premium	\$157.6	\$177.7	\$152.1	\$189.1	\$183.4	16.4%
Property gross written premium	\$50.9	\$47.8	\$49.0	\$64.4	\$63.4	24.5%
Surety gross written premium	\$30.6	\$31.9	\$29.8	\$29.8	\$30.2	-1.6%
Casualty combined ratio	101.5%	93.6%	96.1%	95.0%	98.3%	-3.2pts
Property combined ratio	93.3%	129.8%	78.7%	101.1%	85.0%	-8.3pts
Surety combined ratio	76.4%	83.9%	69.5%	71.2%	82.4%	+6pts

Growth surges

Gross written premium grew by 15.8%, the highest quarterly growth since Q1:12, likely off the back of strong market pricing and opportunities RLI is seeing from market dislocation.

EXHIBIT: RLI GROSS WRITTEN PREMIUM GROWTH

Source: Company reports, Inside P&C

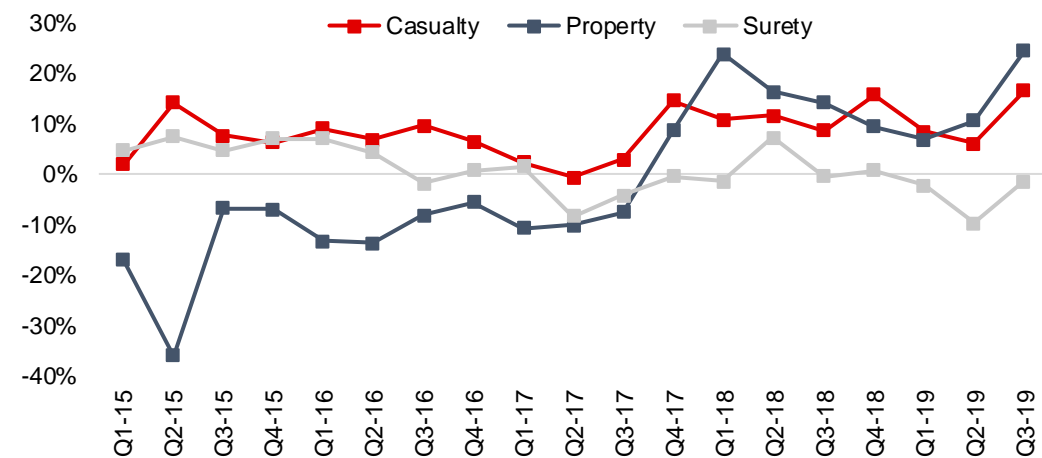


The result was driven by 16.4% growth in **casualty** and 24.5% **property**, marginally offset by 1.6% decline in **surety**.

The significant growth is despite the fact the YoY comparison is distorted by reduced quota share business, exit of healthcare facility business and general liability business for real estate investment trust, all announced in Q4:18. Recall, in Q2:19 RLI reported 5% top-line growth versus 13% excluding the impact of the business exits.

EXHIBIT: RLI Q3 GWP GROWTH BY SEGMENTS

Source: Company reports, Inside P&C



Underwriting

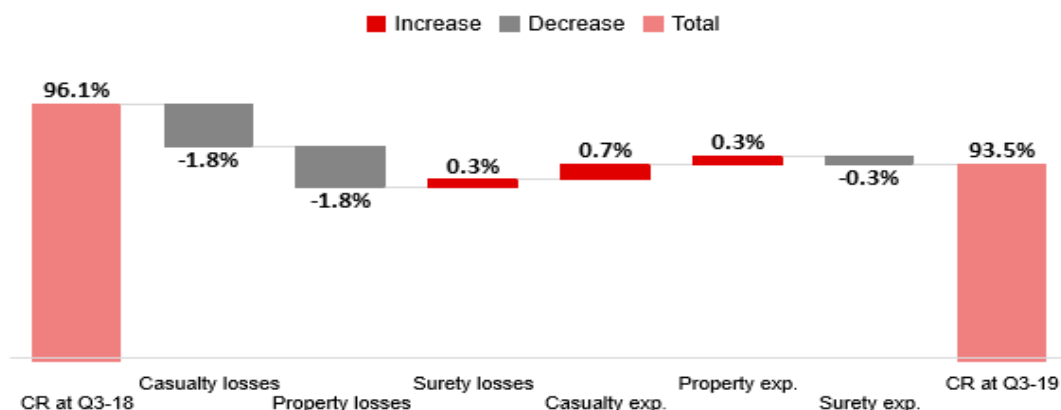
On underwriting, the combined ratio improved by 2.6pt to 93.5%, driven reserve releases, lighter cats and better accident year loss ratio, offset by the higher expense ratio.

- **Reserve releases** increased, defying increased concerns around balance sheet pain in the industry. However, RLI is perhaps one of the weakest harbingers for the industry, provided the carrier has a narrow focus and operates in niche businesses. RLI also has one of the most conservative track records on reserves.
- RLI only disclosed **cat losses** in terms of earnings per share. We pro-forma estimate it at about 1pt on the combined ratio, lower than 3pt in Q3:18.
- In line with the two previous quarters, RLI reported a higher expense ratio. The ratio is up 0.7pt to 41.9%. In the previous quarters, the company justified elevated expense ratio by the strong financial performance (= bonus accruals).

Lower casualty and property losses were the major forces behind improved underwriting, both contributing 1.8pt on the improved ratio.

EXHIBIT: YOY COMBINED RATIO CHANGE DECOMPOSED

Source: Company reports, Inside P&C



Key takeaways by segment:

- **Casualty segment:** The casualty combined ratio improved 3.2pt, with a 3.7pt decrease in loss ratio, offset by 0.4pt expense ratio increase (likely bonus accrual related). Growth was notable at +16.4% on GWP.
- **Property segment:** The property combined ratio improved 8.3pt, largely driven by lower catastrophe losses. Expense ratio increased by 1.3pt, likely associated with higher compensation expenses following another quarter of strong book value growth (main driver of RLI's compensation plan). Growth was stellar at +24.5% on GWP.
- **Surety segment:** Margins remains strong but weakened in recent quarters. The combined ratio increased by 6pt, driven by 3.4pt increase in loss ratio and 2.6pt increase in expense ratio. The top-line continued contraction as the firm continue facing challenging market conditions. Recall, RLI exited

miscellaneous surety products in Q2 and committed to maintain focus on margin over growth.

EXHIBIT: RLI Q3 RESULTS BY SEGMENTS

Source: Company reports, Inside P&C

Line Item (\$mn)	Q3-18	Q3-19	y/y chg
Casualty			
Gross written premiums	\$158	\$183	16.4%
Underwriting gain	-\$2.0	\$2.4	-220.1%
Loss ratio	65.3%	61.7%	-3.7pts
Expense ratio	36.2%	36.6%	+0.4pts
Combined ratio	101.5%	98.3%	-3.2pts
Property			
Gross written premiums	\$51	\$63	24.5%
Underwriting gain	\$2.6	\$6.2	136.6%
Loss ratio	51.6%	42.0%	-9.6pts
Expense ratio	41.7%	43.0%	+1.3pts
Combined ratio	93.3%	85.0%	-8.3pts
Surety			
Gross written premiums	\$31	\$30	-1.6%
Underwriting gain	\$7.1	\$5.2	-27.5%
Loss ratio	13.6%	17.0%	+3.4pts
Expense ratio	62.8%	65.4%	+2.6pts
Combined ratio	76.4%	82.4%	+6pts

Investments

Investment income growth of 7.5% is slowest in two years. Excluding the impact of timing change (some dividends shifting from Q3 to Q2 this year), the investment income will likely still fall short of recent quarters, likely driven in part by weaker alternatives and equity marks. Even so, on RLI's earnings call today, we expect an increased attention on the firm's fixed income portfolio and possible implications of lower interest rates environment on the bottom line.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, Dan Lukpanov and James Thaler.

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