Mercury General (MCY)

Updated July 31st, 2018 by Jonathan Weber

Key Metrics

Current Price:	$49	**5 Year CAGR Estimate:**	5.2%	**Volatility Percentile:**	46.4%
Fair Value Price:	$46	**5 Year Growth Estimate:**	1.4%	**Momentum Percentile:**	11.0%
% Fair Value:	107%	**5 Year Valuation Multiple Estimate:**	-1.3%	**Valuation Percentile:**	47.0%
Dividend Yield:	5.1%	**5 Year Price Target**	$49	**Total Return Percentile:**	32.8%

Overview & Current Events

Mercury General is an insurance company that is active in the following businesses: automobile, homeowners, renters & business insurance. Mercury was founded in 1961 and is currently valued at $2.6 billion. Personal automobile insurance is the most important business unit for Mercury General, the company is active in eleven states with California being the most important market. Insurance is primarily sold through about 10,000 independent agents.

Mercury General announced its second quarter earnings results on July 30. The company earned $0.88 during Q2, an increase of 29% year over year. This earnings growth was driven by a 10% increase in net written premiums, at the same time expenses for catastrophe losses declined from Q2 2017.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$2.12	$3.23	$2.09	$2.79	$2.13	$2.18	$2.28	$2.34	$1.73	$1.64	***$2.55***	***$2.73***
DPS	$2.32	$2.33	$2.37	$2.41	$2.44	$2.45	$2.46	$2.47	$2.48	$2.49	***$2.50***	***$2.55***

Mercury's growth history is weak. From 2008 to 2017 its EPS have declined, and even when we exclude 2016's and 2017's results its growth rate through 2015 was just 1.4% -- not even beating inflation. 2016 and 2017 were two especially hard years, primarily due to unusually high costs from catastrophes such as the California wildfires during the summer of 2017. It is thus likely that earnings will recover substantially in 2018 as long as there is no unusually high number of catastrophes during the current year.

Going forward tax reform will be beneficial for Mercury's profitability. As a US-focused business, the company will benefit from lower corporate tax rates going forward, which should further boost this year's results. Since Mercury hasn't managed to grow its profits consistently over the last decade the growth outlook beyond 2018 is not overly strong, though. It is likely that the company will continue to grow its profits slightly, with relatively big swings on a year-over-year basis. These cyclical results are not unusual for insurance companies with a regional focus such as Mercury.

Mercury's dividend continues to grow despite the cyclicality of its profits, although the dividend growth rate has been very low during the last couple of years. The annual growth rate has averaged just half a percentage point over the last couple of years, dividends thus grow at a slower pace than the rate of inflation.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	22.6	10.8	20.1	14.5	19.6	20.1	21.5	23.1	30.8	35.0	***19.2***	***18.0***
Avg. Yld.	4.8%	6.7%	5.6%	6.0%	5.8%	5.6%	5.0%	4.6%	4.7%	4.4%	***5.1%***	***5.3%***

Mercury has been valued at very high valuations over the last couple of years. This was due to unusually low profits, whereas income investors still held onto Mercury's shares due to the high yield they offered. With rising interest rates fixed income investments are becoming a viable alternative, which pressures the valuations of income stocks.

Shares are trading at ~19 times this year's earnings right now, we believe that its valuation will decline further over the coming years.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

Investors get a high and relatively safe dividend yield of 5.1% right here, which is roughly in the mid of Mercury's historical dividend yield range. Investors usually do not get yields this high from insurance corporations.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
Debt/A	62.3%	58.2%	57.4%	54.3%	56.1%	57.6%	59.1%	60.7%	63.5%	65.5%	***66.0%***	***68.0%***
Payout	109%	72.1%	113%	86.4%	115%	112%	108%	106%	143%	152%	***98.0%***	***93.4%***
Std. Dev.	56.7%	40.7%	17.9%	29.6%	17.6%	17.4%	17.9%	19.5%	22.0%	20.5%	***19.0%***	***21.0%***

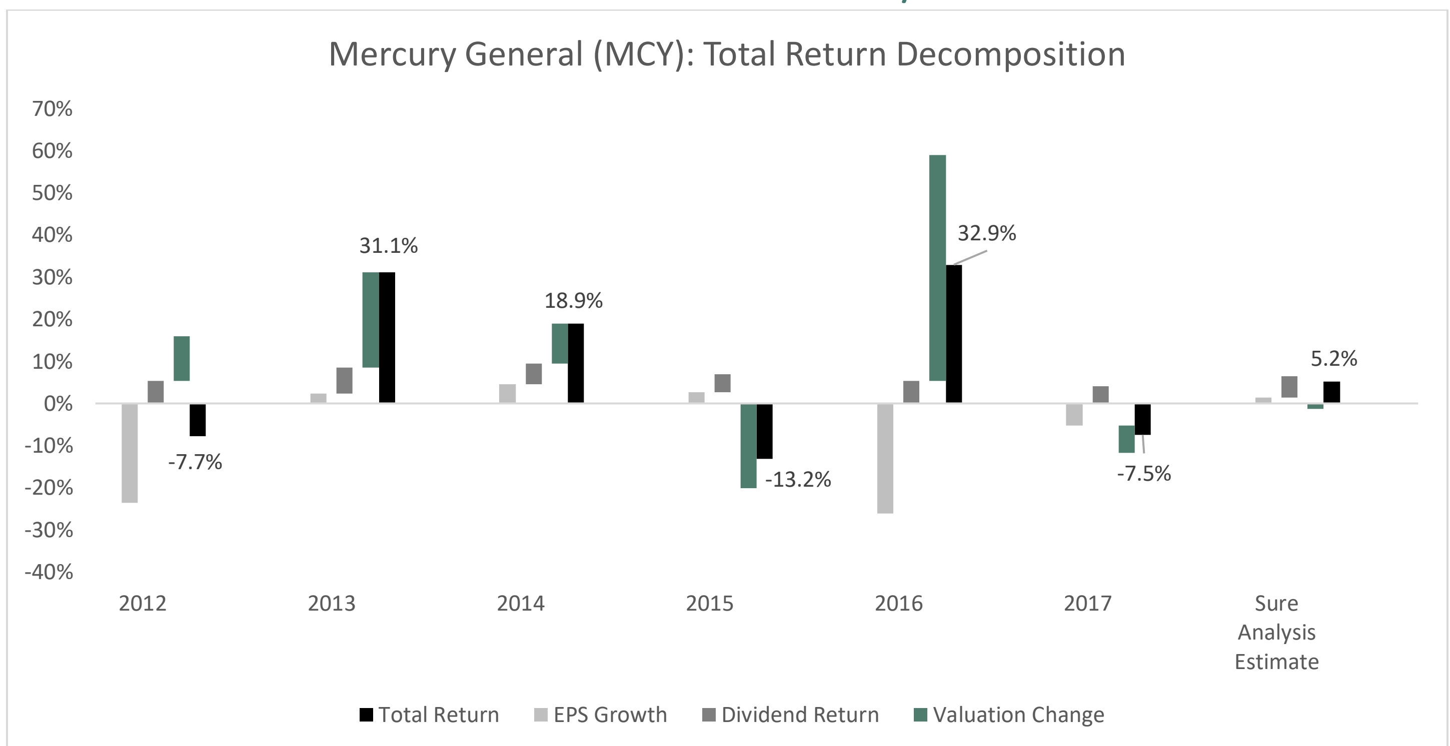
Mercury's balance sheet looks solid: The company has a debt to assets ratio of roughly 66%, which is not unusual for an insurance company. Commercial debt (notes payable) is at a very low level of just $370 million. Moreover, the majority of the debt is non-interest bearing, including loss adjustment expense reserves of $1.5 billion and unearned premiums of $1.2 billion. The low amount of debt for which Mercury has to pay interest means that its interest expenses are very low. At the same time Mercury's investments produce a significant amount of interest earnings, which is why there is no net interest expense. As long as the investments Mercury has made continue to produce a meaningful yield the company's debt levels are not problematic. During Q2 Mercury was able to grow the yield on its investments to 3.3%.

During the last financial crisis Mercury remained profitable, which can be explained by the following two factors: Even during times when the economy is not strong at all people still need insurances for their cars, properties, and other belongings. Demand for Mercury's offerings is thus not entirely dependent upon the economic environment. Mercury also did not invest in very risky assets prior to the financial crisis and therefore could avoid the big losses many other financial corporations had to report. Mercury overall is relatively recession-proof, the company is significantly more impacted by items that affect its operations directly, such as 2017's wildfires in California.

Final Thoughts & Recommendation

Mercury General has a high dividend yield that looks sufficiently safe right here. Apart from that, there is little appeal in this insurance corporation. Shares are trading at a relatively high valuation, and Mercury's growth outlook is not too rosy. Total returns will most likely be limited to a mid-single digits range going forward, which is not too attractive. Once shares trade below fair value they could potentially earn a buy recommendation from Sure Dividend.

Total Return Breakdown by Year



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