

MERCURY GENERAL CORP  
Form 10-K  
February 13, 2019

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2018  
Commission File No. 001-12257

MERCURY GENERAL CORPORATION  
(Exact name of registrant as specified in its charter)

California 95-2211612  
(State or other jurisdiction (I.R.S. Employer  
of incorporation or organization) Identification No.)

4484 Wilshire Boulevard, Los Angeles, California 90010  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (323) 937-1060

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class Name of Each Exchange on Which Registered

Common Stock New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company  Emerging growth company

Non-accelerated filer  " Smaller reporting company"

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the registrant's common equity held by non-affiliates of the registrant at June 30, 2018 was \$1,242,701,986 (which represents 27,276,163 shares of common equity held by non-affiliates multiplied by \$45.56, the closing sales price on the New York Stock Exchange for such date, as reported by the Wall Street Journal).

At February 7, 2019, the registrant had issued and outstanding an aggregate of 55,340,077 shares of its Common Stock.

---

Documents Incorporated by Reference

Certain information from the registrant's definitive proxy statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference into Part III hereof.

MERCURY GENERAL CORPORATION  
INDEX TO FORM 10-K

	Page
<u>PART I</u>	
Item 1 <u>Business</u>	<u>1</u>
<u>General</u>	<u>1</u>
<u>Website Access to Information</u>	<u>2</u>
<u>Organization</u>	<u>2</u>
<u>Production and Servicing of Business</u>	<u>3</u>
<u>Underwriting</u>	<u>4</u>
<u>Claims</u>	<u>4</u>
<u>Loss and Loss Adjustment Expense Reserves and Reserve Development</u>	<u>4</u>
<u>Statutory Accounting Principles</u>	<u>5</u>
<u>Investments</u>	<u>6</u>
<u>Competitive Conditions</u>	<u>7</u>
<u>Reinsurance</u>	<u>8</u>
<u>Regulation</u>	<u>9</u>
<u>Executive Officers of the Company</u>	<u>11</u>
Item 1A <u>Risk Factors</u>	<u>12</u>
Item 1B <u>Unresolved Staff Comments</u>	<u>23</u>
Item 2 <u>Properties</u>	<u>24</u>
Item 3 <u>Legal Proceedings</u>	<u>24</u>
Item 4 <u>Mine Safety Disclosures</u>	<u>24</u>
<u>PART II</u>	
Item 5 <u>Market For Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>25</u>
Item 6 <u>Selected Financial Data</u>	<u>27</u>
Item 7 <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>28</u>
Item 7A <u>Quantitative and Qualitative Disclosures about Market Risks</u>	<u>51</u>
Item 8 <u>Financial Statements and Supplementary Data</u>	<u>53</u>
Item 9 <u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	<u>92</u>
Item 9A <u>Controls and Procedures</u>	<u>92</u>
Item 9B <u>Other Information</u>	<u>93</u>
<u>PART III</u>	
Item 10 <u>Directors, Executive Officers, and Corporate Governance</u>	<u>94</u>
Item 11 <u>Executive Compensation</u>	<u>94</u>
Item 12 <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>94</u>
Item 13 <u>Certain Relationships and Related Transactions, and Director Independence</u>	<u>94</u>
Item 14 <u>Principal Accounting Fees and Services</u>	<u>94</u>
<u>PART IV</u>	
Item 15 <u>Exhibits and Financial Statement Schedules</u>	<u>95</u>

SIGNATURES

100

Financial Statement Schedules

S-1

---

## PART I

## Item 1. Business

## General

Mercury General Corporation ("Mercury General") and its subsidiaries (referred to herein collectively as the "Company") are primarily engaged in writing personal automobile insurance through 14 insurance subsidiaries (referred to herein collectively as the "Insurance Companies") in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical protection, and umbrella insurance. The Company's insurance policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the Company with competitive advantages.

The direct premiums written for the years ended December 31, 2018, 2017 and 2016 by state and line of insurance business were:

## Year Ended December 31, 2018

(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total	
California	\$2,346,403	\$458,065	\$120,234	\$114,838	\$3,039,540	85.6 %
Florida <sup>(1)</sup>	126,756	7	14,149	114	141,026	4.0 %
Other states <sup>(2)</sup>	230,417	66,838	64,069	9,027	370,351	10.4 %
Total	\$2,703,576	\$524,910	\$198,452	\$123,979	\$3,550,917	100.0%
	76.1	% 14.8	% 5.6	% 3.5	% 100.0	%

## Year Ended December 31, 2017

(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total	
California	\$2,117,882	\$404,645	\$102,204	\$109,779	\$2,734,510	84.1 %
Florida <sup>(1)</sup>	140,288	4	17,089	680	158,061	4.9 %
Other states <sup>(2)</sup>	221,871	65,269	58,939	10,282	356,361	11.0 %
Total	\$2,480,041	\$469,918	\$178,232	\$120,741	\$3,248,932	100.0%
	76.3	% 14.5	% 5.5	% 3.7	% 100.0	%

## Year Ended December 31, 2016

(Dollars in thousands)

	Private Passenger Automobile	Homeowners	Commercial Automobile	Other Lines	Total	
California	\$2,059,459	\$369,407	\$86,981	\$104,854	\$2,620,701	82.6 %
Florida <sup>(1)</sup>	154,593	9	24,973	1,067	180,642	5.7 %
Other states <sup>(2)</sup>	238,651	67,481	54,112	10,310	370,554	11.7 %
Total	\$2,452,703	\$436,897	\$166,066	\$116,231	\$3,171,897	100.0%
	77.3	% 13.8	% 5.2	% 3.7	% 100.0	%

- (1) The Company is writing and expects to continue writing nominal premiums in the Florida homeowners market.
- (2) No individual state accounts for more than 4% of total direct premiums written.

The Company offers the following types of automobile coverage: collision, property damage, bodily injury ("BI"), comprehensive, personal injury protection ("PIP"), underinsured and uninsured motorist, and other hazards.

1

---

The Company offers the following types of homeowners coverage: dwelling, liability, personal property, fire, and other hazards.

The following table presents the Company's published maximum limits of liability:

Insurance type	Published maximum limits of liability
Private Passenger Automobile - bodily injury (BI)	\$250,000 per person; \$500,000 per accident <sup>(1)</sup>
Private Passenger Automobile (combined policy limits)	\$500,000 per accident
Private Passenger Automobile - property damage	\$250,000 per accident <sup>(1)</sup>
Commercial Automobile (combined policy limits)	\$1,000,000 per accident
Homeowner property	no maximum <sup>(2) (3)</sup>
Homeowner liability	\$1,000,000 <sup>(3)</sup>
Umbrella liability	\$5,000,000 <sup>(4)</sup>

<sup>(1)</sup> The majority of the Company's automobile policies have liability limits that are equal to or less than \$100,000 per person and \$300,000 per accident for BI and \$50,000 per accident for property damage.

<sup>(2)</sup> The Company obtains facultative reinsurance above a Company retention limit of up to \$7 million.

<sup>(3)</sup> The majority of the Company's homeowner policies have liability limits of \$300,000 or less, a replacement value of \$500,000 or less, and a total insured value of \$1,000,000 or less.

<sup>(4)</sup> The majority of the Company's umbrella policies have liability limits of \$1,000,000.

The principal executive offices of Mercury General are located in Los Angeles, California. The home office of the Insurance Companies and the information technology center are located in Brea, California. The Company also owns office buildings in Rancho Cucamonga and Folsom, California, which are used to support California operations and future expansion, and in Clearwater, Florida and in Oklahoma City, Oklahoma, which house Company employees and several third party tenants. The Company has approximately 4,400 employees. The Company maintains branch offices in a number of locations in California; Clearwater, Florida; Bridgewater, New Jersey; Oklahoma City, Oklahoma; and Austin and San Antonio, Texas.

#### Available Information

The Company's website address is [www.mercuryinsurance.com](http://www.mercuryinsurance.com). The Company's website address is not intended to function as a hyperlink and the information contained on the Company's website is not, and should not be considered part of, and is not incorporated by reference into, this Annual Report on Form 10-K. The Company makes available on its website its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, and amendments to such periodic reports and proxy statements (the "SEC Reports") filed with or furnished to the Securities and Exchange Commission (the "SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after each SEC Report is filed with or furnished to the SEC. In addition, copies of the SEC Reports are available, without charge, upon written request to the Company's Chief Financial Officer, Mercury General Corporation, 4484 Wilshire Boulevard, Los Angeles, California 90010. The SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains the SEC Reports that the Company has filed or furnished electronically with the SEC.

#### Organization

Mercury General, an insurance holding company, is the parent of Mercury Casualty Company, a California automobile insurer founded in 1961 by George Joseph, the Company's Chairman of the Board of Directors.

Mercury General conducts its business through the following subsidiaries:

Insurance Companies	Formed or Acquired	A.M. Best Rating	Primary States
Mercury Casualty Company ("MCC") <sup>(1)</sup>	1961	A	CA, AZ, NV, NY, VA
Mercury Insurance Company ("MIC") <sup>(1)</sup>	1972	A	CA
California Automobile Insurance Company ("CAIC") <sup>(1)</sup>	1975	A	CA
California General Underwriters Insurance Company, Inc. ("CGU") <sup>(1)</sup>	1985	Non-rated	CA
Mercury Insurance Company of Illinois	1989	A	IL
Mercury Insurance Company of Georgia	1989	A	GA
Mercury Indemnity Company of Georgia	1991	A	GA
Mercury National Insurance Company	1991	A	IL
American Mercury Insurance Company	1996	A-	OK, GA, TX, VA
American Mercury Lloyds Insurance Company ("AML")	1996	A-	TX
Mercury County Mutual Insurance Company	2000	A-	TX
Mercury Insurance Company of Florida	2001	A	FL
Mercury Indemnity Company of America	2001	A	FL, NJ
Workmen's Auto Insurance Company ("WAIC") <sup>(1)</sup>	2015	Non-rated	CA

  

Non-Insurance Companies	Formed or Acquired	Purpose
Mercury Select Management Company, Inc.	1997	AML's attorney-in-fact
Mercury Insurance Services LLC	2000	Management services to subsidiaries
AIS Management LLC	2009	Parent company of AIS and PoliSeek
Auto Insurance Specialists LLC ("AIS")	2009	Insurance agency
PoliSeek AIS Insurance Solutions, Inc. ("PoliSeek")	2009	Insurance agency
Animas Funding LLC ("AFL")	2013	Special purpose investment vehicle
Fannette Funding LLC ("FFL")	2014	Special purpose investment vehicle

<sup>(1)</sup> The term "California Companies" refers to MCC, MIC, CAIC, CGU, and WAIC.

#### Production and Servicing of Business

The Company sells its policies through approximately 10,160 independent agents, its 100% owned insurance agencies, AIS and PoliSeek, and directly through internet sales portals. Excluding AIS and PoliSeek, independent agents collectively accounted for approximately 86% of the Company's direct premiums written in 2018 and no single independent agent accounted for more than 1% of the Company's direct premiums written during the last three years. Approximately 2,050 of the independent agents are located in California and approximately 1,458 are located in Florida. The independent agents are independent contractors selected and contracted by the Company and generally also represent competing insurance companies. AIS and PoliSeek represented the Company as independent agents prior to their acquisition in 2009, and continue to act as independent agents selling policies for a number of other insurance companies. Policies sold directly through the internet sales portals are assigned to and serviced by the Company's agents, including AIS and PoliSeek.

The Company believes that it compensates its agents above the industry average. Net commissions incurred in 2018 were approximately 15% of net premiums written.

The Company's advertising budget is allocated among television, radio, newspaper, internet, and direct mailing media with the intent to provide the best coverage available within targeted media markets. While the majority of these advertising costs are borne by the Company, a portion of these costs are reimbursed by the Company's independent agents based upon the number of account leads generated by the advertising. The Company believes that its advertising program is important to generate leads, create brand awareness, and remain competitive in the current insurance climate. In 2018, the Company incurred approximately \$41 million in net advertising expense.





### Underwriting

The Company sets its own automobile insurance premium rates, subject to rating regulations issued by the Department of Insurance or similar governmental agency of each state in which it is licensed to operate ("DOI"). Each state has different rate approval requirements. See "Regulation—Department of Insurance Oversight."

The Company offers standard, non-standard, and preferred private passenger automobile insurance in 11 states. The Company also offers homeowners insurance in 11 states, commercial automobile insurance in 9 states, and mechanical protection insurance in most states.

In California, "good drivers," as defined by the California Insurance Code, accounted for approximately 85% of all California voluntary private passenger automobile policies-in-force at December 31, 2018, while higher risk categories accounted for approximately 15%. The private passenger automobile renewal rate in California (the rate of acceptance of offers to renew) averages approximately 96%.

### Claims

The Company conducts the majority of claims processing without the assistance of outside adjusters. The claims staff administers all claims and manages all legal and adjustment aspects of claims processing.

### Loss and Loss Adjustment Expense Reserves ("Loss Reserves") and Reserve Development

The Company maintains loss reserves for both reported and unreported claims. Loss reserves for reported claims are estimated based upon a case-by-case evaluation of the type of claim involved and the expected development of such claims. Loss reserves for unreported claims are determined on the basis of historical information by line of insurance business. Inflation is reflected in the reserving process through analysis of cost trends and review of historical reserve settlement.

The Company's ultimate liability may be greater or less than management estimates of reported loss reserves. The Company does not discount to a present value that portion of loss reserves expected to be paid in future periods. However, the Company is required to discount loss reserves for federal income tax purposes. The following table provides a reconciliation of beginning and ending estimated reserve balances for the years indicated:

### RECONCILIATION OF NET LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Gross reserves at January 1 <sup>(1)</sup>	\$ 1,510,613	\$ 1,290,248	\$ 1,146,688
Less reinsurance recoverables on unpaid losses	(64,001 )	(13,161 )	(14,253 )
Net reserves at January 1 <sup>(1)</sup>	1,446,612	1,277,087	1,132,435
Incurred losses and loss adjustment expenses related to:			
Current year	2,483,693	2,390,453	2,269,769
Prior years	93,096	54,431	85,369
Total incurred losses and loss adjustment expenses	2,576,789	2,444,884	2,355,138
Loss and loss adjustment expense payments related to:			
Current year	1,543,828	1,550,789	1,508,362
Prior years	831,020	724,570	702,124
Total payments	2,374,848	2,275,359	2,210,486
Net reserves at December 31 <sup>(1)</sup>	1,648,553	1,446,612	1,277,087
Reinsurance recoverables on unpaid losses	180,859	64,001	13,161
Gross reserves at December 31 <sup>(1)</sup>	\$ 1,829,412	\$ 1,510,613	\$ 1,290,248

Under statutory accounting principles ("SAP"), reserves are stated net of reinsurance recoverables on unpaid losses  
(1) whereas under U.S. generally accepted accounting principles ("GAAP"), reserves are stated gross of reinsurance recoverables on unpaid losses.

The increase in the provision for insured events of prior years in 2018 of approximately \$93.1 million primarily resulted from higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business.

The increase in the provision for insured events of prior years in 2017 of approximately \$54.4 million primarily resulted from higher than estimated losses in California automobile and property lines of business, which experienced loss severities in prior accident periods that were higher than previously estimated.

The increase in the provision for insured events of prior years in 2016 of approximately \$85.4 million primarily resulted from the California and Florida automobile lines of business, which experienced loss severities in prior accident periods that were higher than previously estimated.

The Company experienced estimated pre-tax catastrophe losses and loss adjustment expenses of approximately \$289 million (\$67 million, net of reinsurance benefits), \$168 million (\$79 million, net of reinsurance benefits), and \$27 million in 2018, 2017, and 2016, respectively. There were no reinsurance benefits used for catastrophe losses in 2016. The losses in 2018 primarily resulted from wildfires in Northern and Southern California and weather-related catastrophes across several states. The losses in 2017 primarily resulted from wildfires in Northern and Southern California, severe rainstorms in California, and the impact of hurricanes in Texas, Florida and Georgia. The losses in 2016 primarily resulted from severe storms outside of California and rainstorms in California.

#### Statutory Accounting Principles

The Company's results are reported in accordance with GAAP, which differ in some respects from amounts reported under SAP prescribed by insurance regulatory authorities. Some of the significant differences under GAAP are described below:

Policy acquisition costs such as commissions, premium taxes, and other costs that vary with and are primarily related to the successful acquisition of new and renewal insurance contracts, are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned, whereas under SAP, these costs are expensed as incurred. Certain assets are included in the consolidated balance sheets, whereas under SAP, such assets are designated as "nonadmitted assets," and charged directly against statutory surplus. These assets consist primarily of premium receivables that are outstanding for more than 90 days, deferred tax assets that do not meet statutory requirements for recognition, furniture, equipment, leasehold improvements, capitalized software, and prepaid expenses.

Amounts related to ceded reinsurance are shown gross as prepaid reinsurance premiums and reinsurance recoverables, whereas under SAP, these amounts are netted against unearned premium reserves and loss and loss adjustment expense reserves.

Fixed-maturity securities are reported at fair value, whereas under SAP, these securities are reported at amortized cost, or the lower of amortized cost, or fair value, depending on the specific type of security.

Equity securities are marked to market through the consolidated statements of operations, whereas under SAP, these securities are marked to market through unrealized gains and losses in surplus.

Goodwill is reported as the excess of cost of an acquired entity over the fair value of the underlying assets and assessed periodically for impairment. Intangible assets are amortized over their useful lives. Under SAP, goodwill is reported as the excess of cost of an acquired entity over the statutory book value and amortized over 10 years. Its carrying value is limited to 10% of adjusted surplus. Under SAP, intangible assets are not recognized.

The differing treatment of income and expense items results in a corresponding difference in federal income tax expense. Changes in deferred income taxes are reflected as an item of income tax benefit or expense, whereas under SAP, changes in deferred income taxes are recorded directly to statutory surplus as regards policyholders. Admittance testing under SAP may result in a charge to unassigned surplus for non-admitted portions of deferred tax assets. Under GAAP, a valuation allowance may be recorded against the deferred tax assets and reflected as an expense.

Certain assessments paid to regulatory agencies that are recoverable from policyholders in future periods are expensed, whereas under SAP, these assessments are recorded as receivables.

Operating Ratios (SAP basis)

Loss and Expense Ratios

Loss and expense ratios are used to evaluate the underwriting experience of property and casualty insurance companies. Under SAP, losses and loss adjustment expenses are stated as a percentage of premiums earned because losses occur over the life of a policy, while underwriting expenses are stated as a percentage of premiums written rather than premiums earned because

most underwriting expenses are incurred when policies are written and are not spread over the policy period. The statutory underwriting profit margin is the extent to which the combined loss and expense ratios are less than 100%. The following table presents, on a statutory basis, the Insurance Companies' loss, expense and combined ratios, and the private passenger automobile industry combined ratio. Although the Insurance Companies' ratios include lines of insurance business other than private passenger automobile that accounted for 23.9% of direct premiums written in 2018, the Company believes its ratios can be compared to the industry ratios.

	Year Ended December 31,				
	2018	2017	2016	2015	2014
Loss ratio	76.6 %	76.6 %	75.3 %	72.6 %	71.0 %
Expense ratio	24.5 %	25.3 %	25.7 %	26.7 %	27.7 %
Combined ratio	101.0% <sup>(2)</sup>	101.9%	101.0%	99.3 %	98.8 % <sup>(2)</sup>
Industry combined ratio (all writers) <sup>(1)</sup>	N/A	102.2%	106.0%	104.1 %	101.9%
Industry combined ratio (excluding direct writers) <sup>(1)</sup>	N/A	99.9 %	99.7 %	100.2%	99.8 %

<sup>(1)</sup> Source: A.M. Best, Aggregates & Averages (2014 through 2017), for all property and casualty insurance companies (private passenger automobile line only, after policyholder dividends).

<sup>(2)</sup> Combined ratios for 2018 and 2014 do not sum due to rounding.

#### Premiums to Surplus Ratio

The following table presents the Insurance Companies' statutory ratios of net premiums written to policyholders' surplus. Guidelines established by the National Association of Insurance Commissioners (the "NAIC") indicate that this ratio should be no greater than 3 to 1.

	Year Ended December 31,				
	2018	2017	2016	2015	2014
	(Amounts in thousands, except ratios)				
Net premiums written	\$3,495,633	\$3,215,910	\$3,155,788	\$2,999,392	\$2,840,922
Policyholders' surplus	\$1,471,547	\$1,589,226	\$1,441,571	\$1,451,950	\$1,438,281
Ratio	2.4 to 1	2.0 to 1	2.2 to 1	2.1 to 1	2.0 to 1

#### Investments

The Company's investments are directed by the Chief Investment Officer under the supervision of the Investment Committee of the Board of Directors. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve a return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy maintains the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for monitoring credit exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

Tax considerations are important in portfolio management. The Company closely monitors the timing and recognition of capital gains and losses to maximize the realization of any deferred tax assets arising from capital losses. The Company had no capital loss carryforward at December 31, 2018.

## Investment Portfolio

The following table presents the composition of the Company's total investment portfolio:

	December 31,					
	2018		2017		2016	
	Cost <sup>(1)</sup>	Fair Value	Cost <sup>(1)</sup>	Fair Value	Cost <sup>(1)</sup>	Fair Value
	(Amounts in thousands)					
Taxable bonds	\$424,945	\$419,352	\$356,018	\$359,240	\$373,335	\$375,495
Tax-exempt state and municipal bonds	2,544,596	2,565,809	2,467,212	2,533,537	2,422,075	2,439,058
Total fixed maturities	2,969,541	2,985,161	2,823,230	2,892,777	2,795,410	2,814,553
Equity securities	544,082	529,631	474,197	537,240	331,770	357,327
Short-term investments	254,518	253,299	302,693	302,711	375,700	375,680
Total investments	\$3,768,141	\$3,768,091	\$3,600,120	\$3,732,728	\$3,502,880	\$3,547,560

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost.

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time the eligible item is first recognized. For more detailed discussion on the Company's investment portfolio, including credit ratings, see "Liquidity and Capital Resources—C. Invested Assets" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 3. Investments, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

## Investment Results

The following table presents the investment results of the Company for the most recent five years:

	Year Ended December 31,					
	2018	2017	2016	2015	2014	
	(Dollars in thousands)					
Average invested assets at cost <sup>(1) (2)</sup>	\$3,740,497	\$3,582,122	\$3,390,769	\$3,293,948	\$3,204,592	
Net investment income <sup>(3)</sup>						
Before income taxes	\$135,838	\$124,930	\$121,871	\$126,299	\$125,723	
After income taxes	\$121,476	\$109,243	\$107,140	\$110,382	\$111,456	
Average annual yield on investments <sup>(3)</sup>						
Before income taxes	3.6	% 3.5	% 3.6	% 3.8	% 3.9	%
After income taxes	3.3	% 3.1	% 3.2	% 3.4	% 3.5	%
Net realized investment (losses) gains after income taxes	\$(105,481 )	\$54,373	\$(22,266 )	\$(54,474 )	\$52,770	

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

<sup>(2)</sup> At December 31, 2018, fixed maturity securities with call features totaled \$2.7 billion at fair value and amortized cost.

During 2018, net investment income before and after income taxes increased primarily due to higher average invested assets combined with rising market interest rates. Average annual yield on investments before and after

<sup>(3)</sup> income taxes increased primarily due to yield increases in short-term and floating-rate securities resulting from rising market interest rates. Net investment income and average annual yield on investments after income taxes also benefited modestly from the lower tax rate effective January 1, 2018 applied to taxable investment income.

## Competitive Conditions

The Company operates in the highly competitive property and casualty insurance industry subject to competition on pricing, claims handling, consumer recognition, coverage offered and product features, customer service, and geographic coverage. Some of the Company's competitors are larger and well-capitalized national companies that sell

directly to consumers or have broad distribution networks of employed or captive agents.

7

---



Reputation for customer service and price are the principal means by which the Company competes with other insurers. In addition, the marketing efforts of independent agents can provide a competitive advantage. Based on the most recent regularly published statistical compilations of premiums written in 2017, the Company was the sixth largest writer of private passenger automobile insurance in California and the sixteenth largest in the United States.

The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen premium growth during hard market conditions. The Company believes that the automobile insurance industry is in a hard market with carriers generally raising rates, although this also depends on individual state profitability and the carriers' growth appetite.

#### Reinsurance

For California homeowners policies, the Company has reduced its catastrophe exposure from earthquakes by placing earthquake risks directly with the California Earthquake Authority ("CEA"). However, the Company continues to have catastrophe exposure to fires following an earthquake. For more detailed discussion, see "Regulation—Insurance Assessments" below.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2019. For the 12 months ending June 30, 2019 and 2018, the Treaty provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The first \$190 million of losses above the Company's \$10 million retention are covered 100% by the reinsurers. Losses above \$200 million are shared pro-rata with 5% coverage by the reinsurers and 95% retention by the Company, up to \$15 million total coverage provided by the reinsurers. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake. The annual premium for the Treaty is approximately \$22 million for the 12 months ending June 30, 2019, as compared to \$19 million for the 12 months ended June 30, 2018. The increase in the annual premium primarily resulted from an increase in reinsurance rates and growth in the Company's homeowners insurance book of business covered by the Treaty. In addition to the annual premium, the Treaty is subject to reinstatement premiums based on the amount of reinsurance benefits paid to the Company, up to the maximum reinstatement premium of approximately \$22 million and \$19 million if the full amount of benefit is used for the 12 months ending June 30, 2019 and 2018, respectively. The total amount of reinstatement premiums is recorded as ceded reinstatement premiums written at the time of the catastrophe event based on the total amount of reinsurance benefits expected to be used for the event, and such reinstatement premiums are recognized ratably over the remaining term of the Treaty as ceded reinstatement premiums earned.

Two major catastrophe events that occurred in the fourth quarter of 2018, the Camp Fire in Northern California and the Woolsey Fire in Southern California, caused approximately \$206 million and \$43 million, respectively, in losses to the Company, before reinsurance benefits. The combined loss to the Company from these two events, net of reinsurance benefits, totaled approximately \$37 million, representing \$20 million for the Company's initial reinsurance retention for the two catastrophe events, \$10 million for each event, approximately \$11 million Company retention from the first layer of reinstated reinsurance limit previously used up, and approximately \$6 million Company retention on the Camp Fire losses in excess of \$200 million. The Company recorded a total of approximately \$18 million in ceded reinstatement premiums written and \$5 million in ceded reinstatement premiums earned in 2018 for reinstatement of the reinsurance benefits used under the Treaty related to these two catastrophe events.

The Company incurred a total of approximately \$21 million in losses, before reinsurance benefits, resulting from a wildfire, known as the Carr Fire, that occurred in Shasta County of Northern California in the third quarter of 2018. The loss to the Company, net of reinsurance benefits, was \$10 million, which is the Company's retention on the catastrophe event. The Company recorded approximately \$3 million in ceded reinstatement premiums written and \$1 million in ceded reinstatement premiums earned in 2018 for reinstatement of the reinsurance benefits used under the

Treaty related to this catastrophe event.

As a result of reinsurance benefits used for the catastrophes described above under the Treaty ending June 30, 2019, the Company has exhausted the reinstated limit on the first layer (\$30 million limit in excess of \$10 million retention) of the Treaty, and a second reinstatement is not available under the current terms of the Treaty. Should there be another major catastrophe event within the Treaty period ending June 30, 2019, the Company would retain the first \$10 million of losses, retain the following \$30 million of losses reflecting that the reinstated first layer limit has been used up, and have available approximately \$57 million in reinsurance coverage for losses above \$40 million up to \$100 million, 100% reinsurance coverage for losses above \$100 million up to \$200 million and 5% reinsurance coverage for losses above \$200 million up to \$500 million.

In addition, the Company incurred a total of approximately \$109 million in losses, before reinsurance benefits, resulting from two catastrophe events that took place in the fourth quarter of 2017, consisting of the Northern California wildfires with approximately \$83 million in losses and the Southern California wildfires with approximately \$26 million in losses. The combined

losses from these wildfires, net of reinsurance benefits, totaled \$20 million, which is the Company's total retention on the two catastrophe events, \$10 million for each event. The Company recorded a total of approximately \$12 million in ceded reinstatement premiums written in 2017 for reinstatement of the reinsurance benefits used under the Treaty ended June 30, 2018 related to these two catastrophe events, of which \$3 million and \$9 million were recognized as ceded reinstatement premiums earned in 2017 and 2018, respectively.

The Company has reinsurance for PIP claims in Michigan through the Michigan Catastrophic Claims Association, a private non-profit unincorporated association created by the Michigan Legislature. The reinsurance covers losses in excess of \$545,000 per person and has no maximum limit. Michigan law provides for unlimited lifetime coverage for medical costs caused by automobile accidents. The Company ceased writing personal automobile insurance in Michigan in 2016.

The Company carries a commercial umbrella reinsurance treaty and seeks facultative arrangements for large property risks. In addition, the Company has other reinsurance in force that is not material to the consolidated financial statements. If any reinsurers are unable to perform their obligations under a reinsurance treaty, the Company will be required, as primary insurer, to discharge all obligations to its policyholders in their entirety.

#### Regulation

The Insurance Companies are subject to significant regulation and supervision by insurance departments of the jurisdictions in which they are domiciled or licensed to operate business.

#### Department of Insurance Oversight

The powers of the DOI in each state primarily include the prior approval of insurance rates and rating factors and the establishment of capital and surplus requirements, solvency standards, restrictions on dividend payments and transactions with affiliates. DOI regulations and supervision are designed principally to benefit policyholders rather than shareholders.

California Proposition 103 (the "Proposition") requires that property and casualty insurance rates be approved by the California DOI prior to their use and that no rate be approved which is excessive, inadequate, unfairly discriminatory, or otherwise in violation of the provisions of the Proposition. The Proposition specifies four statutory factors required to be applied in "decreasing order of importance" in determining rates for private passenger automobile insurance: (1) the insured's driving safety record, (2) the number of miles the insured drives annually, (3) the number of years of driving experience of the insured and (4) whatever optional factors are determined by the California DOI to have a substantial relationship to risk of loss and are adopted by regulation. The statute further provides that insurers are required to give at least a 20% discount to "good drivers," as defined, from rates that would otherwise be charged to such drivers and that no insurer may refuse to insure a "good driver." The Company's rate plan operates under these rating factor regulations.

Insurance rates in California, Georgia, New York, New Jersey, and Nevada require prior approval from the state DOI, while insurance rates in Illinois, Texas, Virginia, and Arizona must only be filed with the respective DOI before they are implemented. Oklahoma and Florida have a modified version of prior approval laws. Insurance laws and regulations in all states in which the Company operates provide that rates must not be excessive, inadequate, or unfairly discriminatory.

The DOI in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices. For more detailed information on the Company's current financial and market conduct examinations, see "Liquidity and Capital Resources—F. Regulatory Capital Requirements" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

For a discussion of current regulatory matters in California, see "Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

The operations of the Company are dependent on the laws of the states in which it does business and changes in those laws can materially affect the revenue and expenses of the Company. The Company retains its own legislative advocates in California. The Company made direct financial contributions of approximately \$120,000 and \$69,000 to officeholders and candidates in 2018 and 2017, respectively. The Company believes in supporting the political process and intends to continue to make such contributions in amounts which it determines to be appropriate.

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The risk-based capital ("RBC") formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2018, 2017 and 2016, each of the Insurance Companies exceeded the minimum required RBC level. For more detailed information, see "Liquidity and Capital Resources—F. Regulatory Capital Requirements" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### Own Risk and Solvency Assessment

Insurance companies are required to file an Own Risk and Solvency Assessment ("ORSA") with the insurance regulators in their domiciliary states. The ORSA is required to cover, among many items, a company's risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA is intended to be used by state insurance regulators to evaluate the risk exposure and quality of the risk management processes within insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of insurance companies. The Company filed its most recent ORSA Summary Report with the California DOI in November 2018. Compliance with the ORSA requirements did not have a material impact on the Company's consolidated financial statements.

#### Insurance Assessments

The California Insurance Guarantee Association ("CIGA") was created to pay claims on behalf of insolvent property and casualty insurers. Each year, these claims are estimated by CIGA and the Company is assessed for its pro-rata share based on prior year California premiums written in the particular line. These assessments are currently limited to 2% of premiums written in the preceding year and are recouped through a mandated surcharge to policyholders in the year after the assessment. There were no CIGA assessments in 2018.

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowner policy directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other revenue in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been expended and are based upon each company's participation percentage multiplied by the amount of the total assessment. Based upon the most recent information provided by the CEA, the Company's maximum total exposure to CEA assessments at August 7, 2018, the most recent date at which information was available, was \$68.3 million. There was no assessment made in 2018.

The Insurance Companies in other states are also subject to the provisions of similar insurance guaranty associations. There were no material assessments or payments during 2018 in other states.

#### Holding Company Act

The California Companies are subject to California DOI regulation pursuant to the provisions of the California Insurance Holding Company System Regulatory Act (the "Holding Company Act"). The California DOI may examine the affairs of each of the California Companies at any time. The Holding Company Act requires disclosure of any material transactions among affiliates within a holding company system. Some transactions require advance notice and may not be made if the California DOI disapproves the transaction within 30 days after notice. Such transactions include, but are not limited to, extraordinary dividends; management agreements, service contracts, and cost-sharing

arrangements, and modifications thereto; all guarantees that are not quantifiable, or, if quantifiable, exceed the lesser of one-half of 1% of admitted assets or 10% of policyholders' surplus as of the preceding December 31; derivative transactions or series of derivative transactions; reinsurance agreements or modifications thereto in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds 5% of the policyholders' surplus as of the preceding December 31; sales, purchases, exchanges, loans, and extensions of credit; and investments, in the net aggregate, involving more than the lesser of 3% of the respective California Companies' admitted assets or 25% of statutory surplus as regards policyholders as of the preceding December 31. An extraordinary dividend is a dividend which, together with other dividends or distributions made within the preceding 12 months, exceeds the greater of 10% of the insurance company's statutory policyholders' surplus as of the preceding December 31 or the insurance company's statutory net income for the preceding calendar year. The Holding Company Act also requires filing of an annual enterprise risk report identifying the material risks within the insurance holding company system.

California-domiciled insurance companies are also required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2018, the Insurance Companies are permitted to pay in 2019, without obtaining DOI approval for extraordinary dividends, \$145 million in dividends to Mercury General, of which \$116 million may be paid by the California Companies.

The Holding Company Act also provides that the acquisition or change of "control" of a California domiciled insurance company or of any person who controls such an insurance company cannot be consummated without the prior approval of the California DOI. In general, a presumption of "control" arises from the ownership of voting securities and securities that are convertible into voting securities, which in the aggregate constitute 10% or more of the voting securities of a California insurance company or of a person that controls a California insurance company, such as Mercury General. A person seeking to acquire "control," directly or indirectly, of the Company must generally file with the California DOI an application for change of control containing certain information required by statute and published regulations and provide a copy of the application to the Company. The Holding Company Act also effectively restricts the Company from consummating certain reorganizations or mergers without prior regulatory approval.

Each of the Insurance Companies is subject to holding company regulations in the state in which it is domiciled. These provisions are substantially similar to those of the Holding Company Act.

#### Assigned Risks

Automobile liability insurers in California are required to sell BI liability, property damage liability, medical expense, and uninsured motorist coverage to a proportionate number (based on the insurer's share of the California automobile casualty insurance market) of those drivers applying for placement as "assigned risks." Drivers seek placement as assigned risks because their driving records or other relevant characteristics, as defined by the Proposition, make them difficult to insure in the voluntary market. In 2018, assigned risks represented less than 0.1% of total automobile direct premiums written and less than 0.1% of total automobile direct premium earned. The Company attributes the low level of assignments to the competitive voluntary market. Many of the other states in which the Company conducts business offer programs similar to that of California. These programs are not a significant contributor to the business written in those states.

#### Executive Officers of the Company

The following table presents certain information concerning the executive officers of the Company as of February 7, 2019:

Name	Age	Position
George Joseph	97	Chairman of the Board
Gabriel Tirador	54	President and Chief Executive Officer
Theodore R. Stalick	55	Senior Vice President and Chief Financial Officer
Christopher Graves	53	Vice President and Chief Investment Officer
Abby Hosseini	59	Vice President and Chief Information Officer
Victor G. Joseph	32	Vice President and Chief Underwriting Officer
Brandt N. Minnich	52	Vice President and Chief Marketing Officer
Randall R. Petro	55	Vice President and Chief Claims Officer
Heidi C. Sullivan	50	Vice President and Chief Human Capital Officer
Erik Thompson	50	Vice President, Advertising and Public Relations
Charles Toney	57	Vice President and Chief Actuary
Judy A. Walters	72	Vice President, Corporate Affairs and Secretary

Mr. George Joseph, Chairman of the Board of Directors, has served in this capacity since 1961. He held the position of Chief Executive Officer of the Company for 45 years from 1961 through 2006. Mr. Joseph has more than 50 years'

experience in the property and casualty insurance business.

Mr. Tirador, President and Chief Executive Officer, served as the Company's assistant controller from 1994 to 1996. In 1997 and 1998, he served as the Vice President and Controller of the Automobile Club of Southern California. He rejoined the Company in 1998 as Vice President and Chief Financial Officer. He was appointed President and Chief Operating Officer in October 2001 and Chief Executive Officer in 2007. Mr. Tirador has over 20 years' experience in the property and casualty insurance industry and is an inactive Certified Public Accountant.



Mr. Stalick, Senior Vice President and Chief Financial Officer, joined the Company as Corporate Controller in 1997. He was appointed Chief Accounting Officer in October 2000 and Vice President and Chief Financial Officer in 2001. In July 2013, he was named Senior Vice President and Chief Financial Officer. Mr. Stalick is an inactive Certified Public Accountant.

Mr. Graves, Vice President and Chief Investment Officer, has been employed by the Company in the investment department since 1986. Mr. Graves was appointed Chief Investment Officer in 1998, and named Vice President in 2001.

Mr. Hosseini, Vice President and Chief Information Officer, has been employed by the Company since 2008. He served as the Company's Chief Technology Officer for nine years and was appointed Vice President and Chief Information Officer in May 2018. Prior to 2008, he held various leadership positions in information technology, including Senior Vice President, Chief Technology Officer and Chief Information Officer at Option One, Inc. and Senior Vice President and Chief Information Officer at PeopleSupport, Inc.

Mr. Victor Joseph, Vice President and Chief Underwriting Officer has been employed by the Company in various capacities since 2009, and was appointed Vice President and Chief Underwriting Officer in July 2017. Mr. Victor Joseph is Mr. George Joseph's son.

Mr. Minnich, Vice President and Chief Marketing Officer, joined the Company as an underwriter in 1989. In 2007, he joined Superior Access Insurance Services as Director of Agency Operations. In 2008 he rejoined the Company as an Assistant Product Manager, and in 2009, he was named Senior Director of Marketing, a role he held until appointed to his current position later in 2009. Mr. Minnich has over 25 years' experience in the property and casualty insurance industry and is a Chartered Property and Casualty Underwriter.

Mr. Petro, Vice President and Chief Claims Officer, has been employed by the Company in the Claims Department since 1987. Mr. Petro was appointed Vice President in March 2014, and named Chief Claims Officer in March 2015.

Ms. Sullivan, Vice President and Chief Human Capital Officer, joined the Company in 2012. Prior to joining the Company, she served as Senior Vice President, Human Capital for Arcadian Health Plan from 2008 to 2012. Prior to 2008, she held various leadership positions at Kaiser Permanente, Progressive Insurance, and Score Educational Centers.

Mr. Thompson, Vice President, Advertising and Public Relations, joined the Company as Director of Advertising in 2005, and was appointed Vice President, Advertising and Public Relations in October 2017. Prior to joining the Company, Mr. Thompson held various leadership positions in advertising, marketing, and public relations at several organizations, including Universal Studios, Inc., Turner, and Columbia TriStar Television.

Mr. Toney, Vice President and Chief Actuary, joined the Company in 1984 as a programmer/analyst. In 1994, he earned his Fellowship in the Casualty Actuarial Society and was appointed to his current position. In 2011, he became a board member of the Personal Insurance Federation of California. Mr. Toney is Mr. George Joseph's nephew.

Ms. Walters, Vice President, Corporate Affairs and Secretary, has been employed by the Company since 1967, and has served as its Secretary since 1982. Ms. Walters was named Vice President, Corporate Affairs in 1998.

#### Item 1A. Risk Factors

The Company's business involves various risks and uncertainties in addition to the normal risks of business, some of which are discussed in this section. It should be noted that the Company's business and that of other insurers may be adversely affected by a downturn in general economic conditions and other forces beyond the Company's control. In addition, other risks and uncertainties not presently known or that the Company currently believes to be immaterial

may also adversely affect the Company's business. Any such risks or uncertainties, or any of the following risks or uncertainties, that develop into actual events could result in a material and adverse effect on the Company's business, financial condition, results of operations, or liquidity.

The information discussed below should be considered carefully with the other information contained in this Annual Report on Form 10-K and the other documents and materials filed by the Company with the SEC, as well as news releases and other information publicly disseminated by the Company from time to time. The following risk factors are in no particular order.

#### Risks Related to the Company's Business

The Company remains highly dependent upon California to produce revenues and operating profits.

For the year ended December 31, 2018, the Company generated approximately 85% of its direct automobile insurance

premiums written in California. The Company's financial results are subject to prevailing regulatory, legal, economic, demographic, competitive, and other conditions in the states in which the Company operates and changes in any of these conditions could negatively impact the Company's results of operations.

Mercury General is a holding company that relies on regulated subsidiaries for cash flows to satisfy its obligations. As a holding company, Mercury General maintains no operations that generate cash flows sufficient to pay operating expenses, shareholders' dividends, or principal or interest on its indebtedness. Consequently, Mercury General relies on the ability of the Insurance Companies, particularly the California Companies, to pay dividends for Mercury General to meet its obligations. The ability of the Insurance Companies to pay dividends is regulated by state insurance laws, which limit the amount of, and in certain circumstances may prohibit the payment of, cash dividends. Generally, these insurance regulations permit the payment of dividends only out of earned surplus in any year which, together with other dividends or distributions made within the preceding 12 months, do not exceed the greater of 10% of statutory surplus as of the end of the preceding year or the net income for the preceding year, with larger dividends payable only after receipt of prior regulatory approval. The inability of the Insurance Companies to pay dividends in an amount sufficient to enable the Company to meet its cash requirements at the holding company level could have a material adverse effect on the Company's results of operations, financial condition, and its ability to pay dividends to its shareholders.

The Insurance Companies are subject to minimum capital and surplus requirements, and any failure to meet these requirements could subject the Insurance Companies to regulatory action.

The Insurance Companies are subject to risk-based capital standards and other minimum capital and surplus requirements imposed under the applicable laws of their states of domicile. The risk-based capital standards, based upon the Risk-Based Capital Model Act adopted by the NAIC, require the Insurance Companies to report their results of RBC calculations to state departments of insurance and the NAIC. If any of the Insurance Companies fails to meet these standards and requirements, the DOI regulating such subsidiary may require specified actions by the subsidiary.

The Company's success depends on its ability to accurately underwrite risks and to charge adequate premiums to policyholders.

The Company's financial condition, results of operations, and liquidity depend on its ability to underwrite and set premiums accurately for the risks it assumes. Premium rate adequacy is necessary to generate sufficient premium to offset losses, loss adjustment expenses, and underwriting expenses and to earn a profit. In order to price its products accurately, the Company must collect and properly analyze a substantial volume of data; develop, test, and apply appropriate rating formulae; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. The Company's ability to undertake these efforts successfully, and as a result, price accurately, is subject to a number of risks and uncertainties, including but not limited to:

- availability of sufficient reliable data;
- incorrect or incomplete analysis of available data;
- uncertainties inherent in estimates and assumptions, generally;
- selection and application of appropriate rating formulae or other pricing methodologies;
- successful innovation of new pricing strategies;
- recognition of changes in trends and in the projected severity and frequency of losses;
- the Company's ability to forecast renewals of existing policies accurately;
- unanticipated court decisions, legislation or regulatory action;
- ongoing changes in the Company's claim settlement practices;
- changes in operating expenses;
- changing driving patterns;
- extra-contractual liability arising from bad faith claims;
- catastrophes, including those which may be related to climate change;
- unexpected medical inflation; and
- unanticipated inflation in automobile repair costs, automobile parts prices, and used car prices.



Such risks and uncertainties may result in the Company's pricing being based on outdated, inadequate or inaccurate data, or inappropriate analyses, assumptions or methodologies, and may cause the Company to estimate incorrectly future changes in the frequency or severity of claims. As a result, the Company could underprice risks, which would negatively affect the Company's margins, or it could overprice risks, which could reduce the Company's volume and competitiveness. In either event, the Company's financial condition, results of operations, and liquidity could be materially and adversely affected.

The Company's insurance rates are subject to approval by the departments of insurance in most of the states in which the Company operates, and to political influences.

In four of the states in which it operates, including California, the Company must obtain the DOI's prior approval of insurance rates charged to its customers, including any increases in those rates. If the Company is unable to receive approval of the rate changes it requests, or if such approval is delayed, the Company's ability to operate its business in a profitable manner may be limited and its financial condition, results of operations, and liquidity may be adversely affected. Additionally, in California, the law allows for consumer groups to intervene in rate filings, which frequently causes delays in rate approvals and implementation of rate changes and can impact the rate that is ultimately approved.

From time to time, the automobile insurance industry comes under pressure from state regulators, legislators, and special interest groups to reduce, freeze, or set rates at levels that do not correspond with underlying costs, in the opinion of the Company's management. The homeowners insurance business faces similar pressure, particularly as regulators in catastrophe-prone states seek an acceptable methodology to price for catastrophe exposure. In addition, various insurance underwriting and pricing criteria regularly come under attack by regulators, legislators, and special interest groups. The result could be legislation, regulations, or new interpretations of existing regulations that adversely affect the Company's business, financial condition, and results of operations.

The effects of emerging claim and coverage issues on the Company's business are uncertain and may have an adverse effect on the Company's business.

As industry practices and legal, judicial, social, and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect the Company's business by either extending coverage beyond its underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until sometime after the Company has issued insurance policies that are affected by the changes. As a result, the full extent of liability under the Company's insurance policies may not be known for many years after a policy is issued.

Loss of, or significant restriction on, the use of credit scoring in the pricing and underwriting of personal lines products could reduce the Company's future profitability.

The Company uses credit scoring as a factor in pricing and underwriting decisions where allowed by state law. Some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against some groups of people and are seeking to prohibit or restrict the use of credit scoring in underwriting and pricing. Laws or regulations that significantly curtail or regulate the use of credit scoring, if enacted in a large number of states in which the Company operates, could negatively impact the Company's future results of operations.

If the Company cannot maintain its A.M. Best ratings, it may not be able to maintain premium volume in its insurance operations sufficient to attain the Company's financial performance goals.

The Company's ability to retain its existing business or to attract new business in its Insurance Companies is affected by its rating by A.M. Best. A.M. Best currently rates all of the Insurance Companies with sufficient operating history as either A (Excellent) or A- (Excellent). On December 12, 2018, A.M. Best downgraded the Financial Strength Rating ("FSR") of the Company's A+ rated entities to A (Excellent) with Stable outlook from A+ (Superior) with

Negative outlook, and affirmed the FSR of A- (Excellent) with Stable outlook for the Company's A- rated entities. The Company believes that if it is unable to maintain its A.M. Best ratings within the A ratings range, it may face greater challenges to grow its premium volume sufficiently to attain its financial performance goals, which may adversely affect the Company's business, financial condition, and results of operations. Two of the smaller Insurance Companies, California General Underwriters Insurance Company, Inc. and Workmen's Auto Insurance Company, are not rated by A.M. Best and the rating is not critical to the type of business they produce.

The Company may require additional capital in the future, which may not be available or may only be available on unfavorable terms.

The Company's future capital requirements, including to fund future growth opportunities, depend on many factors, including its ability to underwrite new business successfully, its ability to establish premium rates and reserves at levels sufficient

to cover losses, the success of its expansion plans, the performance of its investment portfolio and its ability to obtain financing. The Company may seek to obtain financing through equity or debt issuances, or sales of all or a portion of its investment portfolio or other assets. The Company's ability to obtain financing also depends on economic conditions affecting financial markets and financial strength and claims-paying ability ratings, which are assigned based upon an evaluation of the Company's ability to meet its financial obligations. The Company's current financial strength rating with Fitch and Moody's is A and A2, respectively. If the Company were to seek financing through the capital markets in the future, there can be no assurance that the Company would obtain favorable ratings from rating agencies. Any equity or debt financing, if available at all, may not be available on terms that are favorable to the Company. In the case of equity financing, the Company's shareholders could experience dilution. In addition, such securities may have rights, preferences, and privileges that are senior to those of the Company's current shareholders. If the Company cannot obtain adequate capital on favorable terms or at all, its business, financial condition, and results of operations could be adversely affected.

Changes in market interest rates, defaults on securities and tax considerations may have an adverse effect on the Company's investment portfolio, which may adversely affect the Company's financial results.

The Company's financial results are affected, in part, by the performance of its investment portfolio. The Company's investment portfolio contains interest rate sensitive-investments, such as municipal and corporate bonds. Increases in market interest rates may have an adverse impact on the value of the investment portfolio by decreasing the value of fixed income securities. Declining market interest rates could have an adverse impact on the Company's investment income as it invests positive cash flows from operations and as it reinvests proceeds from maturing and called investments in new investments that could yield lower rates than the Company's investments have historically generated. Defaults in the Company's investment portfolio may produce operating losses and negatively impact the Company's results of operations.

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions, and other factors beyond the Company's control. Market interest rates have been at historic lows for the last several years. Many observers, including the Company, believe that market interest rates will rise as the economy improves. Although the Company takes measures to manage the risks of investing in a changing interest rate environment, it may not be able to mitigate interest rate sensitivity effectively. The Company's mitigation efforts include maintaining a high quality portfolio and managing the duration of the portfolio to reduce the effect of interest rate changes. Despite its mitigation efforts, a significant change in interest rates could have a material adverse effect on the Company's financial condition and results of operations. Although the Company monitors the timing and recognition of capital gains and losses in an effort to maximize the realization of deferred tax assets arising from capital losses, no guaranty can be provided that such monitoring or the Company's tax strategies will be effective.

The Company's valuation of financial instruments may include methodologies, estimates, and assumptions that are subject to differing interpretations and could result in changes to valuations that may materially adversely affect the Company's financial condition or results of operations.

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date.

Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with the inputs used to measure their fair value and the level of market price observability.

During periods of market disruption, including periods of significantly changing interest rates, rapidly widening credit spreads, inactivity or illiquidity, it may be difficult to value certain of the Company's securities if trading becomes less frequent and/or market data become less observable. There may be certain asset classes in historically active markets

with significant observable data that become illiquid due to changes in the financial environment. In such cases, the valuations associated with such securities may rely more on management's judgment and include inputs and assumptions that are less observable or require greater estimation as well as valuation methods that are more sophisticated or require greater estimation. The valuations generated by such methods may be different from the value at which the investments ultimately may be sold. Further, rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within the Company's consolidated financial statements, and the period-to-period changes in value could vary significantly. Decreases in value may have a material adverse effect on the Company's financial condition or results of operations.



Changes in the financial strength ratings of financial guaranty insurers issuing policies on bonds held in the Company's investment portfolio may have an adverse effect on the Company's investment results.

In an effort to enhance the bond rating applicable to certain bond issues, some bond issuers purchase municipal bond insurance policies from private insurers. The insurance generally guarantees the payment of principal and interest on a bond issue if the issuer defaults. By purchasing the insurance, the financial strength ratings applicable to the bonds are based on the credit worthiness of the insurer as well as the underlying credit of the bond issuer. These financial guaranty insurers are subject to DOI oversight. As the financial strength ratings of these insurers are reduced, the ratings of the insured bond issues correspondingly decrease. Although the Company has determined that the financial strength ratings of the underlying bond issues in its investment portfolio are within the Company's investment policy without the enhancement provided by the insurance policies, any further downgrades in the financial strength ratings of these insurance companies or any defaults on the insurance policies written by these insurance companies may reduce the fair value of the underlying bond issues and the Company's investment portfolio or may reduce the investment results generated by the Company's investment portfolio, which could have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Deterioration of the municipal bond market in general or of specific municipal bonds held by the Company may result in a material adverse effect on the Company's financial condition, results of operations, and liquidity.

At December 31, 2018, approximately 68% of the Company's total investment portfolio at fair value and approximately 86% of its total fixed maturity securities at fair value were invested in tax-exempt municipal bonds. With such a large percentage of the Company's investment portfolio invested in municipal bonds, the performance of the Company's investment portfolio, including the cash flows generated by the investment portfolio, is significantly dependent on the performance of municipal bonds. If the value of municipal bond markets in general or any of the Company's municipal bond holdings deteriorates, the performance of the Company's investment portfolio, financial condition, results of operations, and liquidity may be materially and adversely affected.

If the Company's loss reserves are inadequate, its business and financial position could be harmed.

The process of establishing property and liability loss reserves is inherently uncertain due to a number of factors, including underwriting quality, the frequency and amount of covered losses, variations in claims settlement practices, the costs and uncertainty of litigation, and expanding theories of liability. While the Company believes that its actuarial techniques and databases are sufficient to estimate loss reserves, the Company's approach may prove to be inadequate. If any of these contingencies, many of which are beyond the Company's control, results in loss reserves that are not sufficient to cover its actual losses, the Company's financial condition, results of operations, and liquidity may be materially and adversely affected.

There is uncertainty involved in the availability of reinsurance and the collectability of reinsurance recoverable.

The Company reinsures a portion of its potential losses on the policies it issues to mitigate the volatility of the losses on its financial condition and results of operations. The availability and cost of reinsurance is subject to market conditions, which are outside of the Company's control. From time to time, market conditions have limited, and in some cases, prevented insurers from obtaining the types and amounts of reinsurance that they consider adequate for their business needs. As a result, the Company may not be able to successfully purchase reinsurance and transfer a portion of the Company's risk through reinsurance arrangements. In addition, as is customary, the Company initially pays all claims and seeks to recover the reinsured losses from its reinsurers. Although the Company reports as assets the amount of claims paid which the Company expects to recover from reinsurers, no assurance can be given that the Company will be able to collect from its reinsurers. If the amounts actually recoverable under the Company's reinsurance treaties are ultimately determined to be less than the amount it has reported as recoverable, the Company may incur a loss during the period in which that determination is made.

The failure of any loss limitation methods employed by the Company could have a material adverse effect on its financial condition or results of operations.

Various provisions of the Company's policies, such as limitations or exclusions from coverage which are intended to limit the Company's risks, may not be enforceable in the manner the Company intends. In addition, the Company's policies contain conditions requiring the prompt reporting of claims and the Company's right to decline coverage in the event of a violation of that condition. While the Company's insurance product exclusions and limitations reduce the Company's loss exposure and help eliminate known exposures to certain risks, it is possible that a court or regulatory authority could nullify or void an exclusion or legislation could be enacted modifying or barring the use of such endorsements and limitations in a way that would adversely affect the Company's loss experience, which could have a material adverse effect on its financial condition or results of operations.

The Company's business is vulnerable to significant catastrophic property loss, which could have an adverse effect on its financial condition and results of operations.

The Company faces a significant risk of loss in the ordinary course of its business for property damage resulting from natural disasters, man-made catastrophes and other catastrophic events, particularly hurricanes, earthquakes, hail storms, explosions, tropical storms, rain storms, fires, mudslides, sinkholes, war, acts of terrorism, severe weather and other natural and man-made disasters. Such events typically increase the frequency and severity of automobile and other property claims. Because catastrophic loss events are by their nature unpredictable, historical results of operations may not be indicative of future results of operations, and the occurrence of claims from catastrophic events may result in substantial volatility in the Company's financial condition and results of operations from period to period. Although the Company attempts to manage its exposure to such events, the occurrence of one or more major catastrophes in any given period could have a material and adverse impact on the Company's financial condition and results of operations and could result in substantial outflows of cash as losses are paid.

The Company depends on independent agents who may discontinue sales of its policies at any time.

The Company sells its insurance policies primarily through approximately 10,160 independent agents. The Company must compete with other insurance carriers for these agents' business. Some competitors offer a larger variety of products, lower prices for insurance coverage, higher commissions, or more attractive non-cash incentives. To maintain its relationship with these independent agents, the Company must pay competitive commissions, be able to respond to their needs quickly and adequately, and create a consistently high level of customer satisfaction. If these independent agents find it preferable to do business with the Company's competitors, it would be difficult to renew the Company's existing business or attract new business. State regulations may also limit the manner in which the Company's producers are compensated or incentivized. Such developments could negatively impact the Company's relationship with these parties and ultimately reduce revenues.

The Company's expansion plans may adversely affect its future profitability.

The Company intends to continue to expand its operations in several of the states in which the Company has operations and may expand into states in which it has not yet begun operations. The intended expansion will necessitate increased expenditures. The Company intends to fund these expenditures out of cash flows from operations. The expansion may not occur, or if it does occur, may not be successful in providing increased revenues or profitability. If the Company's cash flows from operations are insufficient to cover the costs of the expansion, or if the expansion does not provide the benefits anticipated, the Company's financial condition, results of operations, and ability to grow its business may be harmed.

Any inability of the Company to realize its deferred tax assets, if and when they arise, may have a material adverse effect on the Company's financial condition and results of operations.

The Company recognizes deferred tax assets and liabilities for the future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits. The Company evaluates its deferred tax assets for recoverability based on available evidence, including assumptions about future profitability and capital gain generation. Although management believes that it is more likely than not that the deferred tax assets will be realized, some or all of the Company's deferred tax assets could expire unused if the Company is unable to generate taxable income of an appropriate character and in a sufficient amount to utilize these tax benefits in the future. Any determination that the Company would not be able to realize all or a portion of its deferred tax assets in the future would result in a charge to earnings in the period in which the determination is made. This charge could have a material adverse effect on the Company's results of operations and financial condition. In addition, the assumptions used to make this determination are subject to change from period to period based on changes in tax laws or variances between the Company's projected operating performance and actual results. As a result, significant management judgment is required in assessing the possible need for a deferred tax asset valuation allowance. The changes in the estimates and assumptions used in such assessments and decisions can materially affect the Company's results of operations and financial condition.

The carrying value of the Company's goodwill and other intangible assets could be subject to an impairment write-down.

At December 31, 2018, the Company's consolidated balance sheets reflected approximately \$43 million of goodwill and \$16 million of other intangible assets. The Company evaluates whether events or circumstances have occurred that suggest that the fair values of its goodwill and other intangible assets are below their respective carrying values. The determination that the fair values of the Company's goodwill and other intangible assets are less than their carrying values may result in an impairment write-down. An impairment write-down would be reflected as expense and could have a material adverse effect on the Company's results of operations during the period in which it recognizes the expense. In the future, the Company may incur impairment charges related to goodwill and other intangible assets already recorded or arising out of future acquisitions.

The Company relies on its information technology systems to manage many aspects of its business, and any failure of these systems to function properly or any interruption in their operation could result in a material adverse effect on the Company's business, financial condition, and results of operations.

The Company depends on the accuracy, reliability, and proper functioning of its information technology systems. The Company relies on these information technology systems to effectively manage many aspects of its business, including underwriting, policy acquisition, claims processing and handling, accounting, reserving and actuarial processes and policies, and to maintain its policyholder data. The Company has deployed, and continues to enhance, new information technology systems that are designed to manage many of these functions across the states in which it operates and the lines of insurance it offers. See "Overview—A. General—Technology" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." The failure of hardware or software that supports the Company's information technology systems, the loss of data contained in the systems, or any delay or failure in the full deployment of the Company's information technology systems could disrupt its business and could result in decreased premiums, increased overhead costs, and inaccurate reporting, all of which could have a material adverse effect on the Company's business, financial condition, and results of operations.

In addition, despite system redundancy, the implementation of security measures, and the existence of a disaster recovery plan for the Company's information technology systems, these systems are vulnerable to damage or interruption from:

- earthquake, fire, flood and other natural disasters;
- terrorist attacks and attacks by computer viruses, hackers, phishing, ransomware, or other exploits;
- power loss in areas not covered by backup power generators;
- unauthorized access; and
- computer systems, internet, telecommunications or data network failure.

It is possible that a system failure, accident, or security breach could result in a material disruption to the Company's business. In addition, substantial costs may be incurred to remedy the damages caused by these disruptions. Following implementation of information technology systems, the Company may from time to time install new or upgraded business management systems. To the extent that a critical system fails or is not properly implemented and the failure cannot be corrected in a timely manner, the Company may experience disruptions to the business that could have a material adverse effect on the Company's results of operations.

Cyber security risks and the failure to maintain the confidentiality, integrity, and availability of internal or policyholder systems and data could result in damages to the Company's reputation and/or subject it to expenses, fines or lawsuits.

The Company collects and retains large volumes of internal and policyholder data, including personally identifiable information, for business purposes including underwriting, claims and billing purposes, and relies upon the various information technology systems that enter, process, summarize and report such data. The Company also maintains personally identifiable information about its employees. The confidentiality and protection of the Company's policyholder, employee and Company data are critical to the Company's business. The Company's policyholders and employees have a high expectation that the Company will adequately protect their personal information. The regulatory environment, as well as the requirements imposed by the payment card industry and insurance regulators, governing information, security and privacy laws is increasingly demanding and continues to evolve. Maintaining compliance with applicable information security and privacy regulations may increase the Company's operating costs and adversely impact its ability to market products and services to its policyholders. Furthermore, a penetrated or compromised information technology system or the intentional, unauthorized, inadvertent or negligent release or disclosure of data could result in theft, loss, fraudulent or unlawful use of policyholder, employee or Company data which could harm the Company's reputation or result in remedial and other expenses, fines or lawsuits. Although the Company seeks to mitigate the impact and severity of potential cyber threats through cyber insurance coverage, not every risk or liability can be insured, and for risks that are insurable, the policy limits and terms of coverage

reasonably obtainable in the market may not be sufficient to cover all actual losses or liabilities incurred. In addition, disputes with insurance carriers, including over policy terms, reservation of rights, the applicability of coverage (including exclusions), compliance with provisions (including notice) and/or the insolvency of one or more of our insurers, may significantly affect the amount or timing of recovery.

Changes in accounting standards issued by the Financial Accounting Standards Board (the "FASB") or other standard-setting bodies may adversely affect the Company's consolidated financial statements.

The Company's consolidated financial statements are subject to the application of GAAP, which is periodically revised and/or expanded. Accordingly, the Company is required to adopt new or revised accounting standards from time to time issued by recognized authoritative bodies, including the FASB. It is possible that future changes the Company is required to adopt could

change the current accounting treatment that the Company applies to its consolidated financial statements and that such changes could have a material adverse effect on the Company's financial condition and results of operations.

The Company's disclosure controls and procedures may not prevent or detect acts of fraud.

The Company's disclosure controls and procedures are designed to reasonably assure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to management and is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The Company's management, including its Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, the Company cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by an unauthorized override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and the Company cannot assure that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

Failure to maintain an effective system of internal control over financial reporting may have an adverse effect on the Company's stock price.

The Company is required to include in its Annual Report on Form 10-K a report by its management regarding the effectiveness of the Company's internal control over financial reporting, which includes, among other things, an assessment of the effectiveness of the Company's internal control over financial reporting as of the end of its fiscal year, including a statement as to whether or not the Company's internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in the Company's internal control over financial reporting identified by management. Areas of the Company's internal control over financial reporting may require improvement from time to time. If management is unable to assert that the Company's internal control over financial reporting is effective now or in any future period, or if the Company's independent auditors are unable to express an opinion on the effectiveness of those internal controls, investors may lose confidence in the accuracy and completeness of the Company's financial reports, which could have an adverse effect on the Company's stock price.

The ability of the Company to attract, develop and retain talented employees, managers and executives, and to maintain appropriate staffing levels, is critical to the Company's success.

The Company is constantly hiring and training new employees and seeking to retain current employees. An inability to attract, retain and motivate the necessary employees for the operation and expansion of the Company's business could hinder its ability to conduct its business activities successfully, develop new products and attract customers.

The Company's success also depends upon the continued contributions of its executive officers, both individually and as a group. The Company's future performance will be substantially dependent on its ability to retain and motivate its management team. The loss of the services of any of the Company's executive officers could prevent the Company from successfully implementing its business strategy, which could have a material adverse effect on the Company's business, financial condition, and results of operations.

Uncertain economic conditions may negatively affect the Company's business and operating results.

Uncertain economic conditions could adversely affect the Company in the form of consumer behavior and pressure on its investment portfolio. Consumer behavior could include policy cancellations, modifications, or non-renewals, which may reduce cash flows from operations and investments, may harm the Company's financial position, and may reduce

the Insurance Companies' statutory surplus. Uncertain economic conditions also may impair the ability of the Company's customers to pay premiums as they become due, and as a result, the Company's bad debt reserves and write-offs could increase. It is also possible that claims fraud may increase. The Company's investment portfolios could be adversely affected as a result of financial and business conditions affecting the issuers of the securities in the Company's investment portfolio. In addition, declines in the Company's profitability could result in a charge to earnings for the impairment of goodwill, which would not affect the Company's cash flows but could decrease its earnings, and could adversely affect its stock price.

The Company may be adversely affected if economic conditions result in either inflation or deflation. In an inflationary environment, established reserves may become inadequate and increase the Company's loss ratio, and market interest rates may rise and reduce the value of the Company's fixed maturity portfolio. The departments of insurance may not approve premium rate



increases in time for the Company to adequately mitigate inflated loss costs. In a deflationary environment, some fixed maturity issuers may have difficulty meeting their debt service obligations and thereby reduce the value of the Company's fixed maturity portfolio; equity investments may decrease in value; and policyholders may experience difficulties paying their premiums to the Company, which could adversely affect premium revenue.

#### Risks Related to the Company's Industry

The private passenger automobile insurance industry is highly competitive, and the Company may not be able to compete effectively against larger or better-capitalized companies.

The Company competes with many property and casualty insurance companies selling private passenger automobile insurance in the states in which the Company operates. Many of these competitors are better capitalized than the Company, have higher A.M. Best ratings, and have a larger market share in the states in which the Company operates. The superior capitalization of the competitors may enable them to offer lower rates, to withstand larger losses, and to more effectively take advantage of new marketing opportunities. The Company's competition may also become increasingly better capitalized in the future as the traditional barriers between insurance companies and banks and other financial institutions erode and as the property and casualty industry continues to consolidate. The Company's ability to compete against these larger, better-capitalized competitors depends on its ability to deliver superior service and its strong relationships with independent agents.

The Company may undertake strategic marketing and operating initiatives to improve its competitive position and drive growth. If the Company is unable to successfully implement new strategic initiatives or if the Company's marketing campaigns do not attract new customers, the Company's competitive position may be harmed, which could adversely affect the Company's business and results of operations. Additionally, in the event of a failure of any competitor, the Company and other insurance companies would likely be required by state law to absorb the losses of the failed insurer and would be faced with an unexpected surge in new business from the failed insurer's former policyholders.

The Company may be adversely affected by changes in the private passenger automobile insurance industry. Approximately 76% of the Company's direct premiums written for the year ended December 31, 2018 were generated from private passenger automobile insurance policies. Adverse developments in the market for personal automobile insurance or the personal automobile insurance industry in general, whether related to changes in competition, pricing or regulations, could cause the Company's results of operations to suffer. The property-casualty insurance industry is also exposed to the risks of severe weather conditions, such as rainstorms, snowstorms, hail and ice storms, hurricanes, tornadoes, wild fires, sinkholes, earthquakes and, to a lesser degree, explosions, terrorist attacks, and riots. The automobile insurance business is also affected by cost trends that impact profitability. Factors which negatively affect cost trends include inflation in automobile repair costs, automobile parts costs, new and used car valuations, medical costs, and changes in non-economic costs due to changes in the legal and regulatory environments. In addition, the advent of driverless cars and usage-based insurance could materially alter the way that automobile insurance is marketed, priced, and underwritten.

The Company cannot predict the impact that changing climate conditions, including legal, regulatory and social responses thereto, may have on its business.

Various scientists, environmentalists, international organizations, regulators and other commentators believe that global climate change has added, and will continue to add, to the unpredictability, frequency and severity of natural disasters (including, but not limited to, hurricanes, tornadoes, freezes, droughts, other storms and fires) in certain parts of the world. In response, a number of legal and regulatory measures and social initiatives have been introduced in an effort to reduce greenhouse gas and other carbon emissions that may be chief contributors to global climate change. The Company cannot predict the impact that changing climate conditions, if any, will have on its business or its customers. It is also possible that the legal, regulatory and social responses to climate change could have a negative

effect on the Company's results of operations or financial condition.

Changes in federal or state tax laws could adversely affect the Company's business, financial condition, results of operations, and liquidity.

The Company's financial condition, results of operations, and liquidity are dependent in part on tax policy implemented at the federal and/or state level. For example, a significant portion of the Company's investment portfolio consists of municipal securities that receive beneficial tax treatment under applicable federal tax law. The Company's results are also subject to federal and state tax rules applicable to dividends received from its subsidiaries and its equity holdings. Additionally, changes in tax laws could have an adverse effect on deferred tax assets and liabilities included in the Company's consolidated balance sheets and results of operations. Certain elements of the Tax Cuts and Jobs Act of 2017 (the "Act"), enacted into law on December 22, 2017, are pending final regulations from the Internal Revenue Service and state taxing jurisdictions. The Company cannot predict whether

any tax legislation, in addition to the Act, will be enacted in the near future or whether any such changes to existing federal or state tax law would have a material adverse effect on the Company's financial condition and results of operations.

The insurance industry is subject to extensive regulation, which may affect the Company's ability to execute its business plan and grow its business.

The Company is subject to extensive regulation and supervision by government agencies in each of the states in which its Insurance Companies are domiciled, sell insurance products, issue policies, or manage claims. Some states impose restrictions or require prior regulatory approval of specific corporate actions, which may adversely affect the Company's ability to operate, innovate, obtain necessary rate adjustments in a timely manner or grow its business profitably. These regulations provide safeguards for policyholders and are not intended to protect the interests of shareholders. The Company's ability to comply with these laws and regulations, and to obtain necessary regulatory action in a timely manner is, and will continue to be, critical to its success. Some of these regulations include:

**Required Licensing.** The Company operates under licenses issued by the DOI in the states in which the Company sells insurance. If a regulatory authority denies or delays granting a new license, the Company's ability to enter that market quickly or offer new insurance products in that market may be substantially impaired. In addition, if the DOI in any state in which the Company currently operates suspends, non-renews, or revokes an existing license, the Company would not be able to offer affected products in that state.

**Transactions Between Insurance Companies and Their Affiliates.** Transactions between the Insurance Companies and their affiliates (including the Company) generally must be disclosed to state regulators, and prior approval of the applicable regulator is required before any material or extraordinary transaction may be consummated. State regulators may refuse to approve or delay approval of some transactions, which may adversely affect the Company's ability to innovate or operate efficiently.

**Regulation of Insurance Rates and Approval of Policy Forms.** The insurance laws of most states in which the Company conducts business require insurance companies to file insurance rate schedules and insurance policy forms for review and approval. If, as permitted in some states, the Company begins using new rates before they are approved, it may be required to issue refunds or credits to the Company's policyholders if the new rates are ultimately deemed excessive or unfair and disapproved by the applicable state regulator. In other states, prior approval of rate changes is required and there may be long delays in the approval process or the rates may not be approved. Accordingly, the Company's ability to respond to market developments or increased costs in that state can be adversely affected.

**Restrictions on Cancellation, Non-Renewal or Withdrawal.** Most of the states in which the Company operates have laws and regulations that limit its ability to exit a market. For example, these states may limit a private passenger automobile insurer's ability to cancel and non-renew policies or they may prohibit the Company from withdrawing one or more lines of insurance business from the state unless prior approval is received from the state DOI. In some states, these regulations extend to significant reductions in the amount of insurance written, not only to a complete withdrawal. Laws and regulations that limit the Company's ability to cancel and non-renew policies in some states or locations and that subject withdrawal plans to prior approval requirements may restrict the Company's ability to exit unprofitable markets, which may harm its business and results of operations.

**Other Regulations.** The Company must also comply with regulations involving, among other matters:

- the use of non-public consumer information and related privacy issues;
- the use of credit history in underwriting and rating;
- limitations on the ability to charge policy fees;

limitations on types and amounts of investments;  
the payment of dividends;  
the acquisition or disposition of an insurance company or of any company controlling an insurance company;  
involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;  
reporting with respect to financial condition;  
periodic financial and market conduct examinations performed by state insurance department examiners; and  
the other regulations discussed in this Annual Report on Form 10-K.

The failure to comply with these laws and regulations may also result in regulatory actions, fines and penalties, and in extreme cases, revocation of the Company's ability to do business in that jurisdiction. In addition, the Company may face individual and class action lawsuits by insured and other parties for alleged violations of certain of these laws or regulations.

In addition, from time to time, the Company may support or oppose legislation or other amendments to insurance regulations in California or other states in which it operates. Consequently, the Company may receive negative publicity related to its support or opposition of legislative or regulatory changes that may have a material adverse effect on the Company's financial condition, results of operations, and liquidity.

Regulation may become more restrictive in the future, which may adversely affect the Company's business, financial condition, and results of operations.

No assurance can be given that states will not make existing insurance-related laws and regulations more restrictive in the future or enact new restrictive laws. New or more restrictive regulation in any state in which the Company conducts business could make it more expensive for it to continue to conduct business in these states, restrict the premiums the Company is able to charge or otherwise change the way the Company does business. In such events, the Company may seek to reduce its writings in or to withdraw entirely from these states. In addition, from time to time, the United States Congress and certain federal agencies investigate the current condition of the insurance industry to determine whether federal regulation is necessary. The Company cannot predict whether and to what extent new laws and regulations that would affect its business will be adopted, the timing of any such adoption and what effects, if any, they may have on the Company's business, financial condition, and results of operations.

Assessments and other surcharges for guaranty funds, second-injury funds, catastrophe funds, and other mandatory pooling arrangements may reduce the Company's profitability.

Virtually all states require insurers licensed to do business in their state to bear a portion of the loss suffered by some insured parties as the result of impaired or insolvent insurance companies. Many states also have laws that established second-injury funds to provide compensation to injured employees for aggravation of a prior condition or injury which are funded by either assessments based on paid losses or premium surcharge mechanisms. In addition, as a condition to the ability to conduct business in various states, the Insurance Companies must participate in mandatory property and casualty shared-market mechanisms or pooling arrangements, which provide various types of insurance coverage to individuals or other entities that otherwise are unable to purchase that coverage from private insurers. The effect of these assessments and mandatory shared-market mechanisms or changes in them could reduce the Company's profitability in any given period or limit its ability to grow its business.

The insurance industry faces litigation risks, which, if resolved unfavorably, could result in substantial penalties and/or monetary damages, including punitive damages. In addition, insurance companies incur material expenses defending litigation and their results of operations or financial condition could be adversely affected if they fail to accurately project litigation expenses.

Insurance companies are subject to a variety of legal actions including breach of contract claims, tort claims, fraud and misrepresentation claims, employee benefit claims, and wage and hour claims. In addition, insurance companies incur and likely will continue to incur potential liability for claims related to the insurance industry in general and to the Company's business in particular, such as those related to allegations for failure to pay claims, termination or non-renewal of coverage, interpretation of policy language, policy sales practices, reinsurance matters, and other similar matters. Such actions can also include allegations of fraud, misrepresentation, and unfair or improper business practices and can include claims for punitive damages.

Court decisions and legislative activity may increase exposures for any of the types of claims insurance companies face. There is a risk that insurance companies could incur substantial legal fees and expenses in any of the actions companies defend in excess of amounts budgeted for defense.

The Company and the Insurance Companies are named as defendants in a number of lawsuits. Those that management believes could have a material effect on the Company's consolidated financial statements are described more fully in "Overview—B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data." Litigation, by its very nature, is unpredictable and the outcome of these cases is uncertain. The precise nature of the relief that may be sought or granted in any lawsuit is uncertain and may negatively impact the manner in which the Company conducts its business, which could materially increase the Company's legal expenses and negatively impact the results of operations. In addition, potential litigation involving new claim, coverage, and business practice issues could adversely affect the Company's business by changing the way policies are priced, extending coverage beyond its underwriting intent, or increasing the size of claims.

#### Risks Related to the Company's Stock

The Company is controlled by a small number of shareholders who will be able to exert significant influence over matters requiring shareholder approval, including change of control transactions.

George Joseph and Gloria Joseph collectively own more than 50% of the Company's common stock. Accordingly, George Joseph and Gloria Joseph have the ability to exert significant influence on the actions the Company may take in the future, including change of control transactions. Certain institutional investors also each own approximately between 2% and 5% of the Company's common stock. This concentration of ownership may conflict with the interests of the Company's other shareholders and lenders.

Future equity or debt financing may affect the market price of the Company's common stock and rights of the current shareholders, and the future exercise of options and granting of shares will result in dilution in the investment of the Company's shareholders.

The Company may raise capital in the future through the issuance and sale of its common stock or debt securities. The Company cannot predict what effect, if any, such future financing will have on the market price of its common stock. Sales of substantial amounts of its common stock in the public market or issuance of substantial amounts of debt securities could adversely affect the market price of the Company's outstanding common stock, and may make it more difficult for shareholders to sell common stock at a time and price that the shareholder deems appropriate.

Furthermore, holders of some of the Company's securities may have rights, preferences, and privileges that are senior to those of the Company's current shareholders. In addition, the Company has issued and may issue options to purchase shares of its common stock as well as restricted stock units ("RSUs") to incentivize its executives and key employees. In the event that any options to purchase common stock are exercised or any shares of common stock are issued when the RSUs vest, shareholders will suffer dilution in their investment.

Applicable insurance laws may make it difficult to effect a change of control of the Company or the sale of any of its Insurance Companies.

Before a person can acquire control of a U.S. insurance company or any holding company of a U.S. insurance company, prior written approval must be obtained from the DOI of the state where the insurer is domiciled. Prior to granting approval of an application to acquire control of the insurer or holding company, the state DOI will consider a number of factors relating to the acquirer and the transaction. These laws and regulations may discourage potential acquisition proposals and may delay, deter or prevent a change of control of the Company or the sale by the Company of any of its Insurance Companies, including transactions that some or all of the Company's shareholders might consider to be desirable.

Although the Company has consistently paid increasing cash dividends in the past, it may not be able to pay or continue to increase cash dividends in the future.

The Company has consistently paid cash dividends since the public offering of its common stock in November 1985 and has consistently increased the dividend per share during that time. However, future cash dividends will depend upon a variety of factors, including the Company's profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by the Board of Directors. The Company's ability to pay dividends or continue to increase the dividend per share may also be limited by the ability of the Insurance Companies to make distributions to the Company, which may be restricted by financial, regulatory or tax constraints, and by the terms of the Company's debt instruments. In addition, there can be no assurance that the Company will continue to pay dividends or increase the dividend per share even if the necessary financial and regulatory conditions are met and if sufficient cash is available for distribution.

#### Item 1B. Unresolved Staff Comments

None.





## Item 2. Properties

The Company owns the following buildings which are mostly occupied by the Company's employees. Space not occupied by the Company may be leased to independent third party tenants.

Location	Purpose	Size in Square Feet	Percent Occupied by the Company at December 31, 2018	
Brea, CA	Home office and I.T. facilities (2 buildings)	236,000	100	%
Folsom, CA	Administrative and Data Center	88,000	100	%
Los Angeles, CA	Executive offices	41,000	95	%
Rancho Cucamonga, CA	Administrative	127,000	100	%
Clearwater, FL	Administrative	162,000	51	%
Oklahoma City, OK	Administrative	100,000	25	%

The Company leases additional office space for operations. Office location is not crucial to the Company's operations, and the Company anticipates no difficulty in extending these leases or obtaining comparable office space. In addition, the Company owns 5.9 acres of land in Rancho Cucamonga, California.

In August 2017, the Company completed the sale of approximately six acres of land located in Brea, California (the "Property"), for a total sale price of approximately \$12.2 million. Approximately \$5.7 million of the total sale price was received in the form of a promissory note (the "Note") and the remainder in cash. The Note is secured by a first trust deed and an assignment of rents on the Property, and bears interest at an annual rate of 3.5%, payable in monthly installments. The Note matures in August 2020.

The Company's properties are well maintained, adequately meet its needs, and are being utilized for their intended purposes.

## Item 3. Legal Proceedings

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see "Overview-C. Critical Accounting Policies and Estimates" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 1. Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see "Overview—B. Regulatory and Legal Matters" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data," which is incorporated herein by reference.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

Item 4. Mine Safety Disclosure

Not applicable.

24

---

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

The shares of the Company's common stock are listed and traded on the New York Stock Exchange (trading symbol: MCY).

The closing price of the Company's common stock on February 7, 2019 was \$53.35.

Holders

As of February 7, 2019, there were approximately 111 holders of record of the Company's common stock.

Dividends

For financial statement purposes, the Company records dividends on the declaration date. The Company intends to continue paying quarterly dividends; however, the continued payment and amount of cash dividends will depend upon the Company's operating results, overall financial condition, capital requirements, and general business conditions.

Holding Company Act

Pursuant to the Holding Company Act, California-domiciled insurance companies are required to notify the California DOI of any dividend after declaration, but prior to payment. There are similar limitations imposed by other states on the Insurance Companies' ability to pay dividends. As of December 31, 2018, the Insurance Companies are permitted to pay in 2019, without obtaining DOI approval for extraordinary dividends, \$145 million in dividends to Mercury General, of which \$116 million may be paid by the California Companies.

For a discussion of certain restrictions on the payment of dividends to Mercury General by some of its insurance subsidiaries, see Note 12. Dividends, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

Performance Graph

The following graph compares the cumulative total shareholder returns on the Company's common stock (trading symbol: MCY) with the cumulative total returns on the Standard and Poor's 500 Composite Stock Price Index ("S&P 500 Index") and the Company's industry peer group over the last five years. The graph assumes that \$100 was invested on December 31, 2013 in each of the Company's Common Stock, the S&P 500 Index and the industry peer group and the reinvestment of all dividends.

	2013	2014	2015	2016	2017	2018
Mercury General	\$100.00	\$119.91	\$103.35	\$139.80	\$129.70	\$131.88
Industry Peer Group	100.00	121.90	115.77	139.73	169.53	170.52
S&P 500 Index	100.00	113.69	115.26	129.05	157.22	150.32

The industry peer group consists of Alleghany Corporation, Allstate Corporation, American Financial Group, Arch Capital Group Ltd, Berkley (W.R.), Berkshire Hathaway 'B', Chubb Corporation, Cincinnati Financial Corporation, CNA Financial Corporation, Erie Indemnity Company, Hanover Insurance Group, Markel Corporation, Old Republic International, Progressive Corporation, RLI Corporation, Selective Insurance Group, Travelers Companies, Inc., and XL Group, plc.

Recent Sales of Unregistered Securities

None.

Share Repurchases

None.

## Item 6. Selected Financial Data

The following selected financial and operating data are derived from the Company's audited consolidated financial statements. The selected financial and operating data should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data."

	Year Ended December 31,				
	2018	2017	2016	2015	2014
	(Amounts in thousands, except per share data)				
<b>Income Data:</b>					
Net premiums earned	\$3,368,411	\$ 3,195,437	\$ 3,131,773	\$ 2,957,897	\$ 2,796,195
Net investment income	135,838	124,930	121,871	126,299	125,723
Net realized investment (losses) gains	(133,520 )	83,650	(34,255 )	(83,807 )	81,184
Other	9,275	11,945	8,294	8,911	8,671
Total revenues	3,380,004	3,415,962	3,227,683	3,009,300	3,011,773
Losses and loss adjustment expenses	2,576,789	2,444,884	2,355,138	2,145,495	1,986,122
Policy acquisition costs	572,164	555,350	562,545	539,231	526,208
Other operating expenses	244,630	233,475	235,314	250,839	249,381
Interest	17,036	15,168	3,962	3,168	2,637
Total expenses	3,410,619	3,248,877	3,156,959	2,938,733	2,764,348
(Loss) income before income taxes	(30,615 )	167,085	70,724	70,567	247,425
Income tax (benefit) expense	(24,887 )	22,208	(2,320 )	(3,912 )	69,476
Net (loss) income	\$(5,728 )	\$ 144,877	\$ 73,044	\$ 74,479	\$ 177,949
<b>Per Share Data:</b>					
Basic (loss) earnings per share	\$(0.10 )	\$ 2.62	\$ 1.32	\$ 1.35	\$ 3.23
Diluted (loss) earnings per share	\$(0.10 )	\$ 2.62	\$ 1.32	\$ 1.35	\$ 3.23
Dividends paid per share	\$2.5025	\$ 2.4925	\$ 2.4825	\$ 2.4725	\$ 2.4625

	December 31,				
	2018	2017	2016	2015	2014
	(Amounts in thousands, except per share data)				
<b>Balance Sheet Data:</b>					
Total investments	\$3,768,091	\$ 3,732,728	\$ 3,547,560	\$ 3,380,642	\$ 3,403,822
Total assets	5,433,729	5,101,323	4,788,718	4,628,645	4,600,289
Loss and loss adjustment expense reserves	1,829,412	1,510,613	1,290,248	1,146,688	1,091,797
Unearned premiums	1,236,181	1,101,927	1,074,437	1,049,314	999,798
Notes payable	371,734	371,335	320,000	290,000	290,000
Shareholders' equity	1,617,684	1,761,387	1,752,402	1,820,885	1,875,446
Book value per share	29.23	31.83	31.70	33.01	34.02

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for certain forward-looking statements. Certain statements contained in this report are forward-looking statements based on the Company's current expectations and beliefs concerning future developments and their potential effects on the Company. There can be no assurance that future developments affecting the Company will be those anticipated by the Company. Actual results may differ from those projected in the forward-looking statements. These forward-looking statements involve significant risks and uncertainties (some of which are beyond the control of the Company) and are subject to change based upon various factors, including but not limited to the following risks and uncertainties: changes in the demand for the Company's insurance products, inflation and general economic conditions, including general market risks associated with the Company's investment portfolio; the accuracy and adequacy of the Company's pricing methodologies; catastrophes in the markets served by the Company; uncertainties related to estimates, assumptions and projections generally; the possibility that actual loss experience may vary adversely from the actuarial estimates made to determine the Company's loss reserves in general; the Company's ability to obtain and the timing of the approval of premium rate changes for insurance policies issued in states where the Company operates; legislation adverse to the automobile insurance industry or business generally that may be enacted in the states where the Company operates; the Company's success in managing its business in non-California states; the presence of competitors with greater financial resources and the impact of competitive pricing and marketing efforts; the ability of the Company to successfully manage its claims organization outside of California; the Company's ability to successfully allocate the resources used in the states with reduced or exited operations to its operations in other states; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs; and legal, cyber security, regulatory and litigation risks.

From time to time, forward-looking statements are also included in the Company's quarterly reports on Form 10-Q and current reports on Form 8-K, in press releases, in presentations, on its web site, and in other materials released to the public. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report or statement. The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise.

### OVERVIEW

#### A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a significant impact on the Company's ability to grow and retain business.

The Company is headquartered in Los Angeles, California and writes primarily personal automobile lines of business selling policies through a network of independent agents, 100% owned insurance agents and direct channels, in 11 states: Arizona, California, Florida, Georgia, Illinois, Nevada, New Jersey, New York, Oklahoma, Texas, and Virginia. The Company also offers homeowners, commercial automobile, commercial property, mechanical protection, fire, and umbrella insurance. Private passenger automobile lines of insurance business accounted for approximately 76% of the \$3.6 billion of the Company's direct premiums written in 2018, and approximately 87% of

the private passenger automobile premiums were written in California.

The Company was unable to profitably grow its business in Michigan and Pennsylvania since it began writing insurance in those states in 2004. Michigan and Pennsylvania combined net premiums earned were \$15.4 million and \$18.6 million in 2015 and 2014, respectively, and combined ratios were 137% and 130% in 2015 and 2014, respectively. During the second quarter of 2016, the Company implemented an exit plan to focus resources on other states with better opportunities for sustainable growth, and with the approval of the regulators in Michigan and Pennsylvania, the Company ceased accepting new business in those states in May 2016. The Company has substantially completed the run-off of its Michigan and Pennsylvania operations in 2017, and a limited number of claims remained open at December 31, 2018.

In line with the goal of improving operating efficiencies outside California and overall long-term profitability, the Company

28

---

restructured its claims operations in states outside of California resulting in a workforce reduction of approximately 100 employees, primarily in the Company's New Jersey and Florida branch offices. As a result, during the second quarter of 2016, the Company recorded a charge, primarily in loss and loss adjustment expenses, of approximately \$2 million for employee termination costs.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's consolidated financial statements and notes thereto, and all other items contained within this Annual Report on Form 10-K.

#### 2018 Financial Performance Summary

The Company's net (loss) for the year ended December 31, 2018 was \$(5.7) million, or \$(0.10) per diluted share, compared to net income of \$144.9 million, or \$2.62 per diluted share, for the same period in 2017. Included in net (loss) income was \$135.8 million of pre-tax investment income that was generated during 2018 on a portfolio of \$3.8 billion, at fair value, at December 31, 2018, compared to \$124.9 million of pre-tax investment income that was generated during 2017 on a portfolio of \$3.7 billion, at fair value, at December 31, 2017. Also included in net (loss) income were pre-tax net realized investment (losses) gains of \$(133.5) million and \$83.7 million in 2018 and 2017, respectively, and pre-tax catastrophe losses, net of reinsurance benefits and related reinstatement premiums earned, of approximately \$82.0 million and \$81.6 million in 2018 and 2017, respectively.

During 2018, the Company continued its marketing efforts to enhance name recognition and lead generation. The Company believes that its marketing efforts, combined with its ability to maintain relatively low prices and a strong reputation, make its insurance products competitive in California and in other states.

The Company believes its thorough underwriting process gives it an advantage over its competitors. The Company's agent relationships and underwriting and claims processes are its most important competitive advantages.

The Company's operating results and growth have allowed it to consistently generate positive cash flow from operations, which was approximately \$383 million and \$341 million in 2018 and 2017, respectively. Cash flow from operations has been used to pay shareholder dividends and help support growth.

#### Economic and Industry Wide Factors

**Regulatory Uncertainty**—The insurance industry is subject to strict state regulation and oversight and is governed by the laws of each state in which each insurance company operates. State regulators generally have substantial power and authority over insurance companies including, in some states, approving rate changes and rating factors, and establishing minimum capital and surplus requirements. In many states, insurance commissioners may emphasize different agendas or interpret existing regulations differently than previous commissioners. There is no certainty that current or future regulations and the interpretation of those regulations by insurance commissioners and the courts will not have an adverse impact on the Company.

**Cost Uncertainty**—Because insurance companies pay claims after premiums are collected, the ultimate cost of an insurance policy is not known until well after the policy revenues are earned. Consequently, significant assumptions are made when establishing insurance rates and loss reserves. While insurance companies use sophisticated models and experienced actuaries to assist in setting rates and establishing loss reserves, there can be no assurance that current rates or current reserve estimates will be adequate. Furthermore, there can be no assurance that insurance regulators will approve rate increases when the Company's actuarial analyses indicate that they are needed.

**Economic Conditions**—Many businesses are experiencing the effects of uncertain conditions in the global economy and capital markets, reduced consumer spending and confidence, and continued volatility, which could adversely impact the Company's financial condition, results of operations, and liquidity. Further, volatility in global capital markets could adversely affect the Company's investment portfolio. The Company is unable to predict the impact of current and future global economic conditions on the United States, and California, where the majority of the Company's



business is produced.

Inflation—The largest cost component for automobile insurers is losses, which include medical, replacement automobile parts, and labor costs. There can be significant variation in the overall increases in medical cost inflation, and it is often years after the respective fiscal period ends before sufficient claims have closed for the inflation rate to be known with a reasonable degree of certainty. Therefore, it can be difficult to establish reserves and set premium rates, particularly when actual inflation rates may be higher or lower than anticipated.

29

---

Loss Frequency—Another component of overall loss costs is loss frequency, which is the number of claims per risk insured. Loss frequency trends are affected by many factors such as fuel prices, the economy, the prevalence of distracted driving, and collision avoidance and other technology in vehicles.

Underwriting Cycle and Competition—The property and casualty insurance industry is highly cyclical, with alternating hard and soft market conditions. The Company has historically seen significant premium growth during hard market conditions. The Company believes that the automobile insurance industry is in a hard market with carriers generally raising rates, although this also depends on individual state profitability and the carriers' growth appetite.

#### Technology

The Company implemented Guidewire's InsuranceSuite in 2010, which is a widely adopted industry software leader. Over the past several years, InsuranceSuite has been deployed in most of the states and lines of business in which the Company operates. Throughout 2018, there have been numerous enhancements to the Company's information technology platforms to enhance user experience and improve cross-selling abilities across different distribution channels. In addition, the Company implemented AgentCenter, its enhanced agency portal, and a technology system enabling direct-to-consumer sale of homeowners insurance in 2018. The Company will continue to invest in improving user experiences with its information technology platforms.

#### B. Regulatory and Legal Matters

The process for implementing rate changes varies by state. For more detailed information related to insurance rate approval, see "Item 1. Business—Regulation."

During 2018, the Company implemented rate changes in eleven states. In California, the following rate increases were approved by the California DOI for lines of business that exceeded 5% of the Company's total net premiums earned in 2018:

In January 2019, the California DOI approved a 6.9% rate increase on CAIC's private passenger automobile line of insurance business, which represented approximately 13% of the Company's total net premiums earned in 2018. The Company expects to implement this rate increase in March 2019.

In January 2018, the California DOI approved a 5.0% rate increase on MIC's private passenger automobile line of insurance business, which represented approximately 53% of the Company's total net premiums earned in 2018. This rate increase became effective in March 2018.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8,

2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and

the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. On January 12, 2017, the California DOI filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. While the appeal is still pending, the California DOI returned the entire penalty amount plus accrued interest, a total of \$30.9 million, to the Company in June 2017 in order to avoid accruing further interest. Because the matter has been appealed, the Company has not yet recognized the \$30.9 million as a gain in the consolidated statements of operations; instead, the Company recorded the \$30.9 million plus interest earned, a total of approximately \$31.6 million at December 31, 2018, in other liabilities in the consolidated balance sheets. The Company had filed a motion to dismiss the false advertising portion of the case based on the Superior Court's findings, but the ALJ denied that motion after the appeal was filed. The ALJ did, however, grant the Company's alternative request to stay further proceedings pending the final determination of the appeal. The Company has accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see "Critical Accounting Policies and Estimates" below and Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For material loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see Note 17. Commitments and Contingencies—Litigation of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### C. Critical Accounting Policies and Estimates

##### Loss and Loss Adjustment Expense Reserves ("Loss Reserves")

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a

loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail liability claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company calculates a loss reserve point estimate rather than a range. There is inherent uncertainty with estimates and this is particularly true with loss reserve estimates. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory and legal environments, uncertainty over inflation rates, and uncertainty for unknown items. The Company does not make specific provisions for these uncertainties, rather it considers them in establishing its loss reserve by looking at historical patterns and trends and projecting these out to current loss reserves. The underlying factors and assumptions that serve as the basis for preparing the loss reserve estimate include paid and incurred loss development factors, expected average costs per claim, inflation trends, expected loss ratios, industry data, and other relevant information.

The Company also engages independent actuarial consultants to review the Company's loss reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal rulings that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company generally analyzes the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves. The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid. The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts. The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes. For catastrophe losses on individual properties that are expected to be total losses, the Company typically establishes reserves at the policy limits.

There are many factors that can cause variability between the ultimate expected loss and the actual developed loss. While there are certainly other factors, the Company believes that the following three items tend to create the most variability between expected losses and actual losses.

(1) Inflation

For the Company's California automobile lines of insurance business, total reserves are comprised of the following:

BI reserves—approximately 75% of total reserves

Material damage ("MD") reserves, including collision and comprehensive property damage—approximately 10% of total reserves

Loss adjustment expense reserves—approximately 15% of total reserves.

Loss development on MD reserves is generally insignificant because MD claims are generally settled in a shorter period than BI claims. The majority of the loss adjustment expense reserves are estimated costs to defend BI claims, which tend to require longer periods of time to settle as compared to MD claims.

BI loss reserves are generally the most difficult to estimate because they take longer to close than other coverages. BI coverage in the Company's policies includes injuries sustained by any person other than the insured, except in the case of uninsured or underinsured motorist BI coverage, which covers damages to the insured for BI caused by uninsured or underinsured motorists. BI payments are primarily for medical costs and general damages.

The following table presents the typical closure patterns of BI claims in the Company's California personal automobile insurance coverage:

	% of Total	
	Claims Closed	Dollars Paid
BI claims closed in the accident year reported	38%	13%
BI claims closed one year after the accident year reported	77%	51%
BI claims closed two years after the accident year reported	93%	79%
BI claims closed three years after the accident year reported	98%	90%

BI claims closed in the accident year reported are generally the smaller and less complex claims that settle for approximately \$4,000 to \$5,000 on average, whereas the total average settlement, once all claims are closed in a particular accident year, is approximately \$10,000 to \$16,000. The Company creates incurred and paid loss triangles to estimate ultimate losses utilizing historical payment and reserving patterns and evaluates the results of this analysis against its frequency and severity analysis to establish BI loss reserves. The Company adjusts development factors to account for inflation trends it sees in loss severity. As a larger proportion of claims from an accident year are settled, there emerges a higher degree of certainty for the loss reserves established for that accident year. Consequently, there is generally a decreasing likelihood of loss reserve development on any particular accident year, as those periods age. At December 31, 2018, the accident years that are most likely to develop are the 2016 through 2018 accident years; however, it is possible that older accident years could develop as well.

In general, the Company expects that historical claims trends will continue with costs tending to increase, which is generally consistent with historical data, and therefore the Company believes that it is reasonable to expect inflation to continue. Many potential factors can affect the BI inflation rate, including changes in claims handling process, changes in statutes and regulations, the number of litigated files, increased use of medical procedures such as MRIs and epidural injections, general economic factors, timeliness of claims adjudication, vehicle safety, weather patterns, and gasoline prices, among other factors; however, the magnitude of the impact of such factors on the inflation rate is unknown.

The Company believes that it is reasonably possible that the California automobile BI severity could vary from recorded amounts by as much as 10%, 8%, and 6% for 2018, 2017, and 2016 accident years, respectively; however, the variation could be more or less than these amounts.

During the years 2014 through 2018, the changes in the loss severity amounts for the three preceding accident years from the prior year amounts (BI severity variance from prior year) have ranged as follows:

	High	Low
Immediate preceding accident year	1.4%	(5.1)%
Second preceding accident year	7.5%	(3.1)%
Third preceding accident year	5.2%	(2.9)%

The following table presents the effects on the California automobile BI loss reserves for the 2018, 2017, and 2016 accident years based on possible variations in the severity recorded; however, the variation could be more or less than these amounts.

#### California Automobile Bodily Injury Inflation Reserve Sensitivity Analysis

Accident Year	Number of Claims Expected	Actual Recorded Severity at 12/31/2018	Implied Inflation Rate Recorded <sup>(1)</sup>	(A) Pro-forma severity if actual severity is lower by 10% for 2018, and 8% for 2017, and 10% for 2016	(B) Pro-forma severity if actual severity is higher by 10% for 2018, and 8% for 2017, and 10% for 2016	Favorable loss development if actual severity is less than recorded (Column A)	Unfavorable loss development if actual severity is more than recorded (Column B)



Edgar Filing: MERCURY GENERAL CORP - Form 10-K

					6% for 2016	8% for 2017, and 6% for 2016		
2018	29,073	(2)\$ 15,571	(2)12.9	%	(2)\$ 14,014	\$ 17,128	\$ 45,267,000	\$ (45,267,000 )
2017	28,659	(2)\$ 13,790	(2)13.6	%	(2)\$ 12,687	\$ 14,893	\$ 31,611,000	\$ (31,611,000 )
2016	29,502	(2)\$ 12,140	(2)10.4	%	(2)\$ 11,412	\$ 12,868	\$ 21,477,000	\$ (21,477,000 )
2015	32,136	\$ 10,992	—	—	—	—	—	—
Total Loss Development—Favorable (Unfavorable)							\$ 98,355,000	\$ (98,355,000 )

(1) Implied inflation rate is calculated by dividing the difference between the current and prior year actual recorded severity

by the prior year actual recorded severity. The Company believes that severity increases are caused by litigation, medical costs, inflation, and increased utilization of medical procedures.

During 2016, the Company implemented a claims strategy that reduced the number of small dollar settlements offered shortly after the claims were reported. This strategy reduced the total number of claims expected, which had the effect of increasing the actual recorded severity across the total claims population. There were fewer small dollar claims in the calculation of actual recorded severity for the 2016 through 2018 accident years compared to prior accident years. Consequently, the implied inflation rate recorded for these years are skewed upward due to this strategy change.

## (2) Claim Count Development

The Company generally estimates ultimate claim counts for an accident period based on development of claim counts in prior accident periods. Typically, almost every claim is reported within one year following the end of an accident year and at that point the Company has a high degree of certainty as to the ultimate claim count. There are many factors that can affect the number of claims reported after an accident period ends. These factors include changes in weather patterns, a change in the number of litigated files, the number of automobiles insured, and whether the last day of the accident period falls on a weekday or a weekend. However, the Company is unable to determine which, if any, of the factors actually impact the number of claims reported and, if so, by what magnitude.

At December 31, 2018, there were 26,978 California automobile BI claims reported for the 2018 accident year and the Company estimates that these are expected to ultimately grow by approximately 7.8%. The Company believes that while actual development in recent years has ranged approximately from 3% to 5%, it is reasonable to expect that the range could be as great as between 0% and 10%. Actual development may be more or less than the expected range.

The following table presents the effects on loss development of different claim count within the broader possible range at December 31, 2018:

### California Automobile Bodily Injury Claim Count Reserve Sensitivity Analysis

2018 Accident Year	Claims Reported	Amount Recorded	Total Expected	Total Expected
		at 12/31/2018 at Approximately 7.8% Claim Count Development	Amount If Claim Count Development is 0%	Amount If Claim Count Development is 10%
Claim count	26,978	29,073	26,978	29,676
Approximate average cost per claim	Not meaningful	\$ 15,571	\$ 15,571	\$ 15,571
Total dollars	Not meaningful	\$ 452,696,000	\$ 420,074,000	\$ 462,085,000
Total Loss Development—Favorable (Unfavorable)			\$ 32,622,000	\$ (9,389,000 )

## (3) Unexpected Losses From Older Accident Periods

Unexpected losses are generally not provided for in the current loss reserve because they are not known or expected and tend to be unquantifiable. Once known, the Company establishes a provision for the losses, but it is not possible to provide any meaningful sensitivity analysis as to the potential size of any unexpected losses. These losses can be caused by many factors, including unexpected legal interpretations of coverage, ineffective claims handling, regulations extending claims reporting periods, assumption of unexpected or unknown risks, adverse court decisions as well as many unknown factors. During 2018, the Company did not incur any material unexpected losses related to claims from accident periods prior to 2015.

Unexpected losses are fairly infrequent but can have a large impact on the Company's losses. To mitigate this risk, the Company has established claims handling and review procedures. However, it is still possible that these procedures will not prove entirely effective, and the Company may have material unexpected losses in future periods. It is also possible that the Company has not identified and established a sufficient loss reserve for all material unexpected losses occurring in the older accident years, even though a comprehensive claims file review was undertaken. The Company

may experience additional development on these loss reserves.

Discussion of Losses and Loss Reserves and Prior Period Loss Development at December 31, 2018

At December 31, 2018 and 2017, the Company recorded its point estimate of approximately \$1.83 billion and \$1.51 billion (\$1.65 billion and \$1.45 billion, net of reinsurance), respectively, in loss and loss adjustment expense reserves, which included approximately \$823 million and \$668 million (\$751 million and \$627 million, net of reinsurance), respectively, of incurred-but-

not-reported liabilities ("IBNR"). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to December 31, 2018 and 2017, and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its loss reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For 2018, the Company reported unfavorable development of approximately \$93 million on the 2017 and prior accident years' loss and loss adjustment expense reserves. The unfavorable development in 2018 was primarily attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business.

During 2018, the Company recorded catastrophe losses of approximately \$289 million (\$67 million, net of reinsurance benefits), resulting primarily from wildfires in Northern and Southern California and weather-related catastrophes across several states.

#### Investments

The Company's fixed maturity and equity investments are classified as "trading" and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable preferred stocks, are actively traded on national exchanges or trading markets, and are valued at the last transaction price on the balance sheet date.

#### Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, total return swaps, accounts payable, options sold, and notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 2. Financial Instruments, of the Notes to Consolidated Financial Statements in Item 8. "Financial Statements and Supplementary Data."

The Company's financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. 98.2% of the fair value of these financial instruments held at December 31, 2018 is based on observable market prices, observable pricing parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or pricing parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide

variety of factors, including the type of financial instrument, whether it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted financial instruments may be reduced during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted. For a further discussion, see Note 4. Fair Value Measurements, of the Notes to Consolidated Financial Statements in Item 8. "Financial Statements and Supplementary Data."

#### Income Taxes

At December 31, 2018, the Company's deferred income taxes were in a net asset position mainly due to deferred tax assets

generated by unearned premiums and loss reserve discounting. These deferred tax assets were substantially offset by deferred tax liabilities resulting from deferred acquisition costs. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains, tax-planning strategies available to generate future taxable capital gains, and the Company's capacity to absorb capital losses carried back to prior years, each of which would contribute to the realization of deferred tax benefits. The Company has significant unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. In addition, the Company expects to hold certain debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings. Finally, the Company has the capacity to recoup capital deferred tax assets through tax capital loss carryback claims for taxes paid within permitted carryback periods.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flows from operations and believes that its liquidity needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

The Company's effective income tax rate can be affected by several factors. These generally include large changes in fully-taxable income including net realized investment gains or losses, tax-exempt investment income, nondeductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate was 81.3% for 2018, compared to 13.3% for 2017. The effective tax rate increased despite the reduction in the statutory tax rate from 35% to 21%. Tax-exempt investment income coupled with pre-tax loss caused the effective tax rate for 2018 to increase, while tax-exempt investment income coupled with pre-tax income lowered the effective tax rate for 2017.

As a result of enactment of the Act on December 22, 2017 that is effective for tax years beginning January 1, 2018, the Company made certain tax adjustments for the twelve months ended December 31, 2018 and 2017. For the year ended December 31, 2018, the Company computed its current and deferred income taxes at the new corporate tax rate of 21%, compared to computing only deferred income taxes at 21% and current income taxes at the pre-enactment rate of 35% for the year ended December 31, 2017. Additionally, as a result of recently published guidance in 2018 by the Internal Revenue Service ("IRS"), the amount of deferred income tax liability adjustment recorded at December 31, 2018 resulting from the Act related to loss reserve discounting was based on the information available in the IRS guidance.

The alternative minimum tax ("AMT") credit, previously classified as deferred tax asset that was included in deferred income taxes in the Company's consolidated balance sheets, was reclassified during 2017 to current income taxes receivable as a result of the Act. At December 31, 2018, the Company's AMT credit balance was \$66.7 million. The

AMT credit will be used to offset future federal tax obligations, and as tax refunds, until its benefits are fully realized by December 31, 2021. The amount of income tax adjustment recorded at December 31, 2018 resulting from the Act related to the AMT credit was based on reasonable estimates of the Company's tax obligations using the latest information available.

The Company continues to assess other impacts that the Act may have on business and investment strategies as well as financial results in future years. There are complex factors at play, including the effect of insurance regulation, which will likely require the tax benefits to be passed on to consumers, and changing dynamics in the capital markets, which may result in a shift in the Company's allocation between taxable and tax-exempt investments.

#### Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential liabilities

and accrues for them and/or discloses them in the notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows. See "Regulatory and Legal Matters" above and Note 17. Commitments and Contingencies, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment income to related unearned premiums. To the extent that any of the Company's lines of insurance business become unprofitable, a premium deficiency reserve may be required.

### RESULTS OF OPERATIONS

Year Ended December 31, 2018 Compared to Year Ended December 31, 2017

#### Revenues

Net premiums earned and net premiums written in 2018 increased 5.4% and 8.7%, respectively, from 2017. The increases in net premiums earned and net premiums written were primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of insurance business and growth in the number of private passenger automobile and homeowners policies written in California.

The Company, which predominantly offers six-month personal automobile insurance policies, reintroduced twelve-month personal automobile policies for new business in MIC, its largest insurance subsidiary, in March 2018. Twelve-month policies are generally sold for twice the price of six-month policies. MIC's net premiums written from twelve-month policies in 2018 and 2017 was approximately \$205 million and \$70 million, respectively.

Net premiums earned included ceded premiums earned of \$48.9 million and \$26.9 million in 2018 and 2017, respectively. Net premiums written included ceded premiums written of \$56.0 million and \$33.9 million in 2018 and 2017, respectively. Ceded premiums earned and ceded premiums written increased in 2018, largely due to increased coverage and reinsurance rates, as well as increased reinstatement premiums after increased use of reinsurance benefits following the major wildfires in Northern and Southern California in the second half of 2018.

Net premiums earned, a GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the periods presented and earned on a pro-rata basis over the term of the policies. Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels.

The following is a reconciliation of total net premiums earned to net premiums written:

	Year Ended December	
	31,	
	2018	2017
	(Amounts in thousands)	
Net premiums earned	\$3,368,411	\$3,195,437
Change in net unearned premiums	127,222	20,473
Net premiums written	\$3,495,633	\$3,215,910





## Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Company's consolidated loss, expense, and combined ratios determined in accordance with GAAP:

	Year Ended	
	December 31,	
	2018	2017
Loss ratio	76.5 %	76.5 %
Expense ratio	24.2 %	24.7 %
Combined ratio	100.7%	101.2%

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The Company's loss ratio was affected by unfavorable development of approximately \$93 million and \$54 million on prior accident years' loss and loss adjustment expense reserves for the years ended December 31, 2018 and 2017, respectively. The unfavorable development in 2018 was primarily attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business, while the unfavorable development in 2017 was primarily attributable to higher than estimated California automobile and property losses. The 2018 loss ratio was also negatively impacted by a total of approximately \$67 million of catastrophe losses, net of reinsurance benefits, primarily due to wildfires in Northern and Southern California and weather-related catastrophes across several states. The 2017 loss ratio was also negatively impacted by a total of approximately \$79 million of catastrophe losses, net of reinsurance benefits, primarily due to wildfires in Northern and Southern California, severe rainstorms in California, and the impact of hurricanes in Texas, Florida and Georgia. Excluding the effect of estimated prior periods' loss development and catastrophe losses, the loss ratio was 71.7% and 72.3% for the years ended December 31, 2018 and 2017, respectively. The decrease in the loss ratio primarily resulted from premium rate increases on automobile and homeowners insurance policies, partially offset by higher loss severity.

Expense ratio is calculated by dividing the sum of policy acquisition costs and other operating expenses by net premiums earned. The lower expense ratio for the year ended December 31, 2018 compared to the year ended December 31, 2017 was primarily attributable to net premiums earned growing at a higher rate than policy acquisition costs and other operating expenses.

Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; a combined ratio over 100% generally reflects unprofitable underwriting results.

Income tax (benefit) expense was \$(24.9) million and \$22.2 million for the years ended December 31, 2018 and 2017, respectively. The \$47.1 million decrease in income tax expense was mainly due to a significant decrease in pre-tax income of \$197.7 million, partially offset by a reduced tax benefit on pre-tax loss before net investment income in 2018 as a result of a decrease in the federal corporate tax rate from 35% to 21%. Tax-exempt investment income, a component of total pre-tax (loss) income, did not change significantly compared to the same period in 2017.

## Investments

The following table presents the investment results of the Company:

	Year Ended December 31,	
	2018	2017
	(Amounts in thousands)	
Average invested assets at cost <sup>(1)</sup>	\$3,740,497	\$3,582,122
Net investment income <sup>(2)</sup>		
Before income taxes	\$ 135,838	\$ 124,930

Edgar Filing: MERCURY GENERAL CORP - Form 10-K

After income taxes	\$ 121,476		\$ 109,243	
Average annual yield on investments <sup>(2)</sup>				
Before income taxes	3.6	%	3.5	%
After income taxes	3.3	%	3.1	%
Net realized investment (losses) gains	\$ (133,520 )		\$ 83,650	

---

- (1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period. Net investment income before and after income taxes increased primarily due to higher average invested assets combined with rising market interest rates. Average annual yield on investments before and after income taxes increased primarily due to yield increases in short-term and floating-rate securities resulting from rising market interest rates. Net investment income and average annual yield on investments after income taxes also benefited modestly from the lower tax rate effective January 1, 2018 applied to taxable investment income.

The following tables present the components of net realized investment gains (losses) included in net income:

	Year Ended December 31, 2018		
	Gains (Losses) Recognized in		
	Income		
	Sales	Changes in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses):			
Fixed maturity securities <sup>(1)(2)</sup>	\$(3,014)	\$(53,927 )	\$(56,941 )
Equity securities <sup>(1)(3)</sup>	(2,187 )	(77,494 )	(79,681 )
Short-term investments <sup>(1)</sup>	(2,368 )	(1,237 )	(3,605 )
Note receivable <sup>(1)</sup>	—	(8 )	(8 )
Total return swaps	(132 )	(3,651 )	(3,783 )
Options sold	10,513	(15 )	10,498
Total	\$2,812	\$(136,332)	\$(133,520)

	Year Ended December 31, 2017		
	Gains (Losses) Recognized in		
	Income		
	Sales	Changes in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses):			

Fixed maturity securities <sup>(1)(2)</sup>	\$(2,097)	\$50,403	\$48,306
Equity securities <sup>(1)(3)</sup>	(2,213 )	37,486	35,273
Short-term investments <sup>(1)</sup>	1	38	39
Note receivable <sup>(1)</sup>	—	(122 )	(122 )
Total return swaps	(1,035 )	(1,102 )	(2,137 )
Options sold	2,294	(3 )	2,291
Total	\$(3,050)	\$86,700	\$83,650

(1) The changes in fair value of the investment portfolio and note receivable resulted from the application of the fair value option.

The decreases in fair value of fixed maturity securities during 2018 were primarily due to increases in market interest rates. The increases in fair value in 2017 were primarily due to the overall improvement in the market conditions affecting fixed maturity securities.

The decreases in fair value of equity securities during 2018 were primarily due to the overall decline in the equity markets. The increases in fair value of equity securities during 2017 were primarily due to the overall improvement in the equity markets.



## Net Income

	Year Ended	
	December 31,	
	2018	2017
	(Amounts in thousands, except per share data)	
Net (loss) income	\$ (5,728 )	\$ 144,877
Basic average shares outstanding	55,335	55,316
Diluted average shares outstanding	55,335	55,327
Basic Per Share Data:		
Net (loss) income	\$ (0.10 )	\$ 2.62
Net realized investment (losses) gains, net of tax	\$ (1.90 )	\$ 0.98
Diluted Per Share Data:		
Net (loss) income	\$ (0.10 )	\$ 2.62
Net realized investment (losses) gains, net of tax	\$ (1.90 )	\$ 0.98

## Year Ended December 31, 2017 Compared to Year Ended December 31, 2016

## Revenues

Net premiums earned and net premiums written in 2017 increased 2.0% and 1.9%, respectively, from 2016. The increases in net premiums earned and net premiums written were primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile and homeowners lines of insurance business and growth in the number of homeowners policies written in California. Net premiums earned included ceded premiums earned of \$26.9 million and \$15.8 million in 2017 and 2016, respectively. Net premiums written included ceded premiums written of \$33.9 million and \$17.0 million in 2017 and 2016, respectively. Ceded premiums earned and ceded premiums written increased in 2017, as a result of increased coverage on the Treaty effective July 1, 2017 and reinstatement premiums paid after the use of reinsurance benefits following the Northern and Southern California wildfires in the fourth quarter of 2017.

The following is a reconciliation of total net premiums earned to net premiums written:

	Year Ended December	
	31,	
	2017	2016
	(Amounts in thousands)	
Net premiums earned	\$3,195,437	\$3,131,773
Change in net unearned premiums	20,473	24,015
Net premiums written	\$3,215,910	\$3,155,788

## Expenses

The following table presents the Company's consolidated loss, expense, and combined ratios determined in accordance with GAAP:

	Year Ended	
	December 31,	
	2017	2016
Loss ratio	76.5 %	75.2 %
Expense ratio	24.7 %	25.5 %
Combined ratio	101.2 %	100.7 %

The Company's loss ratio was affected by unfavorable development of approximately \$54 million and \$85 million on prior accident years' loss and loss adjustment expense reserves for the years ended December 31, 2017 and 2016, respectively. The unfavorable development in 2017 was primarily attributable to higher than estimated California automobile and property losses, while the unfavorable development in 2016 was primarily from the California and Florida automobile lines of business. The 2017 loss ratio was also negatively impacted by a total of \$79 million of catastrophe losses, net of reinsurance benefits, primarily due

to wildfires in Northern and Southern California, severe rainstorms in California, and the impact of hurricanes in Texas, Florida and Georgia. The 2016 loss ratio was also negatively impacted by a total of \$27 million of catastrophe losses, mostly due to severe storms outside of California and rainstorms in California. Excluding the effect of estimated prior periods' loss development and catastrophe losses, the loss ratio was 72.3% and 71.6% for the years ended December 31, 2017 and 2016, respectively. The increase in the loss ratio was primarily due to higher loss severity, partially offset by higher average premiums per policy.

The lower expense ratio for the year ended December 31, 2017 was primarily attributable to lower policy acquisition costs and advertising expenses compared to the year ended December 31, 2016.

Income tax expense (benefit) was \$22.2 million and \$(2.3) million for the years ended December 31, 2017 and 2016, respectively. The \$24.5 million increase in income tax expense was mainly due to a significant increase in pre-tax income of \$96.4 million, partially offset by a net tax benefit of approximately \$7.4 million resulting from the income tax effect of the Act.

#### Investments

The following table presents the investment results of the Company:

	Year Ended December 31,	
	2017	2016
	(Amounts in thousands)	
Average invested assets at cost <sup>(1)</sup>	\$3,582,122	\$3,390,769
Net investment income <sup>(2)</sup>		
Before income taxes	\$ 124,930	\$ 121,871
After income taxes	\$ 109,243	\$ 107,140
Average annual yield on investments <sup>(2)</sup>		
Before income taxes	3.5	% 3.6
After income taxes	3.1	% 3.2
Net realized investment gains (losses)	\$ 83,650	\$(34,255 )

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each respective period.

Net investment income before and after income taxes increased due to higher average invested assets. Average annual yield on investments before and after income taxes decreased slightly, primarily due to the maturity and replacement of higher yielding investments purchased when market interest rates were higher, with lower yielding investments purchased during low interest rate environments.

The following tables present the components of net realized investment gains (losses) included in net income:

	Year Ended December 31,		
	2017		
	Gains (Losses) Recognized in		
	Income		
	Sales	Changes in fair value	Total
	(Amounts in thousands)		
Net realized investment gains (losses):			
Fixed maturity securities <sup>(1)(2)</sup>	\$(2,097)	\$50,403	\$48,306
Equity securities <sup>(1)(3)</sup>	(2,213 )	37,486	35,273
Short-term investments <sup>(1)</sup>	1	38	39
Note receivable <sup>(1)</sup>	—	(122 )	(122 )
Total return swaps	(1,035 )	(1,102 )	(2,137 )



Options sold	2,294	(3	)	2,291
Total	\$(3,050)	\$86,700		\$83,650

41

---

	Year Ended December 31, 2016		
	Gains (Losses) Recognized in		
	Income		
	Sales	Changes in fair value	Total
(Amounts in thousands)			
Net realized investment gains (losses):			
Fixed maturity securities <sup>(1)(2)</sup>	\$(15,806)	\$(56,584)	\$(72,390)
Equity securities <sup>(1)(3)</sup>	(499)	23,722	23,223
Short-term investments <sup>(1)</sup>	(524)	57	(467)
Total return swap	107	11,426	11,533
Options sold	3,846	—	3,846
Total	\$(12,876)	\$(21,379)	\$(34,255)

- (1) The changes in fair value of the investment portfolio resulted from the application of the fair value option. The increases in fair value of fixed maturity securities during 2017 were primarily due to the overall improvement in the market conditions affecting fixed maturity securities, while the fair value in 2016 was adversely affected by the increases in market interest rates.
- (2) in the market conditions affecting fixed maturity securities, while the fair value in 2016 was adversely affected by the increases in market interest rates.
- (3) The increases in fair value of equity securities during 2017 and 2016 were primarily due to the overall improvement in the equity markets.

#### Net Income

	Year Ended	
	December 31, 2017	2016
(Amounts in thousands, except per share data)		
Net income	\$ 144,877	\$ 73,044
Basic average shares outstanding	55,316	55,249
Diluted average shares outstanding	55,327	55,302
Basic Per Share Data:		
Net income	\$ 2.62	\$ 1.32
Net realized investment gains (losses), net of tax	\$ 0.98	\$(0.40)
Diluted Per Share Data:		
Net income	\$ 2.62	\$ 1.32
Net realized investment gains (losses), net of tax	\$ 0.98	\$(0.40)

## LIQUIDITY AND CAPITAL RESOURCES

### A. General

The Company is largely dependent upon dividends received from its insurance subsidiaries to pay debt service costs and to make distributions to its shareholders. Under current insurance law, the Insurance Companies are entitled to pay ordinary dividends of approximately \$145 million in 2019 to Mercury General. The Insurance Companies paid Mercury General ordinary dividends of \$135 million during 2018. As of December 31, 2018, Mercury General had approximately \$146 million in investments and cash that could be utilized to satisfy its direct holding company obligations.

The principal sources of funds for the Insurance Companies are premiums, sales and maturity of invested assets, and dividend and interest income from invested assets. The principal uses of funds for the Insurance Companies are the payment of claims and related expenses, operating expenses, dividends to Mercury General, payment of debt and debt service costs, and the purchase of investments.

## B. Cash Flows

The Company has generated positive cash flow from operations since the public offering of its common stock in November 1985. The Company does not attempt to match the duration and timing of asset maturities with those of liabilities; rather, it manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$567.6 million at December 31, 2018 as well as a \$50 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities for the year ended December 31, 2018 was \$383.4 million, an increase of \$42.0 million compared to the year ended December 31, 2017. The increase was primarily due to an increase in premiums collected and a decrease in income taxes paid, partially offset by higher operating expenses and losses and loss adjustment expenses paid. The Company utilized the cash provided by operating activities during the year ended December 31, 2018 primarily for the payment of dividends to its shareholders and net purchases of investment securities.

The following table presents the estimated fair value of fixed maturity securities at December 31, 2018 by contractual maturity in the next five years.

	Fixed Maturity Securities (Amounts in thousands)
Due in one year or less	\$ 166,423
Due after one year through two years	77,465
Due after two years through three years	133,379
Due after three years through four years	97,402
Due after four years through five years	69,089
	\$ 543,758

See "D. Debt" below for cash flow related to outstanding debt.

## C. Invested Assets

### Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.



The following table presents the composition of the total investment portfolio of the Company at December 31, 2018:

	Cost <sup>(1)</sup>	Fair Value
	(Amounts in thousands)	
Fixed maturity securities:		
U.S. government bonds	\$25,131	\$25,003
Municipal securities	2,599,056	2,620,132
Mortgage-backed securities	30,640	30,952
Corporate securities	107,479	105,524
Collateralized loan obligations	169,626	165,789
Other asset-backed securities	37,609	37,761
	2,969,541	2,985,161
Equity securities:		
Common stock	438,504	430,973
Non-redeemable preferred stock	34,429	31,433
Private equity fund	1,481	1,445
Private equity fund measured at net asset value <sup>(2)</sup>	69,668	65,780
	544,082	529,631
Short-term investments	254,518	253,299
Total investments	\$3,768,141	\$3,768,091

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost and equities and other short-term investments at cost.

<sup>(2)</sup> The fair value is measured using the net asset value practical expedient. See Note 4. Fair Value Measurements of the Notes to Consolidated Financial Statements for additional information.

At December 31, 2018, 68.1% of the Company's total investment portfolio at fair value and 86.0% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 50% corporate dividend received deduction, and private equity funds. At December 31, 2018, 80.9% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis.

#### Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The Company's portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The holdings, that are heavily weighted with high coupon issues, are expected to be called prior to maturity. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rates, modified duration is considered a better indicator of price volatility than simple maturity alone.

The following table presents the maturities and durations of the Company's fixed maturity securities and short-term investments:

	December 31, 2018	December 31, 2017
	(in years)	
Fixed Maturity Securities		
Nominal average maturity:		
excluding short-term investments	14.2	12.9
including short-term investments	13.1	11.6
Call-adjusted average maturities:		
excluding short-term investments	4.9	5.3
including short-term investments	4.5	4.8
Modified duration reflecting anticipated early calls:		
excluding short-term investments	4.3	4.4
including short-term investments	4.0	4.0
Short-Term Investments	—	—

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value at December 31, 2018, consistent with the average rating at December 31, 2017. The Company's municipal bond holdings, of which 97.9% were tax exempt, represented 87.8% of its fixed maturity portfolio at December 31, 2018, at fair value, and are broadly diversified geographically.

To calculate the weighted-average credit quality ratings as disclosed throughout this Annual Report on Form 10-K, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each security's average of ratings assigned by nationally recognized securities rating organizations.

Taxable holdings consist principally of investment grade issues. At December 31, 2018, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$36.0 million and \$76.4 million, respectively, at fair value, and represented 1.2% and 2.6%, respectively, of total fixed maturity securities. The majority of non-rated issues are a result of municipalities pre-funding and collateralizing those issues with U.S. government securities with an implicit AAA equivalent credit risk. At December 31, 2017, fixed maturity holdings rated below investment grade and non-rated bonds totaled \$48.3 million and \$78.6 million, respectively, at fair value, and represented 1.7% and 2.7%, respectively, of total fixed maturity securities.

Credit ratings for the Company's fixed maturity portfolio were stable in 2018, with 77.9% of fixed maturity securities at fair value experiencing no change in their overall rating. 13.2% and 8.9% of fixed maturity securities at fair value experienced upgrades and downgrades, respectively, in 2018. The majority of downgrades were slight and still within the investment grade portfolio in 2018.

Edgar Filing: MERCURY GENERAL CORP - Form 10-K

The following table presents the credit quality ratings of the Company's fixed maturity securities by security type at fair value:

Security Type	December 31, 2018					Total Fair Value <sup>(1)</sup>	
	AAA <sup>(1)</sup>	AA <sup>(1)</sup>	A <sup>(1)</sup>	BBB <sup>(1)</sup>	Non-Rated/Other <sup>(1)</sup>		
	(Dollars in thousands)						
U.S. government bonds:							
Treasuries	\$25,003	\$—	\$—	\$—	\$—	\$25,003	
Total	25,003	—	—	—	—	25,003	
	100.0	% —	—	—	—	100.0	%
Municipal securities:							
Insured	27,913	167,640	123,037	71,056	15,144	404,790	
Uninsured	31,931	708,894	1,192,812	217,305	64,400	2,215,342	
Total	59,844	876,534	1,315,849	288,361	79,544	2,620,132	
	2.3	% 33.5	% 50.2	% 10.9	% 3.1	% 100.0	%
Mortgage-backed securities:							
Commercial	5,832	9,897	5,036	4,005	—	24,770	
Agencies	1,817	—	—	—	—	1,817	
Non-agencies:							
Prime	—	59	157	—	958	1,174	
Alt-A	—	887	—	533	1,771	3,191	
Total	7,649	10,843	5,193	4,538	2,729	30,952	
	24.7	% 35.0	% 16.8	% 14.7	% 8.8	% 100.0	%
Corporate securities:							
Basic materials	—	—	—	3,967	2,550	6,517	
Communications	—	—	328	335	—	663	
Consumer, cyclical	—	—	257	7,463	1,790	9,510	
Consumer, non-cyclical	—	—	432	3,312	123	3,867	
Energy	—	—	2,924	25,296	5,959	34,179	
Financial	—	441	15,451	19,692	4,287	39,871	
Industrial	—	—	—	4,161	—	4,161	
Technology	—	—	—	—	—	—	
Utilities	—	—	6,075	136	545	6,756	
Total	—	441	25,467	64,362	15,254	105,524	
	—	0.4	% 24.1	% 61.0	% 14.5	% 100.0	%
Collateralized loan obligations:							
Corporate	23,019	19,463	115,560	—	7,747	165,789	
Total	23,019	19,463	115,560	—	7,747	165,789	
	13.9	% 11.7	% 69.7	% —	% 4.7	% 100.0	%
Other asset-backed securities							
	9,425	—	10,935	10,339	7,062	37,761	
	25.0	% —	% 29.0	% 27.3	% 18.7	% 100.0	%
Total	\$124,940	\$907,281	\$1,473,004	\$367,600	\$112,336	\$2,985,161	
	4.2	% 30.4	% 49.3	% 12.3	% 3.8	% 100.0	%

<sup>(1)</sup> Intermediate ratings are included at each level (e.g., AA includes AA+, AA and AA-).

U.S. Government Bonds

The Company had \$25.0 million and \$13.2 million, or 0.8% and 0.5% of its fixed maturity portfolio, at fair value, in U.S. government bonds at December 31, 2018 and 2017, respectively. At December 31, 2018, Moody's and Fitch



ratings for U.S. government issued debt were Aaa and AAA, respectively, although a significant increase in government deficits and debt could

lead to a downgrade. The Company understands that market participants continue to use rates of return on U.S. government debt as a risk-free rate and have continued to invest in U.S. Treasury securities. The modified duration of the U.S. government bonds portfolio reflecting anticipated early calls was 1.7 years and 2.1 years at December 31, 2018 and 2017, respectively.

#### Municipal Securities

The Company had \$2.62 billion and \$2.56 billion, or 87.8% and 88.4% of its fixed maturity securities portfolio, at fair value, in municipal securities at December 31, 2018 and 2017, respectively, of which \$404.8 million and \$480.6 million, respectively, were insured by bond insurers. The underlying ratings for insured municipal bonds have been factored into the average rating of the securities by the rating agencies with no significant disparity between the absolute bond ratings and the underlying credit ratings as of December 31, 2018 and 2017.

At December 31, 2018 and 2017, respectively, 62.6% and 62.9% of the insured municipal securities, at fair value, most of which were investment grade, were insured by bond insurers that provide credit enhancement in addition to the ratings reflected by the financial strength of the underlying issuers. At December 31, 2018 and 2017, the average rating of the Company's insured municipal securities was A+, which corresponds to the average rating of the investment grade bond insurers. The remaining 37.4% and 37.1% of insured municipal securities at December 31, 2018 and 2017, respectively, were insured by non-rated or below investment grade bond insurers that the Company believes did not provide credit enhancement. The modified duration of the municipal securities portfolio reflecting anticipated early calls was 4.4 years and 4.5 years at December 31, 2018 and 2017, respectively.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings, which generally allows it to recover the full principal amounts upon maturity and avoid forced sales prior to maturity of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of those municipal bonds.

#### Mortgage-Backed Securities

At December 31, 2018 and 2017, respectively, the mortgage-backed securities portfolio of \$31.0 million and \$27.2 million, or 1.0% and 0.9% of the Company's fixed maturity securities portfolio, at fair value, was categorized as loans to "prime" borrowers except for \$3.2 million and \$3.8 million, at fair value, of Alt-A mortgages. Alt-A mortgage backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with credit profiles stronger than those of sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. The Company had holdings of \$24.8 million and \$19.3 million, at fair value, in commercial mortgage-backed securities at December 31, 2018 and 2017, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities was BB at December 31, 2018 and 2017. The weighted-average rating of the entire mortgage backed securities portfolio was A+ at December 31, 2018, compared to A- at December 31, 2017. The modified duration of the mortgage-backed securities portfolio reflecting anticipated early calls was 4.0 years and 4.9 years at December 31, 2018 and 2017, respectively.

#### Corporate Securities

At December 31, 2018 and 2017, respectively, the company had corporate securities of \$105.5 million and \$137.5 million, or 3.5% and 4.8% of its fixed maturity securities portfolio, at fair value. The weighted-average rating was BBB at December 31, 2018 and 2017. The modified duration reflecting anticipated early calls was 2.4 years and 2.6 years at December 31, 2018 and 2017, respectively.

#### Collateralized Loan Obligations

The Company had collateralized loan obligations of \$165.8 million and \$105.2 million, which represented 5.6% and 3.6% of its fixed maturity securities portfolio, at fair value, at December 31, 2018 and 2017, respectively. The

weighted-average rating was A+ at December 31, 2018 and 2017. The modified duration reflecting anticipated early calls was 5.5 years and 6.2 years at December 31, 2018 and 2017, respectively.

## Other Asset-Backed Securities

The Company had other asset-backed securities of \$37.8 million and \$53.1 million, which represented 1.3% and 1.8% of its fixed maturity securities portfolio, at fair value, at December 31, 2018 and 2017, respectively. The weighted-average rating was A+ at December 31, 2018 and 2017. The modified duration reflecting anticipated early calls was 2.1 years and 1.1 years at December 31, 2018 and 2017, respectively.

## Equity Securities

Equity holdings of \$529.6 million and \$537.2 million, at fair value, as of December 31, 2018 and 2017, respectively, consisted of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 50% corporate dividend received deduction, and private equity funds. The net (losses) gains due to changes in fair value of the Company's equity portfolio were \$(77.5) million and \$37.5 million in 2018 and 2017, respectively. The primary cause of the decrease in the value of the Company's equity securities was the overall decline in the equity markets in 2018.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At December 31, 2018, 14.1% of the total investment portfolio, at fair value, was held in equity securities, compared to 14.4% at December 31, 2017.

The following table presents the equity security portfolio by industry sector at December 31, 2018 and 2017:

	December 31, 2018		2017	
	Cost	Fair Value	Cost	Fair Value
	(Amounts in thousands)			
Equity securities:				
Basic materials	\$15,321	\$14,657	\$16,265	\$20,728
Communications	29,268	29,646	17,233	21,289
Consumer, cyclical	35,028	32,722	23,508	29,720
Consumer, non-cyclical	30,189	31,672	23,773	27,246
Energy	56,397	44,444	47,145	53,905
Financial	85,405	86,362	76,335	86,778
Funds	110,177	106,463	102,796	109,115
Industrial	40,730	42,649	29,262	37,540
Technology	47,873	45,677	29,787	39,371
Utilities	93,694	95,339	108,093	111,548
	\$544,082	\$529,631	\$474,197	\$537,240

## D. Debt

Notes payable consist of the following:

	Lender	Interest Rate	Expiration	December 31,	
				2018	2017
				(Amounts in thousands)	
Senior unsecured notes <sup>(1)</sup>	Publicly traded	4.40%	March 15, 2027	\$375,000	\$375,000
Unsecured credit facility <sup>(2)</sup>	Bank of America and Wells Fargo Bank	LIBOR plus 112.5-162.5 basis points	March 29, 2022	—	—
Total principal amount				375,000	375,000
				3,266	3,665

Less unamortized discount and  
debt issuance costs<sup>(3)</sup>

Total

\$371,734 \$371,335

---

(1) On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured senior obligations of the Company, with a 4.4% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The Company used the proceeds from the

48

---

notes to pay off the total outstanding balance of \$320 million under the existing loan and credit facility agreements and terminated the agreements on March 8, 2017. The remainder of the proceeds from the notes was used for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate, including debt issuance costs, of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for (2) the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 18.8% at December 31, 2018, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of February 7, 2019, there have been no borrowings under this facility. The unamortized discount and debt issuance costs of approximately \$3.3 million are associated with the publicly traded \$375 million senior unsecured notes. These are amortized to interest expense over the life of the notes, and (3) the unamortized balance is presented in the Company's consolidated balance sheets as a direct deduction from the carrying amount of the debt. The unamortized debt issuance cost of approximately \$0.2 million associated with the \$50 million five-year unsecured revolving credit facility maturing on March 29, 2022 is included in other assets in the Company's consolidated balance sheets and amortized to interest expense over the term of the credit facility.

The Company was in compliance with all of its financial covenants pertaining to minimum statutory surplus, debt to total capital ratio, and RBC ratio under the unsecured credit facility at December 31, 2018, except that CAIC's RBC ratio as of December 31, 2018 was below the required level. The Company received a waiver of the non-compliance. Notwithstanding the covenant under the unsecured credit facility, CAIC's RBC ratio was well in excess of the regulatory minimum capital requirement at December 31, 2018.

For a further discussion, see Note 7. Notes Payable, of the Notes to Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data."

#### E. Capital Expenditures

In 2018, the Company made capital expenditures, including capitalized software, of approximately \$28.0 million primarily related to information technology.

#### F. Regulatory Capital Requirements

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2018, 2017 and 2016, each of the Insurance Companies exceeded the minimum required RBC level, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratios were less than 300% of the authorized control level RBC as of December 31, 2018, 2017 and 2016. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

Among other considerations, industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.47 billion at December 31, 2018 and net premiums written in 2018 of \$3.5 billion, the ratio of premiums written to surplus was 2.38 to 1.

Insurance companies are required to file an Own Risk and Solvency Assessment ("ORSA") with the insurance regulators in their domiciliary states. The ORSA is required to cover, among many items, a company's risk management policies, the material risks to which the company is exposed, how the company measures, monitors, manages and mitigates material risks, and how much economic and regulatory capital is needed to continue to operate in a strong and healthy manner. The ORSA is intended to be used by state insurance regulators to evaluate the risk exposure and quality of the risk management processes within insurance companies to assist in conducting risk-focused financial examinations and for determining the overall financial condition of insurance companies. The Company filed its most recent ORSA Summary Report with the California DOI in November 2018.

Compliance with the ORSA requirements did not have a material impact on the Company's consolidated financial statements.

The DOI in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices.

The following table presents a summary of recent examinations:

State	Exam Type	Period Under Review	Status
CA,FL,GA,IL,OK,TX	Coordinated Multi-state Financial	2014 to 2017	Fieldwork began in the second quarter of 2018.
CA	Market Conduct Claims	2015	Received final report.
CA	Rating and Underwriting	2014	Fieldwork is completed. Awaiting draft report.
VA	Market Conduct	2014 to 2015	Received final report.
TX	Market Conduct	2016	Received final report.

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company, and none of the findings reported to date are expected to be material to the Company's financial position.

#### OFF-BALANCE SHEET ARRANGEMENTS

As of December 31, 2018, the Company had no off-balance sheet arrangements as defined under Regulation S-K 303(a)(4) and the instructions thereto.

#### CONTRACTUAL OBLIGATIONS

The Company's significant contractual obligations at December 31, 2018 are summarized as follows:

Contractual Obligations <sup>(4)</sup>	Total	Payments Due By Period					
		2019	2020	2021	2022	2023	Thereafter
		(Amounts in thousands)					
Debt (including interest) <sup>(1)</sup>	\$515,250	\$16,500	\$16,500	\$16,500	\$16,500	\$16,500	\$432,750
Lease obligations <sup>(2)</sup>	45,688	12,812	11,547	8,732	6,972	3,659	1,966
Loss and loss adjustment expense reserves <sup>(3)</sup>	1,829,412	1,183,818	316,057	158,592	93,488	45,416	32,041
Total contractual obligations	\$2,390,350	\$1,213,130	\$344,104	\$183,824	\$116,960	\$65,575	\$466,757

- The Company's debt contains various terms, conditions and covenants which, if violated by the Company, would result in a default and could result in the acceleration of the Company's payment obligations. Amounts differ from
- (1) the balances presented on the consolidated balance sheets as of December 31, 2018 because the debt amounts above include interest, calculated at the stated 4.4% coupon rate, and exclude the discount and issuance costs of the debt.
- (2) The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2026.
- (3) Loss and loss adjustment expense reserves represents an estimate of amounts necessary to settle all outstanding claims, including IBNR as of December 31, 2018. The Company has estimated the timing of these payments based



on its historical experience and expectation of future payment patterns. However, the timing of these payments may vary significantly from the amounts shown above. The ultimate cost of losses may vary materially from recorded amounts which are the Company's best estimates. The Company believes that cash flows from operations and existing cash and investments are sufficient to meet these obligations despite the uncertainty in payment patterns. For more detailed information on the Company's liquidity and cash flows, see "Liquidity and Capital Resources—B. Cash Flows" in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

- (4) The table excludes liabilities of \$11.5 million related to uncertainty in tax settlements as the Company is unable to reasonably estimate the timing and amount of related future payments.

#### Item 7A. Quantitative and Qualitative Disclosures about Market Risks

The Company is subject to various market risk exposures primarily due to its investing and borrowing activities. Primary market risk exposures are changes in interest rates, equity prices, and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of creditworthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

##### Overview

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile, and regulatory requirements of the Company's subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The Company's investment committee focuses on strategies to enhance after-tax yields, mitigate market risks, and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration, and credit ratings. Asset allocation limits place restrictions on the total amount of funds that may be invested within an asset class. Duration limits on the fixed maturity securities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

##### Credit Risk

Credit risk results from uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a high credit quality fixed maturity securities portfolio. As of December 31, 2018, the estimated weighted-average credit quality rating of the fixed maturity securities portfolio was A+, at fair value, consistent with the average rating at December 31, 2017.

The following table presents municipal securities by state in descending order of holdings at fair value at December 31, 2018:

States	Fair Value (Amounts in thousands)	Average Rating
Texas	\$396,137	AA-
Florida	229,571	A+
Illinois	214,100	A-
Pennsylvania	154,217	A+
New York	138,268	A+
Other states	1,487,839	A+
Total	\$2,620,132	

At December 31, 2018, the municipal securities portfolio was broadly diversified among the states and the largest holdings were in populous states such as Texas and Florida. These holdings were further diversified primarily among cities, counties, schools, public works, hospitals, and state general obligations. The Company seeks to minimize overall credit risk and ensure diversification by limiting exposure to any particular issuer.

Taxable fixed maturity securities represented 14.0% of the Company's fixed maturity portfolio at December 31, 2018. 6.0% of the Company's taxable fixed maturity securities were comprised of U.S. government bonds, which were rated AAA at December 31, 2018. 3.3% of the Company's taxable fixed maturity securities, representing 0.5% of its total fixed maturity portfolio, were rated below investment grade at December 31, 2018. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

Equity Price Risk

Equity price risk is the risk that the Company will incur losses due to adverse changes in the equity markets.

At December 31, 2018, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$431.0 million in common stocks, \$31.4 million in non-redeemable preferred stocks, and \$67.2 million in private equity funds. Common stocks are typically valued for future economic prospects as perceived by the market.

Common stocks represented 11.4% of total investments at fair value. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured as the percentage change in an individual security's return for a 1% change in the return of the market.

Based on hypothetical reductions in the overall value of the stock market, the following table illustrates estimated reductions in the overall value of the Company's common stock portfolio at December 31, 2018 and 2017:

	December 31,	
	2018	2017
	(Amounts in thousands, except Average Beta)	
Average Beta	0.78	0.88
Hypothetical reduction of 25% in the overall value of the stock market	\$84,040	\$99,828
Hypothetical reduction of 50% in the overall value of the stock market	\$168,080	\$199,656

#### Interest Rate Risk

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. The Company faces interest rate risk, as it invests a substantial amount of funds in interest sensitive assets and issues interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from widening credit spreads and credit exposure to collateralized securities.

The fixed maturity portfolio at December 31, 2018, which represented 79.2% of total investments at December 31, 2018, at fair value, is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age to receive the present value of all the cash flows produced by such assets, including reinvestment of interest. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity securities with a goal of maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturities tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified duration of the overall fixed maturity securities portfolio reflecting anticipated early calls was 4.0 years at December 31, 2018 and 2017, and 3.7 years at December 31, 2016.

If interest rates were to rise by 100 and 200 basis points, the Company estimates that the fair value of its fixed maturity securities portfolio at December 31, 2018 would decrease by \$128.6 million and \$257.3 million, respectively. Conversely, if interest rates were to decrease, the fair value of the Company's fixed maturity securities portfolio would rise, and it may cause a higher number of the Company's fixed maturity securities to be called away. The proceeds from the called fixed maturity securities would likely be reinvested at lower yields, which would result in lower overall investment income for the Company.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
<u>Reports of Independent Registered Public Accounting Firm</u>	<u>54</u>
Consolidated Financial Statements:	
<u>Consolidated Balance Sheets as of December 31, 2018 and 2017</u>	<u>56</u>
<u>Consolidated Statements of Operations for the Years Ended December 31, 2018, 2017, and 2016</u>	<u>57</u>
<u>Consolidated Statements of Shareholders' Equity for the Years Ended December 31, 2018, 2017, and 2016</u>	<u>58</u>
<u>Consolidated Statements of Cash Flows for the Years Ended December 31, 2018, 2017, and 2016</u>	<u>59</u>
<u>Notes to Consolidated Financial Statements</u>	<u>60</u>

53

---

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors

Mercury General Corporation:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Mercury General Corporation and subsidiaries (the Company) as of December 31, 2018 and 2017, the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three year period ended December 31, 2018, and the related notes and financial statement schedules I, II, and IV (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 13, 2019 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company's auditor since 1963.

Los Angeles, California

February 13, 2019

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors

Mercury General Corporation:

Opinion on Internal Control Over Financial Reporting

We have audited Mercury General Corporation and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2018 and 2017, the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2018, and the related notes and financial schedules I, II, and IV (collectively, the consolidated financial statements), and our report dated February 13, 2019 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Los Angeles, California

February 13, 2019





MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands)

	December 31,	
	2018	2017
<b>ASSETS</b>		
Investments, at fair value:		
Fixed maturity securities (amortized cost \$2,969,541; \$2,823,230)	\$2,985,161	\$2,892,777
Equity securities (cost \$544,082; \$474,197)	529,631	537,240
Short-term investments (cost \$254,518; \$302,693)	253,299	302,711
Total investments	3,768,091	3,732,728
Cash	314,291	291,413
Receivables:		
Premiums	555,038	474,060
Accrued investment income	45,373	39,368
Other	6,132	6,658
Total receivables	606,543	520,086
Reinsurance recoverables	221,088	56,349
Deferred policy acquisition costs	215,131	198,151
Fixed assets, net	153,023	145,223
Current income taxes	38,885	61,257
Deferred income taxes	13,339	—
Goodwill	42,796	42,796
Other intangible assets, net	15,534	20,728
Other assets	45,008	32,592
Total assets	\$5,433,729	\$5,101,323
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Loss and loss adjustment expense reserves	\$1,829,412	\$1,510,613
Unearned premiums	1,236,181	1,101,927
Notes payable	371,734	371,335
Accounts payable and accrued expenses	115,071	108,252
Deferred income taxes	—	22,932
Other liabilities	263,647	224,877
Total liabilities	3,816,045	3,339,936
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value:		
Authorized 70,000 shares; issued and outstanding 55,340; 55,332	98,026	97,523
Retained earnings	1,519,658	1,663,864
Total shareholders' equity	1,617,684	1,761,387
Total liabilities and shareholders' equity	\$5,433,729	\$5,101,323

See accompanying Notes to Consolidated Financial Statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year Ended December 31,		
	2018	2017	2016
Revenues:			
Net premiums earned	\$3,368,411	\$3,195,437	\$3,131,773
Net investment income	135,838	124,930	121,871
Net realized investment (losses) gains	(133,520 )	83,650	(34,255 )
Other	9,275	11,945	8,294
Total revenues	3,380,004	3,415,962	3,227,683
Expenses:			
Losses and loss adjustment expenses	2,576,789	2,444,884	2,355,138
Policy acquisition costs	572,164	555,350	562,545
Other operating expenses	244,630	233,475	235,314
Interest	17,036	15,168	3,962
Total expenses	3,410,619	3,248,877	3,156,959
(Loss) income before income taxes	(30,615 )	167,085	70,724
Income tax (benefit) expense	(24,887 )	22,208	(2,320 )
Net (loss) income	\$(5,728 )	\$144,877	\$73,044
Net (loss) income per share:			
Basic	\$(0.10 )	\$2.62	\$1.32
Diluted	\$(0.10 )	\$2.62	\$1.32

See accompanying Notes to Consolidated Financial Statements.

57

---

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

	Year Ended December 31,		
	2018	2017	2016
Common stock, beginning of year	\$97,523	\$95,529	\$90,985
Proceeds of stock options exercised	358	2,102	1,818
Payment for vested restricted stock units and related taxes	—	—	1,671
Reclassification of restricted stock units from equity to liability award	—	(168 )	—
Share-based compensation expense	145	60	142
Excess tax benefits related to share-based compensation	—	—	913
Common stock, end of year	98,026	97,523	95,529
Additional paid in capital, beginning of year	—	—	8,870
Payment for vested restricted stock units and related taxes	—	—	(5,122 )
Reclassification of restricted stock units from equity to liability award	—	—	(3,435 )
Exercise of stock options	—	—	(313 )
Additional paid in capital, end of year	—	—	—
Retained earnings, beginning of year	1,663,864	1,656,873	1,721,030
Net (loss) income	(5,728 )	144,877	73,044
Dividends paid to shareholders	(138,478 )	(137,886 )	(137,201 )
Retained earnings, end of year	1,519,658	1,663,864	1,656,873
Total shareholders' equity	\$1,617,684	\$1,761,387	\$1,752,402

See accompanying Notes to Consolidated Financial Statements.

58

---

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)

	Year Ended December 31,		
	2018	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net (loss) income	\$(5,728 )	\$144,877	\$73,044
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	58,791	55,343	53,258
Net realized investment losses (gains)	133,520	(83,650 )	34,255
Increase in premiums receivable	(80,979 )	(14,908 )	(22,531 )
(Increase) decrease in reinsurance recoverables	(164,739 )	(43,043 )	998
Gain on sale of fixed assets	—	(3,078 )	—
Changes in current and deferred income taxes	(13,898 )	(3,010 )	(2,130 )
(Increase) decrease in deferred policy acquisition costs	(16,980 )	2,675	936
Increase in loss and loss adjustment expense reserves	318,799	220,365	143,560
Increase in unearned premiums	134,254	27,490	25,124
Increase (decrease) in accounts payable and accrued expenses	6,586	(4,178 )	(10,586 )
Share-based compensation	145	60	142
Other, net	13,663	42,462	(4,392 )
Net cash provided by operating activities	383,434	341,405	291,678
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Fixed maturity securities available for sale in nature:			
Purchases	(706,224 )	(734,397 )	(1,077,638 )
Sales	189,306	100,709	396,766
Calls or maturities	334,626	575,735	647,059
Equity securities available for sale in nature:			
Purchases	(1,026,827 )	(831,310 )	(714,113 )
Sales	954,755	679,571	696,138
Calls	—	7,100	—
Changes in securities payable and receivable	4,035	(44,740 )	29,958
Decrease (increase) in short-term investments	45,747	73,005	(191,530 )
Purchase of fixed assets	(27,959 )	(19,443 )	(16,979 )
Sale of fixed assets	—	6,239	14
Other, net	10,105	1,934	3,605
Net cash used in investing activities	(222,436 )	(185,597 )	(226,720 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Dividends paid to shareholders	(138,478 )	(137,886 )	(137,201 )
Employee taxes paid with shares related to share-based compensation	—	—	(3,292 )
Proceeds from stock options exercised	358	2,162	1,632
Net proceeds from issuance of senior notes	—	371,011	—
Payoff of principal on loan and credit facilities	—	(320,000 )	—
Proceeds from bank loan	—	—	30,000
Net cash used in financing activities	(138,120 )	(84,713 )	(108,861 )
Net increase (decrease) in cash	22,878	71,095	(43,903 )
Cash:			
Beginning of year	291,413	220,318	264,221
End of year	\$314,291	\$291,413	\$220,318
<b>SUPPLEMENTAL CASH FLOW DISCLOSURE</b>			
Interest paid	\$16,586	\$9,863	\$3,531



MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

General

Mercury General Corporation ("Mercury General") and its subsidiaries (referred to herein collectively as the "Company") are primarily engaged in writing personal automobile insurance through 14 Insurance Companies in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical protection, fire, and umbrella insurance. The private passenger automobile line of insurance business was more than 76% of the Company's direct premiums written in 2018, 2017, and 2016, of which approximately 87%, 85%, and 84% of the private passenger automobile premiums were written in California during 2018, 2017, and 2016, respectively. Premiums written represents the premiums charged on policies issued during a fiscal period, which is a statutory measure designed to determine production levels.

Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries:  
 Insurance Companies

Mercury Casualty Company ("MCC")	Mercury National Insurance Company
Mercury Insurance Company ("MIC")	American Mercury Insurance Company
California Automobile Insurance Company ("CAIC")	American Mercury Lloyds Insurance Company <sup>(1)</sup>
California General Underwriters Insurance Company, Inc.	Mercury County Mutual Insurance Company <sup>(2)</sup>
Mercury Insurance Company of Illinois	Mercury Insurance Company of Florida
Mercury Insurance Company of Georgia	Mercury Indemnity Company of America
Mercury Indemnity Company of Georgia	Workmen's Auto Insurance Company ("WAIC")

Non-Insurance Companies

Mercury Select Management Company, Inc.	AIS Management LLC
Mercury Insurance Services LLC	Auto Insurance Specialists LLC
Animas Funding LLC ("AFL") <sup>(3)</sup>	PoliSeek AIS Insurance Solutions, Inc.
Fannette Funding LLC ("FFL") <sup>(3)</sup>	

<sup>(1)</sup> American Mercury Lloyds Insurance Company is not owned but is controlled by the Company through its attorney-in-fact, Mercury Select Management Company, Inc.

<sup>(2)</sup> Mercury County Mutual Insurance Company is not owned but is controlled by the Company through a management contract.

<sup>(3)</sup> Special purpose investment vehicle.

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP"), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions and balances have been eliminated.

Certain prior period amounts have been reclassified to conform with the current period presentation.

The Company did not have other comprehensive income (loss) in 2018, 2017 and 2016.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to

reserves for losses and loss adjustment expenses. Actual results could differ from those estimates.

60

---

## Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The primary reasons for electing the fair value option were simplification and cost benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the Financial Accounting Standards Board (the "FASB") for accounting for financial instruments. See Note 2. Financial Instruments for additional information on the fair value option.

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment gains (losses) in the Company's consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company's consolidated statements of operations.

Fixed maturity securities include debt securities, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Premiums and discounts on fixed maturities are amortized using first call date and are adjusted for anticipated prepayments. Premiums and discounts on mortgage-backed securities are adjusted for anticipated prepayment using the retrospective method, with the exception of some beneficial interests in securitized financial assets, which are accounted for using the prospective method.

Equity securities consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 50% corporate dividend received deduction, and private equity funds.

Short-term investments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

In the normal course of investing activities, the Company either forms or enters into relationships with variable interest entities ("VIEs"). A VIE is an entity that either has investors that lack certain essential characteristics of a controlling financial interest, such as simple majority kick-out rights, or lacks sufficient funds to finance its own activities without financial support provided by other entities. The Company performs ongoing qualitative assessments of the VIEs to determine whether the Company has a controlling financial interest in the VIE and therefore is the primary beneficiary. The Company is deemed to have a controlling financial interest when it has both the ability to direct the activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant to the VIE. Based on the Company's assessment, if it determines it is the primary beneficiary, the Company consolidates the VIE in its consolidated financial statements.

The Company forms special purpose investment vehicles to facilitate its investment activities involving derivative instruments such as total return swaps, or limited partnerships such as private equity funds. These special purpose investment vehicles are consolidated VIEs as the Company has determined it is the primary beneficiary of such VIEs. Creditors have no recourse against the Company in the event of default by these VIEs. The Company had no implied or unfunded commitments to these VIEs at December 31, 2018 and 2017. The Company's financial or other support provided to these VIEs and its loss exposure are limited to its collateral and original investment.

The Company also invests directly in limited partnerships such as private equity funds. These investments are non-consolidated VIEs as the Company has determined it is not the primary beneficiary. The Company's maximum exposure to loss is limited to the total carrying value that is included in equity securities in the Company's consolidated balance sheets. At December 31, 2018 and 2017, the Company had no outstanding unfunded commitments to these VIEs whereby the Company may be called by the partnerships during the commitment period to



fund the purchase of new investments and the expenses of the partnerships.

**Securities on Deposit**

As required by statute, the Company's insurance subsidiaries have securities deposited with the departments of insurance or similar governmental agencies in the states in which they are licensed to operate with fair values totaling \$15 million and \$17 million at December 31, 2018 and 2017, respectively.

## Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. The Company does not defer advertising expenditures but expenses them as incurred.

The table below presents a summary of deferred policy acquisition cost amortization and net advertising expense:

	Year Ended December		
	31,		
	2018	2017	2016
	(Amounts in millions)		
Deferred policy acquisition cost amortization	\$572.2	\$555.4	\$562.5
Net advertising expense	40.9	37.4	39.6

## Fixed Assets

Fixed assets are stated at historical cost less accumulated depreciation and amortization. The useful life for buildings is 30 to 40 years. Furniture, equipment, and purchased software are depreciated on a combination of straight-line and accelerated methods over 3 to 7 years. The Company has capitalized certain consulting costs, payroll, and payroll-related costs for employees related to computer software developed for internal use, which are amortized on a straight-line method over the estimated useful life of the software, generally not exceeding 7 years. In accordance with applicable accounting standards, capitalization ceases no later than the point at which a computer software project is substantially complete and ready for its intended use. Leasehold improvements are amortized over the shorter of the useful life of the assets or the life of the associated lease.

The Company periodically assesses long-lived assets or asset groups including building and equipment, for recoverability when events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the Company identifies an indicator of impairment, the Company assesses recoverability by comparing the carrying amount of the asset to the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. An impairment loss is recognized when the carrying amount is not recoverable and is measured as the excess of carrying value over fair value. There were no impairment charges during 2018, 2017, and 2016.

## Goodwill and Other Intangible Assets

Goodwill and other intangible assets arise as a result of business acquisitions and consist of the excess of the cost of the acquisitions over the tangible and intangible assets acquired and liabilities assumed and identifiable intangible assets acquired. Identifiable intangible assets consist of the value of customer relationships, trade names, software and technology, and favorable leases, which are all subject to amortization, and an insurance license which is not subject to amortization.

The Company evaluates goodwill and other intangible assets for impairment annually or whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount of goodwill and other intangible assets may exceed their implied fair values. The Company qualitatively determines whether, more likely than not, the fair value exceeds the carrying amount of a reporting unit. There are numerous assumptions and estimates underlying the qualitative assessments including future earnings, long-term strategies, and the Company's annual planning and forecasting process. If these planned initiatives do not accomplish the targeted objectives, the assumptions and estimates underlying the qualitative assessments could be adversely affected and have a material effect upon the Company's financial condition and results of operations. In addition, the Company evaluates other intangible assets using methods similar to those used for goodwill described above. As of December 31, 2018 and 2017, goodwill and

other intangible impairment assessments indicated that there was no impairment.

**Premium Revenue Recognition**

Premium revenue is recognized on a pro-rata basis over the terms of the policies in proportion to the amount of insurance protection provided. Premium revenue includes installment and other fees for services which are recognized in the periods in which the services are rendered. Unearned premiums represent the portion of the written premium related to the unexpired policy term. Unearned premiums are predominantly computed monthly on a pro-rata basis and are stated gross of reinsurance deductions,

with the reinsurance deduction recorded in other receivables. Net premiums written, a statutory measure designed to determine production levels, were \$3.50 billion, \$3.22 billion, and \$3.16 billion in 2018, 2017, and 2016, respectively.

#### Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses are determined in amounts estimated to cover incurred losses and loss adjustment expenses and established based upon the Company's assessment of claims pending and the development of prior years' loss liabilities. These amounts include liabilities based upon individual case estimates for reported losses and loss adjustment expenses and estimates of such amounts that are incurred but not reported. Changes in the estimated liability are charged or credited to operations as the losses and loss adjustment expenses are re-estimated. The liability is stated net of anticipated salvage and subrogation recoveries, and gross of reinsurance recoverables on unpaid losses.

Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims, such as those involving the Company's bodily injury ("BI") coverages. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date. However, since the provisions for loss reserves are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal ruling that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar

period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes. For catastrophe losses on individual properties that are expected to be total losses, the Company typically establishes reserves at the policy limits.

#### Derivative Financial Instruments

The Company accounts for all derivative instruments, other than those that meet the normal purchases and sales exception, as either an asset or liability, measured at fair value, which is based on information obtained from independent parties. In addition, changes in fair value are recognized in earnings unless specific hedge accounting criteria are met. The Company's derivative instruments include total return swaps and options sold. See Note 8. Derivative Financial Instruments.

#### Earnings Per Share

Basic earnings per share excludes dilution and reflects net income divided by the weighted average shares of common stock outstanding during the periods presented. Diluted earnings per share is based on the weighted average shares of common stock and potential dilutive securities outstanding during the periods presented. At December 31, 2018 and 2017, potential dilutive securities consisted of outstanding stock options. See Note 16. Earnings Per Share, for the required disclosures relating to the calculation of basic and diluted earnings per share.

#### Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized in earnings in the period that includes the enactment date.

At December 31, 2018, the Company's deferred income taxes were in a net asset position, which included a combination of ordinary and capital deferred tax benefits and expenses. In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

#### Reinsurance

Liabilities for unearned premiums and unpaid losses are stated in the accompanying consolidated financial statements before deductions for ceded reinsurance. Unpaid losses and unearned premiums that are ceded to reinsurers are carried in reinsurance recoverables and other assets, respectively, in the Company's consolidated balance sheets. Earned premiums are stated net of deductions for ceded reinsurance.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2019. The Treaty provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake.

The Company recognized ceded premiums earned of approximately \$49 million, \$27 million, and \$16 million in 2018, 2017, and 2016, respectively, which are included in net premiums earned in its consolidated statements of operations, and ceded losses and loss adjustment expenses of approximately \$257 million, \$90 million, and \$2 million

in 2018, 2017, and 2016, respectively, which are included in losses and loss adjustment expenses in its consolidated statements of operations.

The Insurance Companies, as primary insurers, are required to pay losses to the extent reinsurers are unable to discharge their obligations under the reinsurance agreements.

#### Share-Based Compensation

Share-based compensation expenses for all stock options granted or modified are based on their estimated grant-date fair values. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award,

which is the option vesting term of four years. The Company estimates forfeitures expected to occur in determining the amount of compensation cost to be recognized in each period. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

The fair value of each restricted stock unit ("RSU") grant is determined based on the market price on the grant date for awards classified as equity and on each reporting date for awards classified as liability. Compensation cost is recognized based on management's best estimate of the performance goals that will be achieved at the end of the performance period, taking into account expected forfeitures. If the minimum performance goals are not expected to be met, no compensation cost is recognized and any recognized compensation cost would be reversed. See Note 15. Share-Based Compensation for additional disclosures.

#### Revenue from Contracts with Customers

On January 1, 2018, the Company adopted Topic 606, Revenue from Contracts with Customers, using the modified retrospective transition method. The Company had no cumulative-effect adjustment and its consolidated financial statement line items were not impacted as a result of the adoption, mostly because the accounting for insurance contracts was outside of the scope of Topic 606 and the application of the key aspects of revenue recognition of Topic 606 to the Company's in-scope transactions, such as the timing of recognition of revenue (at a point in time vs. over time) and the estimation of refund liability, resulted in recognition of revenues and related expenses consistent with that under the legacy accounting guide, Topic 605.

The Company's revenue from contracts with customers that are in scope of Topic 606 represents the commission income that the Company's 100% owned insurance agencies, Auto Insurance Specialists LLC ("AIS") and PoliSeek AIS Insurance Solutions, Inc. ("Poliseek"), earned from third-party insurers. The Company's commission income from third-party insurers was approximately \$16.0 million and \$15.2 million representing approximately 0.5% and 0.4% of the consolidated total revenue, with related expenses of approximately \$10.5 million and \$10.2 million, for the year ended December 31, 2018 and 2017, respectively. Due to the immateriality of the Company's commission income and its related expenses to the overall consolidated financial statements, the commission income, net of related expenses, is included in other revenues in the Company's consolidated statements of operations, and in other income of the Property and Casualty business segment in the Company's segment reporting in accordance with Topic 280, Segment Reporting (see Note 19. Segment Information).

AIS and PoliSeek are primarily engaged in the marketing and sales of insurance policies in private passenger automobile, commercial automobile and homeowners lines of business. Their revenues primarily consist of commission income received from property and casualty insurers. Approximately 80% of their total revenue is generated from sales of policies issued by the Company's insurance subsidiaries, which are eliminated as intercompany transactions in consolidation, with the remaining from sales of policies issued by third-party property and casualty insurers. The primary performance obligation of AIS and Poliseek in return for the commission income from the insurers is to complete the sale of the policy and deliver the control of the policy to the insurer prior to the policy effective date. In addition, AIS and PoliSeek provide administrative services to the insurer or the policyholder subsequent to the sale of the policy as needed, including processing of endorsements, collection of premiums, and answering general questions concerning the policyholder's account. The administrative services and the costs to perform such services are deemed immaterial in the context of the contract and to the Company's consolidated financial statements, and hence, such services are not identified as a separate performance obligation and the costs to perform such services are not accrued at the time of the sale of the policy but are expensed as incurred as part of the overall operating expenses.

The total revenue from the sale of a policy is recognized when the sale is complete and the policy is effective as all the material aspects of the performance obligation are satisfied and the insurer is deemed to obtain control of the insurance policy at that time. The commission income is constrained such that the revenue is recognized only to the



extent that the commission income received is not likely to be returned to the insurers due to policy cancellations. Any commission income not received when the sale is complete is recognized as commission income receivable, which is included in other receivables in the Company's consolidated balance sheets. The commission income receivable at December 31, 2018 and 2017 was approximately \$1.2 million .

A refund liability is recorded for the expected amount of the commission income that has to be returned to the insurers based on estimated policy cancellations. The refund liability is computed for the entire portfolio of contracts as a practical expedient, rather than for each contract or performance obligation. The estimated policy cancellations and the resulting refund liability are computed using the expected value method based on all relevant information, including historical data. The refund liability at December 31, 2018 and 2017 was approximately \$0.7 million, which was included in other liabilities in the Company's consolidated balance sheets.

As of December 31, 2018 and 2017, the Company had no contract assets, contract liabilities, or capitalized costs to obtain or fulfill a contract, associated with revenues from contracts with customers.

## Recently Issued Accounting Standards

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-15, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software under Subtopic 350-40. This ASU also requires an entity to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement and present such expense in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement and classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element. The entity is also required to present the capitalized implementation costs in the statement of financial position in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented. ASU 2018-15 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-15 on its consolidated financial statements and related disclosures.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820), Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." The amendments in this ASU require certain existing disclosure requirements in Topic 820 to be modified or removed, and certain new disclosure requirements to be added to the Topic. In addition, this ASU allows entities to exercise more discretion when considering fair value measurement disclosures. ASU 2018-13 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-13 on its consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment." ASU 2017-04 removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of Step 2 of the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company does not anticipate that ASU 2017-04 will have a material impact on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of occurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. Subsequently, the FASB has issued an additional ASU on Topic 326 that does not change the core principle of the guidance in ASU 2016-13 but merely clarifies certain aspects of it. ASU 2016-13 and the additional ASU on Topic 326 will be effective for the Company beginning January 1, 2020. While the Company is in the process of evaluating the impact of ASU 2016-13, it does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures as most of its financial instruments with potential exposure to material credit losses are accounted for at fair value through net income.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases." Subsequently, the FASB has issued additional ASUs on Topic 842 that do not change the core principle of the guidance in ASU 2016-02 but merely clarify or expand certain aspects of it. ASU 2016-02 requires a lessee to recognize lease assets and lease liabilities resulting from all leases. ASU 2016-02 retains the distinction between a finance lease and an operating lease. Lessor accounting is largely unchanged from ASC 840. ASU 2016-02 and the additional ASUs on Topic 842 are effective for the Company beginning January 1, 2019. The Company adopted ASU 2016-02 along with the related additional ASUs on Topic 842 on January 1, 2019, using a transition method of applying the new standard at the beginning of the period of adoption and recognizing a cumulative-effect adjustment, if any, to the beginning balance of retained earnings in the period of adoption. In addition, the Company elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed the Company to carry forward its historical lease classification of operating lease for all of its existing leases at the adoption date. Adoption of the new standard resulted in the recognition of operating lease right-of-use ("ROU") assets and operating lease liabilities of approximately \$41 million and \$43 million, respectively, at the adoption date for the Company's operating leases. The difference of approximately \$2 million between the operating lease ROU assets and operating lease liabilities represents reclassification of deferred rent liability (the difference

between the straight-line rent expenses and paid rent amounts under the leases) to operating lease ROU assets from other liabilities at the adoption date. The Company did not have any cumulative-effect adjustment as a result of the adoption. The standard is not expected to materially impact the Company's future consolidated net income or cash flows. The standard will have no impact on its financial covenant compliance under its current unsecured credit facility agreement.

## 2. Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, options sold, total return swaps, accounts payable, and notes payable. Due to their short-term maturity, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried at fair value in the consolidated balance sheets.

The following table presents the fair values of financial instruments:

	December 31,	
	2018	2017
	(Amounts in thousands)	
Assets		
Investments	\$3,768,091	\$3,732,728
Note receivable	5,557	5,565
Liabilities		
Total return swaps	4,851	1,200
Options sold	3	123
Unsecured notes	362,674	385,583
Investments		

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment gains (losses) in the Company's consolidated statements of operations. See Note 3. Investments for additional information.

### Note Receivable

Note receivable was recognized as part of the sale of land in August 2017 (See Note 5. Fixed Assets for additional information on the sale transaction). The Company elected to apply the fair value option to this security at the time it was first recognized. The fair value of note receivable is included in other assets in the Company's consolidated balance sheets, while the changes in fair value of note receivable are included in net realized investment gains (losses) in the Company's consolidated statements of operations.

### Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company as realized gains from investments on the expiration date. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options are included in other liabilities in the Company's consolidated balance sheets.

### Total Return Swaps

The fair values of the total return swaps reflect the estimated amounts that, upon termination of the contracts, would be received for selling an asset or paid to transfer a liability in an orderly transaction at December 31, 2018 and 2017 based on models using inputs, such as interest rate yield curves and credit spreads, observable for substantially the full term of the contract.

Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at December 31, 2018 and 2017 was obtained from a third party pricing service.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 4. Fair Value Measurements.

3. Investments

The following table presents gains (losses) due to changes in fair value of investments that are measured at fair value pursuant to application of the fair value option:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Fixed maturity securities	\$(53,927 )	\$50,403	\$(56,584)
Equity securities	(77,494 )	37,486	23,722
Short-term investments	(1,237 )	38	57
Total (losses) gains	\$(132,658)	\$87,927	\$(32,805)

The following table presents gross gains (losses) realized on the sales of investments:

	Year Ended December 31,								
	2018		2017		2016				
	(Amounts in thousands)								
	Gross Gross		Gross Gross		Gross Gross				
	Realized	Net	Realized	Net	Realized	Net			
	Gains	Losses	Gains	Losses	Gains	Losses			
Fixed maturity securities	\$549	\$(3,563)	\$(3,014)	\$604	\$(2,701)	\$(2,097)	\$3,327	\$(19,133)	\$(15,806)
Equity securities	43,420	(45,607)	(2,187 )	20,835	(23,048)	(2,213 )	29,446	(29,945 )	(499 )
Short-term investments	61	(2,429 )	(2,368 )	21	(20 )	1	6	(530 )	(524 )

Contractual Maturity

At December 31, 2018, fixed maturity holdings rated below investment grade and non-rated comprised 3.0% of total investments at fair value. Additionally, the Company owns securities that are credit enhanced by financial guarantors that are subject to uncertainty related to market perception of the guarantors' ability to perform. Determining the estimated fair value of municipal bonds could become more difficult should markets for these securities become illiquid.

The following table presents the estimated fair values of the Company's fixed maturity securities at December 31, 2018 by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Estimated Fair Value
	(Amounts in thousands)
Fixed maturity securities:	
Due in one year or less	\$ 166,423
Due after one year through five years	377,334
Due after five years through ten years	208,815
Due after ten years	2,232,589
Total	\$ 2,985,161



## Investment Income

The following table presents a summary of net investment income:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Fixed maturity securities	\$ 102,198	\$ 102,790	\$ 104,111
Equity securities	30,496	18,554	14,629
Short-term investments	8,789	8,753	8,936
Total investment income	\$ 141,483	\$ 130,097	\$ 127,676
Less: investment expense	(5,645 )	(5,167 )	(5,805 )
Net investment income	\$ 135,838	\$ 124,930	\$ 121,871

## 4. Fair Value Measurements

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date.

Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in non-active markets; or
- Either directly or indirectly observable inputs as of the reporting date.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

## Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 98.2% of its investment portfolio from an independent pricing service. For a private equity fund that was classified as Level 3 and included in equity securities at December 31, 2018 and 2017, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent,



unobservable inputs from at least one knowledgeable outside security broker to determine the fair value. The fair value of the private equity fund was \$1.4 million and \$1.5 million at December 31, 2018 and 2017, respectively.

Level 1 measurements—Fair values of financial assets and financial liabilities are obtained from an independent pricing service,

and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds/Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets in active markets.

Options sold: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

Level 2 measurements—Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential and commercial mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of \$24.8 million and \$19.3 million in commercial mortgage-backed securities at December 31, 2018 and 2017, respectively.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swaps: Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

Collateralized loan obligations ("CLOs"): Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.

Other asset-backed securities: Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.

Note receivable: Valued based on observable inputs, such as benchmark yields, and considering any premium or discount for the differential between the stated interest rate and market interest rates, based on quoted market prices of similar instruments.

Level 3 measurements—Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Private equity fund: Private equity fund, excluding private equity fund measured at net asset value ("NAV"), is valued based on underlying investments of the fund or assets similar to such investments in active markets, taking into consideration specific unadjusted broker quotes based on net fund value and unobservable inputs from at least one knowledgeable outside security broker related to liquidity assumptions.

Fair value measurement using NAV practical expedient - The fair value of the Company's investment in private equity fund measured at net asset value is determined using NAV as advised by the external fund manager and the third party administrator. The NAV of the Company's limited partnership interest in this fund is based on the manager's and the administrator's valuation of the underlying holdings in accordance with the fund's governing documents and GAAP. In accordance with applicable accounting guidance, this investment, measured at fair value using the NAV practical expedient, is not classified in the fair value hierarchy. The strategy of the fund is to provide current income to investors by investing mainly in equity tranches and sub-investment grade rated debt tranches of CLO issuers in the new and secondary markets, and equity interests in vehicles established to purchase and

warehouse loans in anticipation of a CLO closing or to satisfy regulatory risk retention requirements associated with certain CLOs. The Company has made all of its capital contributions in the fund and had no outstanding unfunded commitments at December 31, 2018 with respect to this fund. The underlying assets of the fund are expected to be liquidated over the period of approximately one to five years from December 31, 2018. The Company does not have the contractual option to redeem but will receive distributions based on the liquidation of the underlying assets and the interest proceeds from the underlying assets. In addition, the Company does not have the ability to withdraw from the fund, or to sell, assign, pledge or transfer its investment, without the consent from the general partner of the fund.

The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains or losses in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

	December 31, 2018			Total
	Level 1	Level 2	Level 3	
	(Amounts in thousands)			
<b>Assets</b>				
<b>Fixed maturity securities:</b>				
U.S. government bonds	\$25,003	\$—	\$—	\$25,003
Municipal securities	—	2,620,132	—	2,620,132
Mortgage-backed securities and agencies	—	30,952	—	30,952
Corporate securities	—	105,524	—	105,524
Collateralized loan obligations	—	165,789	—	165,789
Other asset-backed securities	—	37,761	—	37,761
Total fixed maturity securities	25,003	2,960,158	—	2,985,161
<b>Equity securities:</b>				
Common stock	430,973	—	—	430,973
Non-redeemable preferred stock	—	31,433	—	31,433
Private equity fund	—	—	1,445	1,445
Private equity fund measured at net asset value <sup>(1)</sup>				65,780
Total equity securities	430,973	31,433	1,445	529,631
<b>Short-term investments:</b>				
Short-term bonds	31,472	16,784	—	48,256
Money market instruments	205,043	—	—	205,043
Total short-term investments	236,515	16,784	—	253,299
<b>Other assets:</b>				
Note receivable	—	5,557	—	5,557
Total assets at fair value	\$692,491	\$3,013,932	\$1,445	\$3,773,648
<b>Liabilities</b>				
<b>Other liabilities:</b>				
Total return swaps	—	4,851	—	4,851
Options sold	3	—	—	3
Total liabilities at fair value	\$3	\$4,851	\$—	\$4,854

<sup>(1)</sup> The fair value is measured using the NAV practical expedient; therefore, it is not categorized within the fair value hierarchy. The fair value amount is presented in this table to permit reconciliation of the fair value hierarchy to the amounts presented in the Company's consolidated balance sheets.



Edgar Filing: MERCURY GENERAL CORP - Form 10-K

	December 31, 2017			Total
	Level 1	Level 2	Level 3	
(Amounts in thousands)				
<b>Assets</b>				
<b>Fixed maturity securities:</b>				
U.S. government bonds and agencies	\$ 13,236	\$—	\$—	\$ 13,236
Municipal securities	—	2,556,532	—	2,556,532
Mortgage-backed securities	—	27,165	—	27,165
Corporate securities	—	137,542	—	137,542
Collateralized debt obligations	—	105,202	—	105,202
Other asset-backed securities	—	53,100	—	53,100
Total fixed maturity securities	13,236	2,879,541	—	2,892,777
<b>Equity securities:</b>				
Common stock	429,367	—	—	429,367
Non-redeemable preferred stock	—	34,869	—	34,869
Private equity fund	—	—	1,481	1,481
Private equity fund measured at net asset value <sup>(1)</sup>				71,523
Total equity securities	429,367	34,869	1,481	537,240
<b>Short-term investments:</b>				
Short-term bonds	29,998	2,020	—	32,018
Money market instruments	270,693	—	—	270,693
Total short-term investments	300,691	2,020	—	302,711
<b>Other assets:</b>				
Note receivable	—	5,565	—	5,565
Total assets at fair value	\$ 743,294	\$ 2,921,995	\$ 1,481	\$ 3,738,293
<b>Liabilities</b>				
<b>Other liabilities:</b>				
Total return swaps	\$—	\$ 1,200	\$—	\$ 1,200
Options sold	123	—	—	123
Total liabilities at fair value	\$ 123	\$ 1,200	\$—	\$ 1,323

The following table presents a summary of changes in fair value of Level 3 financial assets:

	Private Equity Funds	
	Year Ended December 31, 2018	2017
(Amounts in thousands)		
Beginning balance	\$ 1,481	\$ 9,068
Net realized (losses) gains included in earnings	(36 )	691
Purchases	—	1,481
Sales/settlements	—	(9,759 )
Ending balance	\$ 1,445	\$ 1,481
The amount of total (losses) gains for the period included in earnings attributable to assets still held at December 31	\$(36 )	\$—

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy in 2018 and 2017.

At December 31, 2018 and 2017, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

## Financial Instruments Disclosed, But Not Carried, at Fair Value

The following tables present the carrying value and fair value of the Company's financial instruments disclosed, but not carried, at fair value, and the level within the fair value hierarchy at which such instruments are categorized:

December 31, 2018

Carrying Value	Fair Value	Level 1	Level 2	Level 3
----------------	------------	---------	---------	---------

(Amounts in thousands)

## Liabilities

## Notes payable:

Unsecured notes	\$371,734	\$362,674	\$ —	-\$362,674	\$ —
-----------------	-----------	-----------	------	------------	------

December 31, 2017

Carrying Value	Fair Value	Level 1	Level 2	Level 3
----------------	------------	---------	---------	---------

(Amounts in thousands)

## Liabilities

## Notes payable:

Unsecured notes	\$371,335	\$385,583	\$ —	-\$385,583	\$ —
-----------------	-----------	-----------	------	------------	------

## Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at December 31, 2018 and 2017 was based on the spreads above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and broker-dealer quotes.

See Note 7. Notes Payable for additional information on unsecured notes.

## 5. Fixed Assets

The following table presents the components of fixed assets:

	December 31,	
	2018	2017
	(Amounts in thousands)	
Land	\$ 18,144	\$ 18,152
Buildings and improvements	138,238	136,827
Furniture and equipment	123,021	118,647
Capitalized software	222,903	202,488
Leasehold improvements	9,986	9,632
	512,292	485,746
Less: accumulated depreciation and amortization	(359,269 )	(340,523 )
Fixed assets, net	\$ 153,023	\$ 145,223

Depreciation expense, including amortization of leasehold improvements, was \$19.9 million, \$21.2 million, and \$20.3 million for 2018, 2017, and 2016, respectively.

In August 2017, the Company completed the sale of approximately six acres of land located in Brea, California (the "Property"), for a total sale price of approximately \$12.2 million. Approximately \$5.7 million of the total sale price was received in the form of a promissory note (the "Note") and the remainder in cash. The Note is secured by a first trust deed and an assignment of rents on the Property, and bears interest at an annual rate of 3.5%, payable in monthly installments. The Note matures in August 2020, and its fair value is included in other assets in the Company's consolidated balance sheets. Only the cash portion of the total sale price of the Property, excluding the Note, is reported in the Company's consolidated statements of cash flows. Interest earned on the Note is recognized in other revenues in the Company's consolidated statements of operations. The Company recognized a gain of approximately \$3.3 million on the sale transaction, which is included in other revenues in its consolidated statements of operations.





## 6. Deferred Policy Acquisition Costs

Deferred policy acquisition costs were as follows:

	December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Balance, beginning of year	\$198,151	\$200,826	\$201,762
Policy acquisition costs deferred	589,144	552,675	561,610
Amortization	(572,164 )	(555,350 )	(562,546 )
Balance, end of year	\$215,131	\$198,151	\$200,826

## 7. Notes Payable

The following table presents information about the Company's notes payable:

	Lender	Interest Rate	Expiration	December 31,	
				2018	2017
				(Amounts in thousands)	
Senior unsecured notes <sup>(1)</sup>	Publicly traded	4.40%	March 15, 2027	\$375,000	\$375,000
Unsecured credit facility <sup>(2)</sup>	Bank of America and Wells Fargo Bank	LIBOR plus 112.5-162.5 basis points	March 29, 2022	—	—
Total principal amount				375,000	375,000
Less unamortized discount and debt issuance costs <sup>(3)</sup>				3,266	3,665
Total				\$371,734	\$371,335

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured senior obligations of the Company, with a 4.4% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The Company used the proceeds from the notes to pay off the total outstanding balance of \$320 million under the existing loan and credit facility agreements and terminated the agreements on March 8, 2017. The remainder of the proceeds from the notes was used for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate, including debt issuance costs, of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 18.8% at December 31, 2018, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of February 7, 2019, there have been no borrowings under this facility. The unamortized discount and debt issuance costs of approximately \$3.3 million are associated with the publicly traded \$375 million senior unsecured notes. These are amortized to interest expense over the life of the notes, and the unamortized balance is presented in the Company's consolidated balance sheets as a direct deduction from the carrying amount of the debt. The unamortized debt issuance cost of approximately \$0.2 million associated with the \$50 million five-year unsecured revolving credit facility maturing on March 29, 2022 is included in other assets in the Company's consolidated balance sheets and amortized to interest expense over the term of the credit facility.

The Company was in compliance with all of its financial covenants pertaining to minimum statutory surplus, debt to total capital ratio, and risk based capital ("RBC") ratio under the unsecured credit facility at December 31, 2018, except that CAIC's RBC ratio as of December 31, 2018 was below the required level. The Company received a waiver of the non-compliance. Notwithstanding the covenant under the unsecured credit facility, CAIC's RBC ratio was well in excess of the regulatory minimum capital requirement at December 31, 2018.

Debt maturities for each of the next five years and thereafter as of December 31, 2018 are as follows:

Maturity	Amounts (in thousands)
2019	\$ —
2020	—
2021	—
2022	—
2023	—
Thereafter	375,000
Total	\$ 375,000

#### 8. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle, formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$31 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 128 basis points prior to the renewal of the agreement in January 2018 and LIBOR plus 120 basis points subsequent to the January 2018 renewal through July 2018, on approximately \$100 million of underlying obligations as of December 31, 2018 and 2017. The agreement had an initial term of one year, subject to periodic renewal. In July 2018, the agreement was renewed through January 24, 2020, and the interest rate was changed to LIBOR plus 105 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle, formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which was renewed for an additional one-year term through February 17, 2018. The total portfolio of underlying obligations was liquidated during June 2017, and the total return swap agreement between AFL and Citibank was terminated on July 7, 2017. Under the agreement, AFL received the income equivalent on underlying obligations due to Citibank and paid to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap was secured by approximately \$40 million of U.S. Treasuries as collateral, which were included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 135 basis points prior to the amendment of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the amendment until June 2017, on approximately \$152 million of underlying obligations as of December 31, 2016.

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains or losses in the consolidated statements of operations:

	Liability Derivatives	
	December 31, 2018	December 31, 2017
	(Amounts in thousands)	
Options sold - Other liabilities	\$3	\$ 123

Total return swaps - Other liabilities	4,851	1,200
Total derivatives	\$4,854	\$ 1,323

75

---

	Gains (Losses) Recognized in Income		
	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Total return swaps - Net realized investment (losses) gains	\$(3,783)	\$(2,137)	\$11,533
Options sold - Net realized investment (losses) gains	10,498	2,291	3,846
Total	\$6,715	\$154	\$15,379

Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. For additional disclosures regarding equity contracts, see Note 4. Fair Value Measurements for additional disclosures regarding options sold.

## 9. Goodwill and Other Intangible Assets

### Goodwill

There were no changes in the carrying amount of goodwill during 2018 and 2017. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during 2018 and 2017. All of the Company's goodwill is associated with the Property and Casualty business segment (See Note 19. Segment Information for additional information on the reportable business segment).

### Other Intangible Assets

The following table presents the components of other intangible assets:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of December 31, 2018				
Customer relationships	\$53,048	\$(47,897)	\$ 5,151	11
Trade names	15,400	(6,417)	8,983	24
Technology	4,300	(4,300)	—	10
Insurance license	1,400	—	1,400	Indefinite
Total intangible assets, net	\$74,148	\$(58,614)	\$ 15,534	
As of December 31, 2017				
Customer relationships	\$52,890	\$(43,617)	\$ 9,273	11
Trade names	15,400	(5,775)	9,625	24
Technology	4,300	(3,870)	430	10
Insurance license	1,400	—	1,400	Indefinite
Total intangible assets, net	\$73,990	\$(53,262)	\$ 20,728	

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during 2018 and 2017.

Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was \$5.5 million, \$5.4 million, and \$6.1 million for the years ended December 31, 2018, 2017, and 2016, respectively. None of the intangible assets with definite useful lives are anticipated to have a residual value.



The following table presents the estimated future amortization expense related to other intangible assets as of December 31, 2018:

Year Ending December 31, Amortization Expense	
(Amounts in thousands)	
2019	\$ 5,036
2020	889
2021	869
2022	845
2023	681
Thereafter	5,814
Total	\$ 14,134

## 10. Income Taxes

### Income tax provision

The Company and its subsidiaries file a consolidated federal income tax return. The income tax expense (benefit) consisted of the following components:

Year Ended December 31,			
	2018	2017	2016
(Amounts in thousands)			
Federal			
Current	\$14,190	\$10,898	\$17,444
Deferred	(39,244 )	10,934	(21,947 )
	\$(25,054)	\$21,832	\$(4,503 )
State			
Current	\$1,982	\$955	\$2,239
Deferred	(1,815 )	(579 )	(56 )
	\$167	\$376	\$2,183
Total			
Current	\$16,172	\$11,853	\$19,683
Deferred	(41,059 )	10,355	(22,003 )
Total	\$(24,887)	\$22,208	\$(2,320 )

As a result of the Tax Cuts and Jobs Act of 2017 (the "Act"), the Company's deferred tax assets and liabilities were measured using the new corporate tax rate of 21% at December 31, 2018 and 2017. For the year ended December 31, 2018, the Company measured its current income taxes using the new corporate tax rate of 21%, rather than the pre-enactment corporate tax rate of 35%. Additionally in 2018, as a result of a determination made by the Office of Management and Budget, the Company reversed the previously recorded provisional 6.6% sequestration reduction to its alternative minimum tax ("AMT") credit that originally resulted from repeal of the corporate AMT and reclassification of AMT credit carryforwards to current taxes receivable as a refundable credit.

In computing taxable income, property and casualty insurers reduce underwriting income by losses and loss adjustment expenses incurred. The amount of the deduction for losses incurred associated with unpaid losses is discounted at the interest rates and for the loss payment patterns prescribed by the U.S. Treasury. The Act changes the prescribed interest rates to rates based on corporate bond yield curves and extends the applicable time periods for the loss payment pattern. These changes are effective for tax years beginning after 2017 and are subject to a transition rule that spreads the additional tax payments from the amount determined by applying these changes versus the previous calculated amount over the subsequent eight years beginning in 2018. The changes included in the Act related to discounting of unpaid losses are broad and complex. The Securities Exchange Commission has issued rules that would allow for a measurement period of up to one year after the enactment date of the Act to finalize the recording of the related tax impacts. The Company recorded a total deferred tax liability adjustment of approximately \$8.6 million at



December 31, 2018 related to the changes in discounting of unpaid losses included in the Act based on the guidance published in 2018 by the Internal Revenue Service.

77

---

Edgar Filing: MERCURY GENERAL CORP - Form 10-K

The following table presents a reconciliation of the tax expense (benefit) based on the statutory rate to the Company's actual tax expense (benefit) in the consolidated statements of operations:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Computed tax (benefit) expense at 21% for 2018 and 35% for 2017 and 2016	\$(6,429 )	\$58,480	\$24,753
Tax-exempt interest income	(13,507 )	(26,038 )	(26,197 )
Dividends received deduction	(1,082 )	(2,296 )	(2,303 )
State tax expense	439	158	1,907
Nondeductible expenses	390	348	303
Cumulative impact from change in tax rate	—	(11,449 )	—
(Reversal in 2018) reduction of AMT credit carryforward due to sequestration in 2017	(4,088 )	4,088	—
Other, net	(610 )	(1,083 )	(783 )
Income tax (benefit) expense	\$(24,887)	\$22,208	\$(2,320 )

Deferred Income Taxes

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets.

The following table presents the significant components of the Company's net deferred tax assets and liabilities:

	December 31,	
	2018	2017
	(Amounts in thousands)	
Deferred tax assets:		
20% of net unearned premiums	\$52,644	\$47,110
Discounting of loss reserves and salvage and subrogation recoverable for tax purposes	9,245	6,451
Write-down of impaired investments	356	387
Tax credit carryforwards	—	230
Expense accruals	7,019	6,192
Tax asset on net unrealized loss on securities carried at fair value	1,055	—
Other deferred tax assets	3,257	3,174
Total gross deferred tax assets	73,576	63,544
Deferred tax liabilities:		
Deferred policy acquisition costs	(45,178 )	(41,612 )
Tax liability on net unrealized gain on securities carried at fair value	—	(27,574 )
Tax depreciation in excess of book depreciation	(4,594 )	(5,686 )
Undistributed earnings of insurance subsidiaries	(3,017 )	(3,907 )
Tax amortization in excess of book amortization	(2,729 )	(2,280 )
Other deferred tax liabilities	(4,719 )	(5,417 )
Total gross deferred tax liabilities	(60,237 )	(86,476 )
Net deferred tax assets (liabilities)	\$13,339	\$(22,932)



### Uncertainty in Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on its tax returns, only if the positions are "more-likely-than-not" sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its financial statements.

There was a \$0.9 million increase to the total amount of unrecognized tax benefits related to tax uncertainties during 2018. The increase was the result of tax positions taken regarding state tax apportionment issues based on management's judgment and latest information available. The Company does not expect any changes in unrecognized tax benefits to have a material impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2015 through 2017 for federal taxes and 2011 through 2017 for California state taxes. For tax years 2003 through 2010, the Company achieved a resolution with the Franchise Tax Board ("FTB") in December 2017 and paid a \$4.6 million negotiated settlement amount in accordance with the settlement agreement provided by the FTB and signed by the Company. The settlement agreement was approved by the California attorney general in 2018. The Company believes that resolution of tax years 2003 through 2010 has the potential to establish guidance for future audit assessments proposed by the FTB for future tax years.

The Company is currently under examination for tax years 2011 through 2016. For tax years 2011 through 2013, the FTB issued Notices of Proposed Assessments ("NPAs") to the Company, for which the Company submitted a formal protest in 2018. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the FTB, an appeal with the California Office of Tax Appeals, or litigation in Superior Court. For tax years 2014 through 2016, the FTB commenced its audit in December 2017 and has not yet completed its audit. The Company believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

The following table presents a reconciliation of the beginning and ending balances of unrecognized tax benefits:

	December 31,	
	2018	2017
	(Amounts in thousands)	
Balance at January 1	\$ 9,674	\$ 12,954
Additions (reductions) based on tax positions related to:		
Current year	662	85
Prior years	279	(3,365 )
Balance at December 31	\$ 10,615	\$ 9,674

If unrecognized tax benefits were recognized, \$11.5 million and \$10.1 million, including accrued interest, penalties and federal tax benefit related to unrecognized tax benefits, would impact the Company's effective tax rate at December 31, 2018 and 2017, respectively.

The Company recognizes interest and penalties related to unrecognized tax benefits as a part of income taxes. The Company recognized an accrued net expense (benefit) related to interest and penalty of approximately \$0.5 million, \$(1.1) million, and \$0.6 million for the years ended December 31, 2018, 2017 and 2016, respectively. The net benefit for the year ended 2017 is largely due to reversal of accrued interest and penalty following the settlement with the FTB for tax years 2003 through 2010. The Company carried an accrued interest and penalty balance of approximately \$2.9 million and \$2.4 million at December 31, 2018 and 2017, respectively.



## 11. Loss and Loss Adjustment Expense Reserves

The following table presents the activity in loss and loss adjustment expense reserves:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Gross reserves at January 1	\$ 1,510,613	\$ 1,290,248	\$ 1,146,688
Less reinsurance recoverables on unpaid losses	(64,001 )	(13,161 )	(14,253 )
Net reserves at January 1	1,446,612	1,277,087	1,132,435
Incurred losses and loss adjustment expenses related to:			
Current year	2,483,693	2,390,453	2,269,769
Prior years	93,096	54,431	85,369
Total incurred losses and loss adjustment expenses	2,576,789	2,444,884	2,355,138
Loss and loss adjustment expense payments related to:			
Current year	1,543,828	1,550,789	1,508,362
Prior years	831,020	724,570	702,124
Total payments	2,374,848	2,275,359	2,210,486
Net reserves at December 31	1,648,553	1,446,612	1,277,087
Reinsurance recoverables on unpaid losses	180,859	64,001	13,161
Gross reserves at December 31	\$ 1,829,412	\$ 1,510,613	\$ 1,290,248

The increase in the provision for insured events of prior years in 2018 of approximately \$93.1 million primarily resulted from higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims as well as higher than estimated defense and cost containment expenses in the California automobile line of insurance business.

The increase in the provision for insured events of prior years in 2017 of approximately \$54.4 million primarily resulted from higher than estimated losses in California automobile and property lines, which experienced higher loss severity on liability coverages including bodily injury and property damage and higher loss adjustment expenses than originally estimated.

The increase in the provision for insured events of prior years in 2016 of approximately \$85.4 million primarily resulted from the California and Florida automobile lines of business which experienced higher loss severity on liability coverages including bodily injury, combined single limits and property damage than was originally estimated.

The Company experienced pre-tax catastrophe losses and loss adjustment expenses of approximately \$289 million (\$67 million, net of reinsurance benefits), \$168 million (\$79 million, net of reinsurance benefits), and \$27 million in 2018, 2017, and 2016, respectively. There were no reinsurance benefits used for catastrophe losses in 2016. The losses in 2018 were primarily due to wildfires in Northern and Southern California and weather-related catastrophes across several states. The losses in 2017 were primarily due to wildfires in Northern and Southern California, severe rainstorms in California, and the impact of hurricanes in Texas, Florida and Georgia. The losses in 2016 were primarily due to severe storms outside of California, and rainstorms in California.

The following is information about incurred and paid claims development as of December 31, 2018, net of reinsurance, as well as cumulative claim frequency and the total of incurred-but-not-reported liabilities plus expected development on reported claims included within the net incurred claims amounts for our two major product lines: automobile and homeowners lines of business. As the information presented is for these two major product lines only, the total incurred and paid claims development shown below does not correspond to the aggregate development presented in the table above, which is for all product lines and includes unallocated claims adjustment expenses. The cumulative number of reported claims represents open claims, claims closed with payment, and claims closed without payment. It does not include an estimated amount for unreported claims. The number of claims is measured by claim

event (such as a car accident or storm damage) and an individual claim event may result in more than one reported claim. The Company considers a claim that does not result in a liability as a claim closed without payment.

The information about incurred and paid claims development for the years ended December 31, 2009 to 2017 is presented as unaudited supplementary information.

Edgar Filing: MERCURY GENERAL CORP - Form 10-K

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Automobile Insurance)

For the Years Ended December 31,

Accident Year	2009 <sup>(1)</sup>	2010 <sup>(1)</sup>	2011 <sup>(1)</sup>	2012 <sup>(1)</sup>	2013 <sup>(1)</sup>	2014 <sup>(1)</sup>	2015 <sup>(1)</sup>	2016 <sup>(1)</sup>	2017 <sup>(1)</sup>	2018
(Amounts in thousands)										
2009	\$1,372,833	\$1,349,025	\$1,361,116	\$1,361,652	\$1,365,551	\$1,371,779	\$1,372,694	\$1,372,259	\$1,371,812	\$1,371,812
2010		1,367,547	1,357,750	1,364,307	1,374,638	1,379,336	1,381,056	1,386,105	1,388,077	1,388,077
2011			1,343,919	1,367,000	1,380,557	1,388,363	1,393,878	1,398,518	1,405,112	1,405,112
2012				1,424,754	1,408,222	1,409,104	1,414,878	1,426,735	1,436,034	1,436,034
2013					1,448,567	1,431,058	1,447,881	1,458,421	1,464,071	1,464,071
2014						1,467,175	1,454,366	1,473,545	1,486,322	1,486,322
2015							1,551,105	1,588,443	1,610,839	1,610,839
2016								1,672,853	1,669,642	1,669,642
2017									1,703,857	1,703,857
2018										1,780,000
									Total	\$15,000,000

<sup>(1)</sup> The information for the years 2009 to 2017 is presented as unaudited supplemental information.

Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Automobile Insurance)  
For the Years Ended December 31,

Accident Year	2009 <sup>(1)</sup>	2010 <sup>(1)</sup>	2011 <sup>(1)</sup>	2012 <sup>(1)</sup>	2013 <sup>(1)</sup>	2014 <sup>(1)</sup>	2015 <sup>(1)</sup>	2016 <sup>(1)</sup>	2017 <sup>(1)</sup>	2018
(Amounts in thousands)										
2009	\$913,340	\$1,137,807	\$1,260,424	\$1,326,439	\$1,355,210	\$1,363,526	\$1,370,564	\$1,371,956	\$1,371,933	\$1,371,933
2010		908,954	1,143,984	1,268,142	1,335,871	1,365,464	1,375,799	1,384,333	1,387,835	1,387,835
2011			926,983	1,152,459	1,277,808	1,347,082	1,378,920	1,391,101	1,394,684	1,400,000
2012				955,647	1,194,648	1,304,511	1,372,828	1,409,911	1,422,705	1,434,000
2013					974,445	1,217,906	1,340,724	1,413,999	1,447,004	1,460,000
2014						967,481	1,231,413	1,358,472	1,432,472	1,476,000
2015							1,040,253	1,336,223	1,466,368	1,560,000
2016								1,094,006	1,395,199	1,554,000
2017									1,076,079	1,399,000
2018										1,082,000
									Total	\$14,100,000
										All outstanding liabilities before 2009, net of reinsurance (505,000)
										Loss and allocated loss adjustment expense reserves, net of reinsurance \$1,290,000



---

<sup>(1)</sup> The information for the years 2009 to 2017 is presented as unaudited supplemental information.

Incurred Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Homeowners' Insurance)

For the Years Ended December 31,

Accident Year	2009 <sup>(1)</sup>	2010 <sup>(1)</sup>	2011 <sup>(1)</sup>	2012 <sup>(1)</sup>	2013 <sup>(1)</sup>	2014 <sup>(1)</sup>	2015 <sup>(1)</sup>	2016 <sup>(1)</sup>	2017 <sup>(1)</sup>	2018	As of December 31, 2018 Total of Incurred But Not Reported Liability Plus Expected Development on Reported Claims (Amounts in thousands)
(Amounts in thousands)											
2009	\$ 135,889	\$ 135,000	\$ 131,680	\$ 133,087	\$ 133,121	\$ 134,718	\$ 134,597	\$ 134,478	\$ 134,359	\$ 134,374	\$62 17
2010		165,727	157,566	160,983	160,472	160,206	160,015	159,608	159,662	159,720	136 21
2011			167,414	170,623	170,052	169,600	169,390	169,621	170,126	170,334	310 23
2012				196,063	188,010	190,376	191,548	192,057	191,804	192,905	674 25
2013					191,903	188,915	188,026	186,795	187,165	188,014	780 23
2014						199,298	202,621	203,218	202,513	204,986	1,341 25
2015							234,800	234,881	233,501	236,855	3,131 24
2016								250,691	259,489	259,497	6,525 24
2017									309,491	295,163	12,180 24
2018										311,798	59,688 23
									Total	\$2,153,646	

<sup>(1)</sup> The information for the years 2009 to 2017 is presented as unaudited supplemental information.

Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance (Homeowners' Insurance)  
For the Years Ended December 31,

Accident Year	2009 <sup>(1)</sup>	2010 <sup>(1)</sup>	2011 <sup>(1)</sup>	2012 <sup>(1)</sup>	2013 <sup>(1)</sup>	2014 <sup>(1)</sup>	2015 <sup>(1)</sup>	2016 <sup>(1)</sup>	2017 <sup>(1)</sup>	2018	
(Amounts in thousands)											
2009	\$86,034	\$119,306	\$126,591	\$130,928	\$132,180	\$134,381	\$134,378	\$134,301	\$134,229	\$134,193	
2010		95,057	137,628	149,084	155,191	156,853	158,053	158,943	159,268	159,435	
2011			111,909	153,845	162,870	166,375	167,806	168,621	168,914	169,757	
2012				128,618	175,029	182,756	188,121	190,373	190,649	191,660	
2013					133,528	174,295	180,858	183,860	185,168	186,132	
2014						139,615	186,996	194,605	198,758	202,193	
2015							163,196	213,994	224,178	230,480	
2016								173,537	234,215	245,878	
2017									217,900	269,254	
2018										213,038	
									Total	\$2,002,020	
										All outstanding liabilities before 2009, net of reinsurance	2,416
											\$154,043

Loss and allocated loss adjustment expense reserves, net of reinsurance

---

(1) The information for the years 2009 to 2017 is presented as unaudited supplemental information.

The following is unaudited supplementary information about average historical claims duration as of December 31, 2018.

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance

Years	1	2	3	4	5	6	7	8	9	10
Automobile insurance	64.7%	17.3%	8.7%	5.0%	2.5%	0.8%	0.6%	0.3%	0.1%	<del>%</del>

## Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance

Years	1	2	3	4	5	6	7	8	9	10
Homeowners insurance	67.3%	23.0%	4.7%	2.6%	1.1%	0.7%	0.3%	0.2%	0.1%	<del>%</del>

The reconciliation of the net incurred and paid claims development tables to the liability for claims and claim adjustment expenses in the consolidated balance sheets is as follows.

## Reconciliation of the Disclosure of Incurred and Paid Claims Development to the Loss and Loss Adjustment Expense Reserves

	December 31, 2018 (Amounts in thousands)
Net outstanding liabilities	
Automobile insurance	\$ 1,294,025
Homeowners' insurance	154,043
WAIC automobile insurance	17,508
Other short-duration insurance lines	90,003
Loss and loss adjustment expense reserves, net of reinsurance recoverables on unpaid losses	1,555,579
Reinsurance recoverables on unpaid losses	
Automobile insurance	41,316
Homeowners' insurance	138,096
Other short-duration insurance lines	1,447
Total reinsurance recoverables on unpaid losses	180,859
Insurance lines other than short-duration	1,079
Unallocated claims adjustment expenses	91,895
	92,974
Total gross loss and loss adjustment expense reserves	\$ 1,829,412

## 12. Dividends

The following table presents shareholder dividends paid:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands, except per share data)		
Total paid	\$ 138,478	\$ 137,886	\$ 137,201
Per share paid	\$ 2.5025	\$ 2.4925	\$ 2.4825

The Insurance Companies are subject to the financial capacity guidelines established by their domiciliary states. The payment of dividends from statutory unassigned surplus of the Insurance Companies is restricted, subject to certain statutory limitations. As of December 31, 2018, the insurance subsidiaries of the Company are permitted to pay approximately \$145 million in dividends in 2019 to Mercury General without the prior approval of the DOI of domiciliary states. The above statutory regulations may have the effect of indirectly limiting the ability of the Company to pay shareholder dividends. During 2018, 2017, and 2016, the Insurance Companies paid Mercury General ordinary dividends of \$135 million, \$109 million, and \$111 million, respectively.

On February 1, 2019, the Board of Directors declared a \$0.6275 quarterly dividend payable on March 28, 2019 to shareholders of record on March 14, 2019.

## 13. Statutory Balances and Accounting Practices

The Insurance Companies prepare their statutory-basis financial statements in conformity with accounting practices prescribed or permitted by the insurance departments of their domiciliary states. Prescribed statutory accounting practices primarily include those published as statements of statutory accounting principles by the National Association of Insurance Commissioners

(the "NAIC"), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. As of December 31, 2018, there were no material permitted statutory accounting practices utilized by the Insurance Companies.

The following table presents the statutory net income, and statutory capital and surplus of the Insurance Companies, as reported to regulatory authorities:

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Statutory net income <sup>(1)</sup>	\$81,935	\$117,376	\$82,359
Statutory capital and surplus	\$1,471,547	\$1,589,226	\$1,441,571

<sup>(1)</sup> Statutory net income reflects differences from GAAP net income, including changes in the fair value of the investment portfolio as a result of the application of the fair value option.

The Insurance Companies must comply with minimum capital requirements under applicable state laws and regulations. The RBC formula is used by insurance regulators to monitor capital and surplus levels. It was designed to capture the widely varying elements of risks undertaken by writers of different lines of insurance business having differing risk characteristics, as well as writers of similar lines where differences in risk may be related to corporate structure, investment policies, reinsurance arrangements, and a number of other factors. The Company periodically monitors the RBC level of each of the Insurance Companies. As of December 31, 2018, 2017 and 2016, each of the Insurance Companies exceeded the minimum required RBC level, as determined by the NAIC and adopted by the state insurance regulators. None of the Insurance Companies' RBC ratios were less than 300% of the authorized control level RBC as of December 31, 2018, 2017 and 2016. Generally, an RBC ratio of 200% or less would require some form of regulatory or company action.

#### 14. Profit Sharing Plan and Annual Cash Bonuses

The Company's employees are eligible to become members of the Profit Sharing Plan (the "Plan"). The Company, at the option of the Board of Directors, may make annual contributions to the Plan, and the contributions are not to exceed the greater of the Company's net income for the plan year or its retained earnings at that date. In addition, the annual contributions may not exceed an amount equal to 15% of the compensation paid or accrued during the year to all participants under the Plan. No contributions were made in the past three years.

The Plan includes an option for employees to make salary deferrals under Section 401(k) of the Internal Revenue Code. The matching contributions, at a rate set by the Board of Directors, totaled \$9.0 million, \$8.6 million, and \$8.2 million for 2018, 2017, and 2016, respectively.

The Plan also includes an employee stock ownership plan that covers substantially all employees. The Board of Directors authorizes the Plan to purchase the Company's common stock in the open market for allocation to the Plan participants. No purchases were made during the past three years.

The Company also provides company-wide annual cash bonuses to all eligible employees based on performance criteria for each recipient and for the Company as a whole. The Company performance goals were based on the Company's premium growth and combined ratio. The Company did not pay any company-wide annual cash bonuses to all eligible employees in 2018 and 2017, and paid \$16.8 million in such bonuses in 2016.

#### 15. Share-Based Compensation

In February 2015, the Company adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan (the "2005 Plan") which expired in January 2015. The 2015 Plan was approved at the Company's

Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock under the 2015 Plan are authorized for issuance upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of RSU or deferred stock awards. As of December 31, 2018, the Company had 75,250 RSUs and 80,000 stock options granted and outstanding and 4,744,750 shares of common stock available for future grant under the 2015 Plan.

The following table presents a summary of cash received, compensation costs recognized and excess tax expense (benefit), related to the Company's share-based awards:

	Year Ended December		
	31,		
	2018	2017	2016
	(Amounts in thousands)		
Cash received from stock option exercises	\$358	\$2,162	\$1,632
Compensation cost, all share-based awards	145	60	142
Excess tax expense (benefit), all share-based awards	4	8	(913 )

#### Stock Option Awards

Stock option awards become exercisable at a rate of 25% per year beginning one year from the date granted, are granted at the closing price of the Company's stock on the date of grant, and expire after 10 years.

In February 2018, the Compensation Committee of the Company's Board of Directors awarded a total of 80,000 stock options to four senior executives under the 2015 Plan which will vest over the four-year requisite service period. The fair values of these stock options were estimated on the date of grant using a closed-form option valuation model (Black-Scholes). No stock options were awarded in 2017 and 2016 under the 2015 Plan.

The following table provides the assumptions used in the calculation of grant-date fair values of these stock options based on the Black-Scholes option pricing model:

Weighted-average grant-date fair value	\$8.09
Expected volatility	33.18 %
Risk-free interest rate	2.62 %
Expected dividend yield	5.40 %
Expected term in months	72

Expected volatility is based on historical volatility of the Company's stock over the term of the stock options. The Company estimated the expected term of stock options, which represents the period of time that stock options granted are expected to be outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

The following table presents a summary of the stock option activity for the year ended December 31, 2018:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in 000's)
Outstanding at January 1, 2018	42,500	\$ 44.72		
Granted	80,000	\$ 43.01		
Exercised	(8,000)	\$ 44.75		
Canceled or expired	(15,000)	\$ 48.52		
Outstanding at December 31, 2018	99,500	\$ 42.77	7.9	\$ 890
Exercisable at December 31, 2018	19,500	\$ 41.78	3.2	\$ 194

The aggregate intrinsic values in the table above represent the total pre-tax intrinsic value (the difference between the Company's closing stock price and the stock option exercise price, multiplied by the number of in-the-money stock options) that would have been received by the stock option holders had all stock options been exercised on



December 31, 2018. The aggregate intrinsic values of stock options exercised were \$42,000, \$371,000, and \$591,000 for 2018, 2017, and 2016, respectively. The total fair value of stock options vested during 2018, 2017, and 2016 was \$0, \$142,000, and \$142,000, respectively.

The following table presents information regarding stock options outstanding at December 31, 2018:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
\$33.61-\$42.46	7,000	0.7	\$ 35.48	7,000	\$ 35.48
\$43.01-\$45.30	92,500	8.5	\$ 43.32	12,500	\$ 45.30

As of December 31, 2018, the Company had \$0.5 million of unrecognized compensation expense related to stock options awarded under the 2015 Plan, which will be recognized ratably over the remaining vesting period of approximately 3.1.

#### Restricted Stock Unit Awards

In February 2016, the Compensation Committee of the Company's Board of Directors granted performance-based vesting RSU awards to the Company's senior management and key employees under the 2015 Plan.

The following table presents the RSU grants summary at December 31, 2018:

Grant year	2016
Three-year performance period ending December 31, 2018	
Vesting shares, target (net of forfeited)	75,250
Vesting shares, maximum (net of forfeited)	141,094

No RSUs were awarded in 2018 and 2017 under the 2015 Plan.

The following table presents a summary of RSU awards activity, based on target vesting, during the years indicated:

	Year Ended December 31,					
	2018		2017		2016	
	Shares	Weighted-Average Fair Value per Share	Shares	Weighted-Average Fair Value per Share	Shares	Weighted-Average Fair Value per Share
Outstanding at January 1	169,000	\$ 53.66	271,000	\$ 51.09	263,250	\$ 45.94
Granted	—	\$ —	—	\$ —	95,750	\$ 53.49
Vested	—	\$ —	(82,000 )	\$ 45.17	(78,500 )	\$ 36.82
Forfeited/Canceled	(8,000 )	\$ 53.49	(20,000 )	\$ 53.62	(9,500 )	\$ 50.46
Expired	(85,750 )	\$ 53.80	—	\$ —	—	\$ —
Outstanding at December 31	75,250	\$ 53.51	169,000	\$ 53.66	271,000	\$ 51.09

The RSU awards vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. Performance thresholds are based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. As of December 31, 2018, 20,500 target RSUs granted in 2016 have been forfeited because the recipients were no longer employed by the Company. Expired shares represent shares that did not meet the vesting requirements.

The fair value of each RSU grant was determined based on the closing price of the Company's common stock on the grant date for awards classified as equity and on each reporting date for awards classified as a liability. Compensation cost is recognized based on management's best estimate of the performance goals that will be achieved. If the minimum performance goals are not met, no compensation cost will be recognized and any recognized compensation

cost would be reversed.

In March 2018, based on certification by the Compensation Committee of the Company's Board of Directors of the results of the three-year performance period ended December 31, 2017, all of the outstanding RSUs granted in 2015 expired unvested because the Company did not meet the minimum three-year performance threshold.

86

---

In March 2017, a total of approximately \$3.6 million was paid upon vesting of 61,445 RSUs awarded in 2014 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2016.

In February 2016, 88,074 shares of common stock, net of 58,822 shares withheld for payroll taxes, were issued upon vesting of 146,896 RSUs awarded in 2013 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2015.

At December 31, 2016, the Company determined that it was probable that the Company's Board of Directors would modify the payment method for the vested 2014 grant awards and pay for the vested awards in cash in lieu of shares of the Company's common stock. As a result, the 2014 grants were reclassified from equity to liability awards at December 31, 2016. \$3.4 million of the amount previously recognized in additional paid-in capital for the 2014 grant awards was reclassified to other liabilities in the consolidated balance sheets at December 31, 2016. Additional \$0.2 million was reclassified from additional paid-in capital to other liabilities at the vesting date of February 28, 2017 for the 2014 grant awards, based on the additional amount of awards vested from December 31, 2016 to the vesting date.

#### 16. Earnings Per Share

The following table presents a reconciliation of the numerators and denominators of the basic and diluted earnings per share calculations:

	Year Ended December 31, 2018		2017		2016				
	Loss (Numerator)	Weighted Shares (Denominator)	Per-Share Income Amount (Numerator)	Weighted Shares (Denominator)	Per-Share Income Amount (Numerator)	Weighted Shares (Denominator)	Per-Share Income Amount		
(Amounts and numbers in thousands, except per-share data)									
Basic EPS									
(Loss) income available to common stockholders	\$ (5,728)	55,335	\$ (0.10 )	\$ 144,877	55,316	\$ 2.62	\$ 73,044	55,249	\$ 1.32
Effect of dilutive securities:									
Options	—	—	—	11	—	—	11		
RSUs	—	—	—	—	—	—	42		
Diluted EPS									
(Loss) income available to common stockholders after assumed conversions	\$ (5,728)	55,335	\$ (0.10 )	\$ 144,877	55,327	\$ 2.62	\$ 73,044	55,302	\$ 1.32

Potentially dilutive securities representing approximately 78,500, 0, and 27,600 shares of common stock for 2018, 2017, and 2016, respectively, were excluded from the computation of diluted earnings (loss) per common share because their effect would have been anti-dilutive. For the year ended December 31, 2018, the dilutive impact of incremental shares was excluded as the Company generated a net loss.

#### 17. Commitments and Contingencies

##### Operating Leases

The Company is obligated under various non-cancellable lease agreements providing for office space, automobiles, and office equipment that expire at various dates through the year 2026. For leases that contain predetermined escalations of the minimum rentals, the Company recognizes the related rent expense on a straight-line basis and records the difference between the recognized rental expense and the amount paid under the lease as deferred rent in other liabilities. The total deferred rent liability amounted to \$2.4 million and \$2.1 million at December 31, 2018 and

2017, respectively. Total rent expense recognized under these lease agreements was \$14.9 million, \$14.8 million, and \$15.2 million for 2018, 2017, and 2016, respectively.

The following table presents future minimum commitments for operating leases as of December 31, 2018:  
Year Ending December 31, Operating Leases

	(Amounts in thousands)
2019	\$ 12,812
2020	11,547
2021	8,732
2022	6,972
2023	3,659
Thereafter	1,966

#### California Earthquake Authority ("CEA")

The CEA is a quasi-governmental organization that was established to provide a market for earthquake coverage to California homeowners. The Company places all new and renewal earthquake coverage offered with its homeowners policies directly with the CEA. The Company receives a small fee for placing business with the CEA, which is recorded as other income in the consolidated statements of operations. Upon the occurrence of a major seismic event, the CEA has the ability to assess participating companies for losses. These assessments are made after CEA capital has been expended and are based upon each company's participation percentage multiplied by the amount of the total assessment. Based upon the most recent information provided by the CEA, the Company's maximum total exposure to CEA assessments at August 7, 2018, the most recent date at which information was available, was approximately \$68.3 million. There was no assessment made in 2018.

#### Regulatory Matters

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed. The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the

right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not

premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. On January 12, 2017, the California DOI filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. While the appeal is still pending, the California DOI returned the entire penalty amount plus accrued interest, a total of \$30.9 million, to the Company in June 2017 in order to avoid accruing further interest. Because the matter has been appealed, the Company has not yet recognized the \$30.9 million as a gain in the consolidated statements of operations; instead, the Company recorded the \$30.9 million plus interest earned, a total of approximately \$31.6 million at December 31, 2018, in other liabilities in the consolidated balance sheets. The Company had filed a motion to dismiss the false advertising portion of the case based on the Superior Court's findings, but the ALJ denied that motion after the appeal was filed. The ALJ did, however, grant the Company's alternative request to stay further proceedings pending the final determination of the appeal. The Company has accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

#### Litigation

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see Note 1. Summary of Significant Accounting Policies.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate.

The Company is also involved in proceedings relating to assessments and rulings made by the FTB. See Note 10. Income Taxes.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.



## 18. Quarterly Financial Information (Unaudited)

The following table presents summarized quarterly financial data for 2018 and 2017:

	Quarter Ended			
	March 31	June 30	September 30	December 31
	(Amounts in thousands, except per share data)			
<b>2018</b>				
Net premiums earned	\$808,084	\$833,959	\$858,135	\$868,233
Change in fair value of financial instruments pursuant to the fair value option	(58,532 )	8,793	(12,907 )	(70,020 )
(Loss) income before income taxes	(59,699 )	73,246	70,286	(114,448 )
Net (loss) income	(42,607 )	60,180	58,578	(81,879 )
Basic (loss) earnings per share	(0.77 )	1.09	1.06	(1.48 )
Diluted (loss) earnings per share	(0.77 )	1.09	1.06	(1.48 )
Dividends paid per share	0.6250	0.6250	0.6250	0.6275
<b>2017</b>				
Net premiums earned	\$789,770	\$797,666	\$801,205	\$806,796
Change in fair value of financial instruments pursuant to the fair value option	21,857	20,275	17,608	28,065
Income before income taxes	30,599	68,752	58,247	9,487
Net income	26,980	51,633	46,485	19,779
Basic earnings per share	0.49	0.93	0.84	0.36
Diluted earnings per share	0.49	0.93	0.84	0.36
Dividends paid per share	0.6225	0.6225	0.6225	0.6250

Net income for 2018 was primarily attributable to net premiums earned, net investment income and income tax benefit on pre-tax loss, partially offset by net realized investment losses, operating expenses and losses and loss adjustment expenses, including catastrophe losses and unfavorable development on prior accident years' loss and loss adjustment expense reserves. The primary causes of the net loss for the fourth quarter of 2018 were the decreases in the fair values of the Company's fixed maturity and equity securities due to the rising market interest rates and the overall decline in the equity markets.

Net income for 2017 was primarily attributable to net premiums earned, net investment income and net realized investment gains, partially offset by operating expenses and losses and loss adjustment expenses, including catastrophe losses and unfavorable development on prior accident years' loss and loss adjustment expense reserves. The primary causes of the net income for the fourth quarter of 2017 were the increases in the fair values of the Company's fixed maturity and equity securities due to the overall market improvement, net investment income, and a net tax benefit of \$7.4 million due to the effect of the Act.

## 19. Segment Information

The Company is primarily engaged in writing personal automobile insurance and provides related property and casualty insurance products to its customers through 14 subsidiaries in 11 states, principally in California.

The Company has one reportable business segment - the Property and Casualty business segment.

The Company's Chief Operating Decision Maker evaluates operating results based on pre-tax underwriting results which is calculated as net premiums earned less (a) losses and loss adjustment expenses and (b) underwriting expenses (policy acquisition costs and other operating expenses).

Expenses are allocated based on certain assumptions that are primarily related to premiums and losses. The Company's net investment income, net realized investment gains (losses), other income, and interest expense are excluded in

evaluating pre-tax underwriting profit. The Company does not allocate its assets, including investments, or income taxes in evaluating pre-tax underwriting profit.

90

---

### Property and Casualty Lines

The Property and Casualty business segment offers several insurance products to the Company's individual customers and small business customers. These insurance products are: private passenger automobile, which is the Company's primary business, and related insurance products such as homeowners, commercial automobile and commercial property. These insurance products are primarily sold to the Company's individual customers and small business customers, which increases retention of the Company's private personal automobile client base. The insurance products comprising the Property and Casualty business segment are sold through the same distribution channels, mainly through independent and 100% owned insurance agents, and go through a similar underwriting process.

### Other Lines

The Other business segment represents net premiums written and earned from an operating segment that does not meet the quantitative thresholds required to be considered a reportable segment. This operating segment offers automobile mechanical protection warranties which are primarily sold through automobile dealerships and credit unions.

The following table presents operating results by reportable segment for the years ended:

	Year Ended December 31,								
	2018			2017			2016		
	Property & Casualty	Other	Total	Property & Casualty	Other	Total	Property & Casualty	Other	Total
	(Amounts in millions)								
Net premiums earned	\$3,337.9	\$30.5	\$3,368.4	\$3,160.9	\$34.5	\$3,195.4	\$3,089.9	\$41.9	\$3,131.8
Less:									
Losses and loss adjustment expenses	2,562.0	14.8	2,576.8	2,427.8	17.1	2,444.9	2,333.2	21.9	2,355.1
Underwriting expenses	802.7	14.1	816.8	773.1	15.6	788.7	780.4	17.5	797.9
Underwriting (loss) gain	(26.8 )	1.6	(25.2 )	(40.0 )	1.8	(38.2 )	(23.7 )	2.5	(21.2 )
Investment income			135.8			124.9			121.9
Net realized investment (losses) gains			(133.5 )			83.7			(34.3 )
Other income			9.3			11.9			8.3
Interest expense			(17.0 )			(15.2 )			(4.0 )
Pre-tax (loss) income			\$(30.6 )			\$167.1			\$70.7
Net (loss) income			\$(5.7 )			\$144.9			\$73.0

The following table presents the Company's net premiums earned and direct premiums written by line of insurance business for the years ended:

	Year Ended December 31,								
	2018			2017			2016		
	Property & Casualty	Other	Total	Property & Casualty	Other	Total	Property & Casualty	Other	Total
	(Amounts in millions)								
Private passenger automobile	\$2,602.1	\$—	\$2,602.1	\$2,473.8	\$—	\$2,473.8	\$2,435.7	\$—	\$2,435.7
Homeowners	459.4	—	459.4	431.6	—	431.6	414.0	—	414.0
Commercial automobile	190.1	—	190.1	171.9	—	171.9	161.3	—	161.3
Other	86.3	30.5	116.8	83.6	34.5	118.1	78.9	41.9	120.8
Net premiums earned	\$3,337.9	\$30.5	\$3,368.4	\$3,160.9	\$34.5	\$3,195.4	\$3,089.9	\$41.9	\$3,131.8
Private passenger automobile	\$2,703.6	\$—	\$2,703.6	\$2,480.0	\$—	\$2,480.0	\$2,452.7	\$—	\$2,452.7
Homeowners	524.9	—	524.9	469.9	—	469.9	436.9	—	436.9
Commercial automobile	198.5	—	198.5	178.2	—	178.2	166.1	—	166.1
Other	97.2	26.7	123.9	92.9	27.9	120.8	89.0	27.3	116.3
Direct premiums written	\$3,524.2	\$26.7	\$3,550.9	\$3,221.0	\$27.9	\$3,248.9	\$3,144.7	\$27.3	\$3,172.0

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure  
None

Item 9A. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

#### Management's Report on Internal Control Over Financial Reporting

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework (2013). Based upon its assessment, the Company's management believes that, as of December 31, 2018, the Company's internal control over financial reporting is effective based on these criteria.

KPMG LLP, the independent registered public accounting firm that audited the consolidated financial statements included in this 2018 Annual Report on Form 10-K, has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2018, which is included herein.

#### Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

#### Item 9B. Other Information

None

PART III

Item 10. Directors, Executive Officers, and Corporate Governance

Item 11. Executive Compensation

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13. Certain Relationships and Related Transactions, and Director Independence

Item 14. Principal Accounting Fees and Services

Information regarding executive officers of the Company is included in Part I. For other information called for by Items 10, 11, 12, 13 and 14, reference is made to the Company's definitive proxy statement for its Annual Meeting of Shareholders, which will be filed with the SEC within 120 days after December 31, 2018 and which is incorporated herein by reference.

## PART IV

## Item 15. Exhibits and Financial Statement Schedules

The following documents are filed as a part of this report:

1. Financial Statements: The Consolidated Financial Statements for the year ended December 31, 2018 are contained herein as listed in the Index to Consolidated Financial Statements on page 53.

2. Financial Statement Schedules:

Report of Independent Registered Public Accounting Firm

Schedule I—Summary of Investments—Other than Investments in Related Parties

Schedule II—Condensed Financial Information of Registrant

Schedule IV—Reinsurance

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or Notes thereto.

## 3. Exhibits

Form 10-K Exhibit No.	Description of Exhibit	If Incorporated by Reference, Documents with Which Exhibit was Previously Filed with the SEC
3.1	<u>Articles of Incorporation of the Company, as amended to date.</u>	<u>This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.</u>
3.2	<u>Amended and Restated Bylaws of the Company.</u>	<u>This document was filed as an exhibit to Registrant's Form 10-O for the quarterly period ended September 30, 2007, and is incorporated herein by this reference.</u>
3.3	<u>First Amendment to Amended and Restated Bylaws of the Company.</u>	<u>This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 4, 2008, and is incorporated herein by this reference.</u>
3.4	<u>Second Amendment to Amended and Restated Bylaws of the Company.</u>	<u>This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on February 25, 2009, and is incorporated herein by this reference.</u>
4.1	Shareholders' Agreement dated as of October 7, 1985 among the Company, George Joseph and Gloria Joseph.	This document was filed as an exhibit to Registrant's Registration Statement on Form S-1, File No. 33-899, and is incorporated herein by this reference. (Not available on the SEC website. Filed prior to the SEC Edgar filing mandate).
4.2	<u>Indenture, dated as of March 8, 2017, between Mercury General Corporation and Wilmington Trust, National Association.</u>	<u>This document was filed as an exhibit to Registrant's Form 8-K, filed with the Securities and Exchange Commission on March 8, 2017, and is incorporated herein by this reference.</u>
4.3	<u>First Supplemental Indenture, dated as of March 8, 2017, between Mercury General Corporation and Wilmington Trust, National Association.</u>	<u>This document was filed as an exhibit to Registrant's Form 8-K, filed with the Securities and Exchange Commission on March 8, 2017, and is incorporated herein by this reference.</u>
10.1*	Profit Sharing Plan, as Amended and Restated as of March 11, 1994.	This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1993, and is incorporated herein by this reference. (Not available on the SEC website. Filed prior to the SEC Edgar filing mandate).
10.2*	Amendment 1994-I to the Mercury General Corporation Profit Sharing Plan.	This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference. (Not available on the SEC



website. Filed prior to the SEC Edgar filing mandate).

- 10.3\* Amendment 1994-II to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1994, and is incorporated herein by this reference. (Not available on the SEC website. Filed prior to the SEC Edgar filing mandate).
- 10.4\* Amendment 1996-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.
- 10.5\* Amendment 1997-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1996, and is incorporated herein by this reference.
- 10.6\* Amendment 1998-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and is incorporated herein by this reference.
- 10.7\* Amendment 1999-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.
- 10.8\* Amendment 1999-II to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1999, and is incorporated herein by this reference.
- 10.9\* Amendment 2001-I to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.
- 10.10\* Amendment 2002-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.
- 10.11\* Amendment 2002-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2002, and is incorporated herein by this reference.
- 10.12\* Amendment 2003-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.
- 10.13\* Amendment 2004-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2004, and is incorporated herein by this reference.
- 10.14\* Amendment 2006-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2007, and is incorporated herein by this reference.
- 10.15\* Amendment 2006-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.
- 10.16\* Amendment 2007-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2007, and is incorporated herein by this reference.
- 10.17\* Amendment 2008-1 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.
- 10.18\* Amendment 2008-2 to the Mercury General Corporation Profit Sharing Plan. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2008, and is incorporated herein by this reference.
- 10.19\*

- |  |   |
|--|---|
| <u>Amendment 2009-1 to the Mercury General Corporation Profit Sharing Plan.</u>        | <u>This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2009, and is incorporated herein by this reference.</u> |
| 10.20* <u>Amendment 2009-2 to the Mercury General Corporation Profit Sharing Plan.</u> | <u>This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2009, and is incorporated herein by this reference.</u> |
| 10.21* <u>Amendment 2011-1 to the Mercury General Corporation Profit Sharing Plan.</u> | <u>This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2011, and is incorporated herein by this reference.</u> |

10.22\* Amendment 2013-1 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2013, and is incorporated herein by this reference.

10.23\* Amendment 2014-1 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference.

10.24\* Amendment 2014-2 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference.

10.25\* Amendment 2015-1 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2015, and is incorporated herein by this reference.

10.26\* Amendment 2015-2 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2015, and is incorporated herein by this reference.

10.27\* Amendment 2017-1 to the Mercury General Corporation Profit Sharing Plan.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2018, and is incorporated herein by this reference.

10.28\* Amendment 2019-1 to the Mercury General Corporation Profit Sharing Plan.  
Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Casualty Company, Mercury Insurance Company, California Automobile Insurance Company and California General Insurance Company.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.30 Expense Reimbursement and Services Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and American Mercury Insurance Company.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.31 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Georgia.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.32 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Georgia.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.33 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Insurance Company of Illinois.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein by this reference.

10.34 Management Agreement effective January 1, 2001 between Mercury Insurance Services, LLC and Mercury Indemnity Company of Illinois.

This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2000, and is incorporated herein

- 10.35 Management Agreement effective January 1, 2002 between Mercury Insurance Services, LLC and Mercury Insurance Company of Florida and Mercury Indemnity Company of Florida. by this reference.  
This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2001, and is incorporated herein by this reference.
- 10.36 Management Agreement dated January 22, 1997 between Mercury County Mutual Insurance Company and Mercury Insurance Services, LLC. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2006, and is incorporated herein by this reference.  
This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 10, 2013, and is incorporated herein by this reference.
- 10.37\* Mercury General Corporation Senior Executive Incentive Bonus Plan. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on November 1, 2010, and is incorporated herein by this reference.  
This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 16, 2005, and is incorporated herein by this reference.
- 10.38\* Amended and Restated Mercury General Corporation 2005 Equity Incentive Award Plan.
- 10.39\* Form of Incentive Stock Option Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan.

- 10.40\* Form of Restricted Stock Unit Award Agreement under the Mercury General Corporation 2005 Equity Incentive Award Plan. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on October 5, 2010, and is incorporated herein by this reference.
- 10.41\* Mercury General Corporation Annual Incentive Plan. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on May 2, 2011, and is incorporated herein by this reference.
- 10.42\* Mercury General Corporation 2015 Incentive Award Plan This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.43\* Form of Restricted Stock Unit Agreement under the Mercury General Corporation 2015 Incentive Award Plan This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.44\* Form of Stock Option Agreement under the Mercury General Corporation 2015 Incentive Award Plan This document was filed as an exhibit to Registrant's Form S-8 filed with the Securities and Exchange Commission on February 20, 2015 (File No. 333-202204), and is incorporated herein by this reference.
- 10.45\* Form of Restricted Stock Unit Agreement under the Mercury General Corporation 2015 Incentive Award Plan (2016 and later version). This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on March 23, 2016, and is incorporated herein by this reference.
- 10.46 Credit Agreement, dated as of March 29, 2017, by and among Mercury General Corporation, Bank of America, as Administrative Agent, and the Lenders party thereto. This document was filed as an exhibit to Registrant's Form 8-K filed with the Securities and Exchange Commission on April 3, 2017, and is incorporated herein by this reference.
- 10.47\* Separation Agreement and General Release, effective May 24, 2018, by and between Allan Lubitz and Mercury Insurance Services, LLC. This document was filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended June 30, 2018, and is incorporated herein by this reference.
- 21.1 Subsidiaries of the Company. This document was filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 2014, and is incorporated herein by this reference.
- 23.1 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Annual Report on Form 10-K and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document

101.CALXBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LABXBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

\* Denotes management contract or compensatory plan or arrangement.



## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MERCURY GENERAL  
CORPORATION

BY/S/ GABRIEL TIRADOR  
Gabriel Tirador  
President and Chief Executive Officer  
February 13, 2019

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/S/ GEORGE JOSEPH George Joseph	Chairman of the Board	February 13, 2019
/S/ GABRIEL TIRADOR Gabriel Tirador	President and Chief Executive Officer and Director (Principal Executive Officer)	February 13, 2019
/S/ THEODORE R. STALICK Theodore R. Stalick	Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	February 13, 2019
/S/ GEORGE G. BRAUNEGG George G. Braunegg	Director	February 13, 2019
/S/ RAMONA L. CAPPELLO Ramona L. Cappello	Director	February 13, 2019
/S/ JAMES G. ELLIS James G. Ellis	Director	February 13, 2019
/S/ JOSHUA E. LITTLE Joshua E. Little	Director	February 13, 2019
/S/ MARTHA E. MARCON Martha E. Marcon	Director	February 13, 2019



## SCHEDULE I

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES  
DECEMBER 31, 2018

Type of Investment	Cost	Fair Value	Amounts in the Balance Sheet
	(Amounts in thousands)		
Fixed maturity securities:			
U.S. government bonds	\$25,131	\$25,003	\$ 25,003
Municipal securities	2,599,056	2,620,132	2,620,132
Mortgage-backed securities	30,640	30,952	30,952
Corporate securities	107,479	105,524	105,524
Collateralized loan obligations	169,626	165,789	165,789
Other asset-backed securities	37,609	37,761	37,761
Total fixed maturity securities	2,969,541	2,985,161	2,985,161
Equity securities:			
Common stock	438,504	430,973	430,973
Non-redeemable preferred stock	34,429	31,433	31,433
Private equity fund	1,481	1,445	1,445
Private equity fund measured at net asset value <sup>(1)</sup>	69,668	65,780	65,780
Total equity securities	544,082	529,631	529,631
Short-term investments	254,518	253,299	253,299
Total investments	\$3,768,141	\$3,768,091	\$ 3,768,091

<sup>(1)</sup> The fair value is measured using the NAV practical expedient. See Note 4. Fair Value Measurements of the Notes to Consolidated Financial Statements for additional information.

See accompanying Report of Independent Registered Public Accounting Firm  
S-1

## SCHEDULE I, Continued

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES  
DECEMBER 31, 2017

Type of Investment	Cost	Fair Value	Amounts in the Balance Sheet
	(Amounts in thousands)		
Fixed maturity securities:			
U.S. government bonds and agencies	\$13,355	\$13,236	\$13,236
Municipal securities	2,490,150	2,556,532	2,556,532
Mortgage-backed securities	26,454	27,165	27,165
Corporate securities	136,013	137,542	137,542
Collateralized loan obligations	104,323	105,202	105,202
Other asset-backed securities	52,935	53,100	53,100
Total fixed maturity securities	2,823,230	2,892,777	2,892,777
Equity securities:			
Common stock	368,619	429,367	429,367
Non-redeemable preferred stock	34,429	34,869	34,869
Private equity fund	1,481	1,481	1,481
Private equity fund measured at net asset value <sup>(1)</sup>	69,668	71,523	71,523
Total equity securities	474,197	537,240	537,240
Short-term investments	302,693	302,711	302,711
Total investments	\$3,600,120	\$3,732,728	\$3,732,728

<sup>(1)</sup> The fair value is measured using the NAV practical expedient. See Note 4. Fair Value Measurements of the Notes to Consolidated Financial Statements for additional information.

See accompanying Report of Independent Registered Public Accounting Firm  
S-2

---

## SCHEDULE II

MERCURY GENERAL CORPORATION  
 CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
 BALANCE SHEETS

	December 31,	
	2018	2017
	(Amounts in thousands)	
<b>ASSETS</b>		
Investments, at fair value:		
Equity securities (cost \$110,279; \$113,216)	\$119,037	\$141,227
Short-term investments (cost \$3,166; \$21,233)	3,166	21,231
Investment in subsidiaries	1,850,582	1,976,400
Total investments	1,972,785	2,138,858
Cash	24,140	8,475
Accrued investment income	161	178
Amounts receivable from affiliates	1,172	231
Current income taxes	—	8,857
Income tax receivable from affiliates	19,225	6,338
Other assets	446	663
Total assets	\$2,017,929	\$2,163,600
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Notes payable	\$371,734	\$371,335
Accounts payable and accrued expenses	25	—
Amounts payable to affiliates	3,082	507
Income tax payable to affiliates	580	17,213
Current income taxes	17,773	—
Deferred income taxes	1,691	8,242
Other liabilities	5,360	4,916
Total liabilities	400,245	402,213
Commitments and contingencies		
Shareholders' equity:		
Common stock	98,026	97,523
Retained earnings	1,519,658	1,663,864
Total shareholders' equity	1,617,684	1,761,387
Total liabilities and shareholders' equity	\$2,017,929	\$2,163,600

See accompanying notes to condensed financial information.

See accompanying Report of Independent Registered Public Accounting Firm

S-3

---

## SCHEDULE II, Continued

MERCURY GENERAL CORPORATION  
 CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
 STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Revenues:			
Net investment income	\$4,661	\$4,090	\$4,032
Net realized investment (losses) gains	(10,797)	19,279	6,062
Other	2	—	17
Total revenues	(6,134)	23,369	10,111
Expenses:			
Other operating expenses	2,343	1,918	2,673
Interest	17,036	14,856	2,690
Total expenses	19,379	16,774	5,363
(Loss) income before income taxes and equity in net income of subsidiaries	(25,513)	6,595	4,748
Income tax (benefit) expense	(5,144)	1,572	8,514
(Loss) income before equity in net income of subsidiaries	(20,369)	5,023	(3,766)
Equity in net income of subsidiaries	14,641	139,854	76,810
Net (loss) income	\$(5,728)	\$144,877	\$73,044

See accompanying notes to condensed financial information.

See accompanying Report of Independent Registered Public Accounting Firm

S-4

## SCHEDULE II, Continued

MERCURY GENERAL CORPORATION  
CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2018	2017	2016
	(Amounts in thousands)		
Cash flows from operating activities:			
Net cash (used in) provided by operating activities	\$(16,108)	\$(14,503)	\$4,731
Cash flows from investing activities:			
Capital contribution to subsidiaries	(541 )	(140,125 )	(30,125 )
Distributions received from special purpose entities	5,998	5,243	4,898
Dividends received from subsidiaries	135,000	109,000	110,800
Fixed maturity securities available for sale in nature:			
Purchases	—	—	(1,060 )
Sales	—	1,614	—
Equity securities available for sale in nature:			
Purchases	(22,286 )	(22,406 )	(64,807 )
Sales	33,052	18,876	73,942
Calls	—	4,000	—
Decrease (increase) in short-term investments	18,065	(20,607 )	515
Other, net	605	310	1,614
Net cash provided by (used in) investing activities	169,893	(44,095 )	95,777
Cash flows from financing activities:			
Dividends paid to shareholders	(138,478 )	(137,886 )	(137,201 )
Employee taxes paid with shares related to share-based compensation	—	—	(3,292 )
Proceeds from stock options exercised	358	2,162	1,632
Net proceeds from issuance of senior notes	—	371,011	—
Payoff of principal on loan and credit facilities	—	(180,000 )	—
Proceeds from bank loan	—	—	30,000
Net cash (used in) provided by financing activities	(138,120 )	55,287	(108,861 )
Net increase (decrease) in cash	15,665	(3,311 )	(8,353 )
Cash:			
Beginning of year	8,475	11,786	20,139
End of year	\$24,140	\$8,475	\$11,786
SUPPLEMENTAL CASH FLOW DISCLOSURE			
Interest paid	\$16,586	\$9,435	\$2,397
Income taxes paid (refunded), net	\$4,296	\$346	\$(339 )

See accompanying notes to condensed financial information.

See accompanying Report of Independent Registered Public Accounting Firm

S-5



MERCURY GENERAL CORPORATION  
CONDENSED FINANCIAL INFORMATION OF REGISTRANT  
NOTES TO CONDENSED FINANCIAL INFORMATION

The accompanying condensed financial information should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report.

Distributions received from Special Purpose Entities

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle, formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$31 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest equal to LIBOR plus 128 basis points prior to the renewal of the agreement in January 2018 and LIBOR plus 120 basis points subsequent to the January 2018 renewal through July 2018, on approximately \$100 million of underlying obligations as of December 31, 2018 and 2017. The agreement had an initial term of one year, subject to periodic renewal. In July 2018, the agreement was renewed through January 24, 2020, and the interest rate was changed to LIBOR plus 105 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle, formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which was renewed for an additional one-year term through February 17, 2018. The total portfolio of underlying obligations was liquidated during June 2017, and the total return swap agreement between AFL and Citibank was terminated on July 7, 2017. Under the agreement, AFL received the income equivalent on underlying obligations due to Citibank and paid to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap was secured by approximately \$40 million of U.S. Treasuries as collateral, which were included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 135 basis points prior to the amendment of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the amendment until June 2017, on approximately \$152 million of underlying obligations as of December 31, 2016.

Distributions of \$6.0 million and \$5.2 million were received in 2018 and 2017, respectively, from these special purpose entities.

Dividends received from Subsidiaries

Dividends of \$135,000,000, \$109,000,000 and \$110,800,000 were received by Mercury General from its 100% owned insurance subsidiaries in 2018, 2017 and 2016, respectively, and are recorded as a reduction to investment in subsidiaries.

Capitalization of Insurance Subsidiaries

Mercury General made capital contributions to its insurance subsidiaries of \$541,000, \$140,125,000 and \$30,125,000 in 2018, 2017 and 2016, respectively.

Notes Payable

On March 8, 2017, Mercury General completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured senior obligations of Mercury General, with a 4.4% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The Company used the proceeds from the notes to pay off the total outstanding balance of \$320 million under the existing loan and credit facility agreements and terminated the agreements on March 8, 2017. The remainder of the proceeds from the notes was used for general corporate purposes. Mercury General incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective

annualized interest rate, including debt issuance costs, of approximately 4.45%.

Commitments and Contingencies

On March 29, 2017, Mercury General entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's

See accompanying Report of Independent Registered Public Accounting Firm  
S-6

---

debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 18.8% at December 31, 2018, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of February 7, 2019, there have been no borrowings under this facility.

#### Federal Income Taxes

The Company files a consolidated federal income tax return for the following entities:

Mercury Casualty Company	Mercury County Mutual Insurance Company
Mercury Insurance Company	Mercury Insurance Company of Florida
California Automobile Insurance Company	Mercury Indemnity Company of America
California General Underwriters Insurance Company, Inc.	Mercury Select Management Company, Inc.
Mercury Insurance Company of Illinois	Mercury Insurance Services LLC
Mercury Insurance Company of Georgia	AIS Management LLC
Mercury Indemnity Company of Georgia	Auto Insurance Specialists LLC
Mercury National Insurance Company	PoliSeek AIS Insurance Solutions, Inc.
American Mercury Insurance Company	Animas Funding LLC
American Mercury Lloyds Insurance Company	Fannette Funding LLC
Workmen's Auto Insurance Company	

The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses incurred by the insurance subsidiaries to the extent it can be used in the current consolidated return.

SCHEDULE IV  
 MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 REINSURANCE  
 THREE YEARS ENDED DECEMBER 31,  
 Property and Liability Insurance Earned Premiums

	2018	2017	2016
	(Amounts in thousands)		
Direct amounts	\$3,416,687	\$3,221,493	\$3,146,864
Ceded to other companies	(48,941 )	(26,881 )	(15,846 )
Assumed	665	825	755
Net amounts	\$3,368,411	\$3,195,437	\$3,131,773

See accompanying Report of Independent Registered Public Accounting Firm  
 S-8