S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL

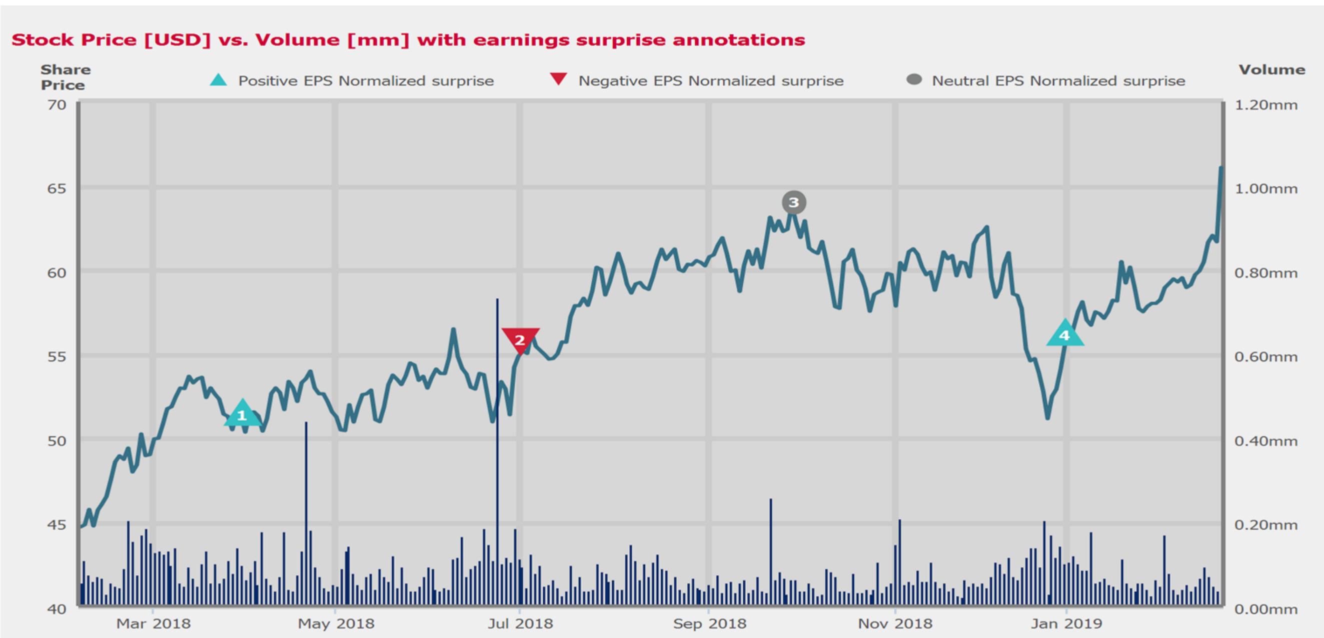
FQ4 2018 Earnings Call Transcripts

Friday, February 22, 2019 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2018-			-FQ1 2019-	-FY 2018-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.43	0.46	6.98	0.50	1.79	1.79
Revenue (mm)	60.61	56.90	(6.12 %)	62.46	222.33	222.11

Currency: USD
Consensus as of Feb-22-2019 8:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2018	0.37	0.38	1 2.70 %
FQ2 2018	0.49	0.46	2 (6.12 %)
FQ3 2018	0.49	0.49	3 0.00 %
FQ4 2018	0.43	0.46	4 6.98 %

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Call Participants

EXECUTIVES

Brian Donald Haney
Senior VP & COO

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Michael Patrick Kehoe
President & CEO

ANALYSTS

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Fourth Quarter 2018 Kinsale Capital Group, Inc.'s Conference Call. [Operator Instructions]

Before we get started, let me remind everyone that through the course of the teleconference, Kinsale's management may make comments that reflect their intentions, beliefs, expectations for the future. As always, these forward-looking statements are subject to certain risk factors, which could cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including in the 2017 Annual Report on Form 10-K, which should be reviewed carefully. The company has furnished a Form 8-K with the Securities and Exchange Commission that contains the press release announcing its fourth quarter results.

Kinsale's management may also reference certain non-GAAP financial measures in the call today. A reconciliation of the GAAP to these measures can be found in the press release, which is available at the company's website at www.kinsalecapitalgroup.com.

I will now need to turn the conference over to Kinsale's President and CEO, Mr. Michael Kehoe. Please go ahead, sir.

Michael Patrick Kehoe
President & CEO

Good morning, everyone, and thank you for joining us today. With me are Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer.

After a few introductory comments by me, Bryan Petrucelli will review Kinsale's financial highlights for the quarter; and then Brian Haney is going to provide some commentary on our quarterly performance and discuss our market outlook. After that, we'll follow-up with any questions you may have.

Just as a reminder, the Kinsale strategy combines disciplined underwriting and claim handling with technology-enabled low costs to deliver attractive returns and growth. We focus on smaller and sometimes hard to place accounts within the excess and surplus lines market. And unlike competitors, we maintain absolute control over the underwriting and the claim management process and do not outsource those functions to external parties. We believe these strategies help Kinsale drive attractive loss ratios.

Further, Kinsale uses proprietary technology and automation combined with an owner-operator business culture to operate at a significant expense advantage over many larger competitors. And the combination of disciplined underwriting with low costs is an endgame winner every time.

For the fourth quarter, Kinsale posted strong growth and profitability. With a combined ratio of 87.1% for the quarter and 85.3% for the year, we generated a 15.4% operating return on equity for the year 2018. And as a reminder, our forward guidance is a mid-80s combined ratio and a mid-teens operating return on equity.

The 87.1% combined ratio for the fourth quarter was slightly elevated by the $5 million pretax loss on Hurricane Michael in October. Note we had previously estimated this loss as $4 million pretax, developed slightly higher since we issued that estimate in early November.

Gross premiums -- gross written premiums grew by almost 27% for the fourth quarter and by 23.5% for the full year. This strong growth rate is driven by the strength of Kinsale's business model and by the ongoing dislocation within the excess and surplus lines market. And we expect this dislocation to continue for the near term.

And with that, I'm going to turn it over to Bryan Petrucelli.

Bryan Paul Petrucelli

Senior VP, Treasurer & CFO

Thanks, Mike. The results for the fourth quarter and the full year were strong and generally in line with expectations. We continue to generate market-leading combined ratios and believe demonstrates the strength of our low-cost model irrespective of market conditions.

We reported net income of $4.5 million for the fourth quarter of 2018, down slightly from $5.9 million for the fourth quarter of last year, and it's due primarily to Hurricane Michael, as Mike just mentioned, and the impact from unrealized losses related to our equity securities that are now reported through the income statement as a result of the GAAP accounting rule change in 2018. The decrease was mitigated somewhat by a lower effective tax rate in 2018 and a charge in 2017 related to the enactment of the Tax Reform Act.

Net operating earnings increased by 29.8% to $10.1 million compared to $7.8 million in the fourth quarter of last year. The increase in operating earnings was largely driven by the lower effective tax rate in 2018 and the tax charge last year that I just mentioned. Our effective income tax rate was 16.5% for the full year of 2018 compared to 35.4% last year, and lower primarily due to the Tax Reform Act and tax benefits from the exercise of stock options and interest on our tax-exempt investments.

The company generated underwriting income of $7.7 million and a combined ratio of 87.1% compared to $8 million and 83.1% for the fourth quarter of last year. The combined ratio for the fourth quarter of 2018 included 2.2 points from net favorable prior year loss reserve development compared to 1.1 points from net unfavorable prior year loss reserve development last year.

Cat activity this quarter contributed 8.7 points to the combined ratio compared to 1.8 points in the fourth quarter of 2017. The year-to-date combined ratio of 85.3% included 2.7 points from cat losses and benefited from 3.3 points of net favorable prior year loss reserve development compared to a combined ratio of 84% last year that included 5.1 points from cat losses and 6.4 points from net favorable prior year loss reserve development.

Annualized operating return on equity of 15.5% for the fourth quarter of 2018 and 15.4% for the full year of 2018 was in line with our mid-teens guidance compared to 13.2% for the fourth quarter and 11.9% for the full year last year.

Gross written premiums were $72.1 million, representing 27% over the fourth quarter of 2017, and year-to-date, as Mike mentioned, written premiums have increased 23.5% over last year. Increases continue to be generated from an overall increase in underwriting activity across most lines of business and due to the reasons Mike mentioned previously, including improved market conditions. Brian Haney will get into this in a little more detail here shortly.

On the investment side, no significant change in strategy, and net investment income increased by 48.8% over the fourth quarter of last year to $4.6 million, up from $3.1 million last year and as a result of discontinued growth in the investment portfolio and rising interest rates. Gross investment returns increased to 3% from 2.4% last year. Basic and diluted operating EPS were $0.20 and $0.40 per share, respectively, for the quarter -- fourth quarter 2018 compared to $0.27 and $0.36 per share last year.

And with that, I'll pass it over to Brian Haney.

Brian Donald Haney
Senior VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 27% in the fourth quarter, which is the highest rate of any quarter for the year and the highest growth rate in nearly 5 years.

Our allied health care, commercial property and management liability divisions continued to grow nicely as does our Inland Marine division. Our Aspera [indiscernible] 41% for the quarter.

Overall, submissions continue to increase at a strong pace. Submissions in the fourth quarter were up 22% over the fourth quarter of 2017. We look at submissions as a good leading indicator for growth rates going forward, and the vast majority of our 17 divisions have had and continue to have positive growth in submissions.

The growth rates in premium and submissions have encouraged us to be more assertive in pushing for rate increases. We have a very heterogenous mix of business so it is difficult to boil all the various rate movement down to one single number. But if we had to do that, we'd say the rate increase was somewhere in the 3% to 5% range and gradually accelerating. Certain lines like property have much stronger rate increases. We expect to keep pushing bigger rate increases going forward.

While it is tough for us to know exactly what is driving increased wealth business, I suspect that the announcement from many competitors of scaling back on certain programs or exiting certain programs all together has had something to do with it. As a reminder, we don't give out the pan to third parties. But when competitor programs are falling apart, we do tend to see a rush on submissions. Accounts which would previously not have been shopped due to the presence of an easily accessible, often underpriced program will tend to be shopped aggressively when the cheap insurance is no longer available. I've said in the past that I suspect we would continue to see more poor results coming out of the programs in the next few years. That's exactly what we've been seeing, and I suspect we are not done seeing it.

So we feel optimistic about the state of things. The acceleration of submission growth shows no signs of abating. Our simple yet effective business model, combined with our excellent systems, has well positioned us to take full advantage of the opportunities we are now seeing. We have a great team that is working hard to deliver superior returns to our investors, and I think the future seems very bright for us.

And with that, I'll turn it over to Mike.

Michael Patrick Kehoe
President & CEO
Thanks, Brian. Operator, we're now ready to field any questions in the queue.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Mark Hughes from SunTrust.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

The ceded premiums this quarter were down a bit sequentially. They were kind of steady year-over-year. The ratio was -- and I think usually, the property has higher ceded premiums if I remember correctly. And it sounds like you did well on commercial property in terms of top line growth, but still your ceded premiums were down. Was that more of a seasonal issue? Or is -- there's some other mix going on there?

Michael Patrick Kehoe
President & CEO

I think the ratio of ceded premiums is going to fluctuate almost exclusively with the mix of business. Our primary casualty business, we don't have any reinsurance on that book. The excess cash, really depending on the limits we cede, a very high percentage and the property is in the middle. So the mix of business is going to cause a little bit of a fluctuation there.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Okay, understood. The dislocation, does that include Lloyd's? Are you seeing movement there?

Michael Patrick Kehoe
President & CEO

Absolutely. Lloyd's and AIG, I think, have been the 2 big E&S writers. If you look at Lloyd's collectively, I think it was 23% market share in 2017. The 2018 statistics haven't been published yet, but AIG has always been the second largest writer of recent years, and they're both going through a lot of restructuring. But it's not limited to those 2 entities. I mean, there's all sorts of activity that you see in the trade press of companies trying to triage their books of business to improve profitability. And so I think that's -- for a healthy company that's been disciplined in its underwriting, it's a pretty favorable opportunity to not just grow the business but expand margins at the same time.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Your current accident year loss has -- really took a nice decline this quarter. I know in the past, you had a pattern of sort of being conservative upfront and seeing how the year develops. Did -- when you think about 2018, did you -- was this a function of a better loss experience or the better pricing kicking in that gave you that gain? Or was that your conservatism kind of playing out for the full year?

Michael Patrick Kehoe
President & CEO

I think it's mostly attributable to just the normal variability that you're going to have in reported losses. I think we're clearly focused on being conservative in how we reserve our book of business. That's a very explicit goal for us as a company. We want to set our reserves in a conservative fashion so that they're likely to develop favorably in the years ahead. And if you look at our track record now over 9 accident years, all of our accident years have developed favorably, except for the 2011 year, which was a very modest size year. It was our first full year in business. So no change in our strategy of being conservative. I think any kind of variation from quarter-to-quarter, even year-to-year, which is the kind of the -- within the normal bounds of variability.

Mark Douglas Hughes

SunTrust Robinson Humphrey, Inc., Research Division

Then a final quick one, Bryan, what's the best tax rate to use for 2019?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Yes, Mark. It's a little tough to tell because what really drives that variability from quarter-to-quarter is the volume of stock options that are exercised over many periods. I think what you typically see is that there's -- tends to be more activity in the second half of the year than the first. So I think the best way to look at it is to look at that annual rate and stick with that. I think it is going to bounce around from quarter-to-quarter just based on what I just said.

Operator

And our next question comes from Jeff Schmitt from William Blair.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

I believe you said growth of Aspera was 41%. Could you maybe discuss where that growth -- where you're seeing that growth and sort of what your outlook is for 2019?

Brian Donald Haney
Senior VP & COO

Well, we're seeing that through some geographic expansion. So we've entered a few new states recently. We're also seeing that expansion from getting into more commercial products. So the bulk of what we write now is personal lines. We do have the capability to write commercial lines within Aspera, and that has been growing as well. So it's really a combination of geographic expansion into a few new states and expansion of the commercial product line.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

What type of commercial products -- I'm sorry.

Michael Patrick Kehoe
President & CEO

Yes, I was just going to say I think our -- we view that as part of our growth story over the years ahead. It's grown from 0 to I think slightly below 5% of our total volume over the last couple of years, and we would expect that trajectory to continue.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

What type of commercial products are going through there?

Brian Donald Haney
Senior VP & COO

It's similar to what we write on the individual risk side within the other divisions. I would say they're smaller, though. So if you were to look at what the most -- the small business division within the rest of the company is most similar to what Aspera writes on the commercial side.

Jeffrey Paul Schmitt
William Blair & Company L.L.C., Research Division

Okay. And then cash and cash equivalents continues to be pretty high at the current $75 million. What's the strategy there? I mean, are you thinking of M&A opportunities? Or why wouldn't that be put to work in the investment portfolio?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

I think it's just holding onto it, looking for the best investment opportunities we can have. We have no expectation of M&A in the foreseeable future.

Michael Patrick Kehoe
President & CEO

Yes. Our strategy -- this is Mike Kehoe, Jeff. Our strategy is to grow organically. We think we've got a very competitive model with our expense advantage, with our focus on a fairly defined niche, use of automation to drive kind of best-in-class service levels. We think we can grow at a healthy clip without any kind of dealmaking.

Operator

[Operator Instructions] And our next question comes from Scott Heleniak from RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Just the first question, I wanted to follow up a little bit on the dislocation that you're seeing. If you could talk a little bit more about some of the specific areas. I know you mentioned Lloyd's and AIG, but are there any particular lines that come to mind that sort of stick out there? And did you see a big change in that, an increase in the dislocation Q4 versus Q3?

Brian Donald Haney
Senior VP & COO

I would say -- this is Brian Haney. I would say in our allied health lines, we're definitely seeing an uptick in the last 12 months. I would say versus last quarter, it's similar. But versus last year, I think it's much more favorable for us. Commercial property, I think, still is continuing to benefit from the effects of all the catastrophes. So again, that's one where it's no more dislocated, if you will, than it was last quarter, but a lot more so than it would've been 1.5 years ago. Those are really the ones that jump to mind, the biggest ones.

Michael Patrick Kehoe
President & CEO

One thing I can think of is there's a headline a month or so ago, where AIG announced they were going to discontinue about half of their program book, and that probably covers a whole range of different coverages and lines of business. So I think it's a broad reassessment of profitability across the industry, and it's a good tailwind for a company like Kinsale.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Yes. And so are you seeing -- is your appetite a little bit bigger now in the property side just given kind of the change in market conditions than it was maybe a few years ago and just on the pricing side, the dislocation that you're seeing?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Yes. I wouldn't say our appetite is about any bigger. It's probably smaller. It's just we're seeing a lot more opportunities and getting a lot more quotes out and just writing a lot more. But yes, we're not getting more expense than what we're willing to write.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Right, okay. And I wanted to follow up on a comment, Brian, you made a couple quarters ago about some opportunities to write some larger account business than you had seen before. And I was wondering if you -- I know you didn't mention it in Q3, but wondering if you saw that again in Q4 and that some of the growth drivers is also just seeing the bigger premium accounts than maybe you had a few years ago.

Brian Donald Haney
Senior VP & COO

Yes. Keep in mind, large accounts are a small percentage of what we do. So it's never going to -- the bread and butter, what we do is always going to be small accounts. That being said, it was a -- we have seen a trend that there's just a lot more of those accounts available. We're very selective when we look at large accounts because they still tend to draw irrational competition. That all being said, fourth quarter of 2018 was better for us in terms of premium and large accounts than fourth quarter of 2017.

Scott Gregory Heleniak
RBC Capital Markets, LLC, Research Division

Okay, that's fair. And then, I guess, the last question I have was just the -- so you have the 17 divisions now and is there any plans to expand that into some new areas for '19 or '20? I know that there's probably not anything to announce, but anything you can share on that front or just keep growing on -- in the lines you're in right now?

Michael Patrick Kehoe
President & CEO

I think part of being an E&S company is you're always looking for new opportunities. I mean, it's a very dynamic market in which we work and focus. But given the strong top line growth across our portfolio, there's probably a little bit more of a focus on -- a slightly more focus on just growing the business that we're already targeting. We're also putting a lot of effort into system development and process improvement. And that's an area of emphasis that's not so much expanding the product line, it's just being more efficient and smarter about how we handle the current business. So that's kind of our near-term focus.

Operator

And I'm not showing any further questions. I would now like to turn the call back to President and CEO, Mr. Michael Kehoe, for any further remarks.

Michael Patrick Kehoe
President & CEO

Okay. Thank you, operator, and thanks, everybody, for joining us and we look forward to speaking with you again in a few months after the first quarter. Have a good day.

Operator
Ladies and gentlemen, thank you for your participation in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.