S&P Global
Market Intelligence

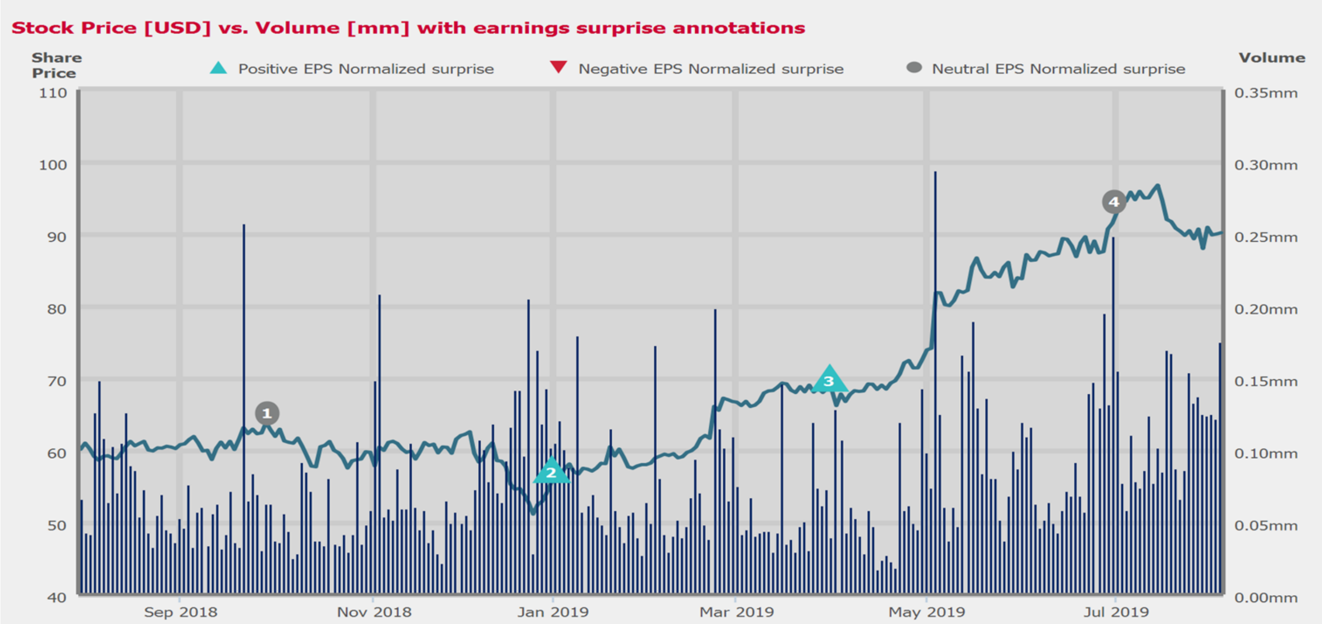
Kinsale Capital Group, Inc.
NasdaqGS:KNSL
FQ2 2019 Earnings Call Transcripts

Friday, August 02, 2019 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2019-			-FQ3 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.56	0.57	0.00	0.60	2.46	2.68
Revenue (mm)	69.56	72.57	4.33	73.10	277.82	334.25

Currency: USD
Consensus as of Aug-02-2019 10:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2018	0.49	0.49	1 0.00 %
FQ4 2018	0.43	0.46	2 6.98 %
FQ1 2019	0.50	0.64	3 25.49 %
FQ2 2019	0.56	0.57	4 0.00 %

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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 & Director

ANALYSTS

Adam Klauber
William Blair & Company L.L.C., Research Division

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

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

Presentation

Operator

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 and 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 the 2018 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 second quarter results.

Kinsale's management may also reference certain non-GAAP financial measures in the call today. A reconciliation of 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 turn the call over to Kinsale's President and CEO, Mr. Michael Kehoe. Please go ahead, sir.

Michael Patrick Kehoe
President, CEO & Director

Thank you, operator, and thank you, everyone, for joining us this morning. Joining me today are both Bryan Petrucelli, Chief Financial Officer for Kinsale; and Brian Haney, Chief Operating Officer.

I'll begin the call with some introductory comments, and then Bryan Petrucelli will follow with our financial results, and then Brian Haney will follow him with a discussion of Kinsale's underwriting results and provide some market commentary. We will then follow up with any questions you may have.

As a reminder, Kinsale 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 claim management process, and we do not outsource those functions to external parties. We use proprietary technology and automation to operate at a significant expense advantage over many larger competitors. As we like to say, the combination of disciplined underwriting and low costs is an endgame winner every time.

For the second quarter, Kinsale posted strong profitability and growth. The combined ratio for the quarter was 84.8%, and the annualized operating return on equity for the quarter was 16.7%. These numbers are consistent with our forward guidance of a mid-teens return on equity and a mid-80s combined ratio. Premium growth for the quarter was 35.7%.

The growth we experienced in the second quarter was driven by Kinsale's business strategy in addition to the rising level of dislocation within the excess and surplus lines market. For comparison purposes, the 35.7% second quarter growth was up from 32.5% growth in the first quarter and 27% growth in the fourth quarter of 2018. If the improved -- if the improving pricing environment and growth prospects continue, in order for us to capitalize on these robust growth trends, there's a possibility we could raise a modest amount of equity capital before year-end.

Now I'll turn the call over to Bryan Petrucelli for the financial report.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Thanks, Mike. We had another strong quarter, and we continue to generate market-leading combined ratios and returns for our investors.

We reported net income of $13.8 million for the second quarter of 2019, an increase of 36% when compared to $10.1 million for the second quarter of 2019 (sic) [2018] and due primarily to growth in the business and increases in the fair value of our equity investments. Net operating earnings increased by 26% to $12.4 million compared to $9.9 million in the second quarter of last year. Our effective income tax rate was 17.4% for the first half of 2019 compared to 18.2% last year.

The company generated underwriting income of $10.1 million and a combined ratio of 84.8% compared to $8.4 million and 83.5% last year. The combined ratio for the second quarter of 2019 included 2.2 points from net favorable prior-year loss reserve development compared to 4.4 points from net favorable prior-year loss reserve development last year. Cat activity contributed 1 point to the second quarter 2019's combined ratio and was negligible last year.

Annualized operating return on equity was 16.7% for the second quarter and 18.4% on an annualized year-to-date basis. Gross written premiums were $94.9 million, representing a 36% increase over last year. And again, increases continued to be generated from an overall increase in underwriting activity across most lines of business and due to the reasons Mike already mentioned, including continued improvement in market conditions. Brian Haney will get in a little more detail here in a bit.

On the investment side, net investment income increased by 27% versus over the second quarter of 2019 (sic) [2018] to $4.8 million from $3.8 million last year as a result of continued growth in the investment portfolio. Gross investment returns increased to 3.2% from 2.9% for the first half of the year, and diluted operating EPS was $0.57 per share for the second quarter of 2019 compared to $0.46 per share last year and a $1.21 per share for the first half of 2019 compared to $0.83 last year.

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

Brian Donald Haney
Senior VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 36% in the second quarter. Most of our divisions grew. Our commercial property business, comprising the commercial property and Inland Marine divisions, was up 83% for the quarter off of a relatively small base. We are seeing a significant uptick in the market opportunity in that area.

We are pushing rates up materially in property and we are making an effort to get more quotes out and get them out faster. We are also seeing strong growth in our allied health care, management liability and environmental divisions, but the growth is widespread across many different divisions and classes of business. Our Aspera units were up 83% for the quarter -- I'm sorry, 38% for the quarter.

Submission growth was 28% for the second quarter. We continue to see substantial across-the-board increases in submission volume in most divisions. We are doing our best to keep up with the flow of submissions while keeping up our customer service levels, and for the most part, we are succeeding, but in some areas, the increase in submissions has been so dramatic that understandably, our capacity to get to all the submissions in our usual speedy manner has been affected. We continue to be assertive in seeking rate increases.

As a reminder, we have a very heterogeneous book of business, which complicates reducing all the rate movement to a single number, but all that being said, we see rates being up in the plus 5% to plus 7% range in the aggregate. We are seeing higher rate increases for property and lower increases for some professional lines.

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

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

Question and Answer

Operator

[Operator Instructions] And our first question comes from the line of Mark Hughes with SunTrust.

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

The development this quarter, 2 points. You had more last quarter, obviously. Any observations about the pace of development, maybe touching on any inflation in costs, frequency, severity? Was this just normal volatility? Or how should we look at it?

Michael Patrick Kehoe
President, CEO & Director

Yes. I would not look at that as any kind of secular trend. I think it was really just the normal volatility you get in the 90-day period in a smaller company.

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

The kind of dislocation, does that have to do with any acceleration in losses?

Michael Patrick Kehoe
President, CEO & Director

No. When we talk about dislocation, I think what we are talking about is some of the headlines you see in the trade press where companies are reacting to poor financial results by revising underwriting strategies; in some cases, reducing capacity; in some cases, stepping back from certain lines of business; in some cases, raising prices. You see some delegated underwriting arrangements under stress. That kind of dislocation really is the best word I can think for, right, is pretty therapeutic for an E&S company. I don't know if Brian Haney, do you have anything you want to add to that?

Brian Donald Haney
Senior VP & COO

No. I would just sort of just echo your comment. It's dislocation in other people's books of business that's kind of leading to what we're seeing. It's not -- what you saw in the losses was not dislocation coming out of our book.

Operator

[Operator Instructions] And our next question comes from the line of Jeff Schmitt with William Blair.

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

Looking at the adverse development of -- it looks to be about $6 million in the first half for kind of strengthening 2011 through '16. Are you just taking a more conservative approach? And you had referenced kind of an emergence of loss trends there. Can you maybe discuss what you're seeing there and why you did that?

Michael Patrick Kehoe
President, CEO & Director

Yes. This is Mike Kehoe. I would say the -- for a couple of years in a row now, we have gradually lengthened our reporting patterns to allow for a slower release of IBNR. Essentially, we're injecting a little bit of additional conservatism in how long we anticipate losses to emerge. And so when we change those estimates, it has the effect of showing up as adverse development on some of those older accident years in the quarter. Essentially, what it is, is I think -- maybe the best way to describe it is just adding a little bit of conservatism. I would probably -- it's probably prudent to remind everybody that on an inception-to-date basis, all of our accident years have developed favorably except one. So the 2011 year was our first full year in business, and obviously, it was a very small year. We definitely strive to be conservative in how we reserve. The goal is to set reserves that are more likely to develop favorably than unfavorably. And so in general, I think we've achieved that level of success, but we're constantly reacting to current results and adjusting reserves to, I think, maintain that level of conservatism.

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

Okay. And looking at -- obviously, submission growth is really high right now. And looking at your average premium per policy, it's still actually staying flat. So I guess are you -- is this dislocation really as some of the big guys pull back? Are competitors just moving upmarket and just leaving that much opportunity on the smaller accounts?

Michael Patrick Kehoe
President, CEO & Director

Brian Haney, do you want to take that?

Brian Donald Haney
Senior VP & COO

This is Brian Haney. Yes. I would say it's -- I would characterize it differently. I would say it's the -- a lot of the divisions that are growing the fastest at our company are the smaller divisions, the divisions that are focused on smaller accounts. But your hypothesis that it might be people moving upmarket is not unreasonable either, but I think it's more just a function of which divisions are growing rather than us focusing on smaller accounts.

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

Okay. And then obviously, the property lines in particular are doing really well. You even talked about both commercial property and Aspera. How much of that is rate? And what type of rate are you getting there?

Brian Donald Haney
Senior VP & COO

I mean, it's really tough to boil that small a book down to one number, but I would say those rates are well under the double-digit rate increases. So the commercial property book are 83%. So most of it is not rate, but the rate increase is very significant.

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

Is that the same for Aspera, too?

Brian Donald Haney
Senior VP & COO

Yes. Aspera took a very large double-digit -- high teens, probably around 20%, I think, rate increase a while back. So probably more of their growth is rates than would be the case for commercial property.

Operator

And our next question comes from the line of Adam Klauber with William Blair.

Adam Klauber
William Blair & Company L.L.C., Research Division

Just a follow-up or 2 on the growth. And I know you probably won't know exactly, but how much just ballpark is most of the new business coming from prior E&S market? Or is a good chunk of it coming from business that used to be in the standard market that switched over to E&S market?

Brian Donald Haney
Senior VP & COO

This is Brian Haney. It will be very tough for us to know that, but I think most of it is either business that was previously E&S or business that was previously written through a program or some binding authority. I don't think a typical is that -- I don't think a typical account came to us from a standard lines company like, let's say, like Travelers.

Michael Patrick Kehoe
President, CEO & Director

And then maybe just one follow-up on that, Adam, would be that I think the E&S market is growing at a really healthy rate right now. And some of that's going to be just economic growth in the economy. Some of that's going to be standard business coming over to the E&S side.

Brian Donald Haney
Senior VP & COO

This is Brian Haney again. I should qualify that. A lot of the business come to us because it's experienced losses. In that case, it could very well have been from a standard lines company, but...

Adam Klauber
William Blair & Company L.L.C., Research Division

Right. And I know you don't know exactly, but that's helpful. And then on property, are you writing more, generally more in 1 region? Is it more Texas, more Florida, more California? Or is it pretty well spread out?

Brian Donald Haney
Senior VP & COO

The commercial property is pretty well spread out. I would say we're underweight in quake and on the West Coast in particular, but it's pretty widespread. On the Aspera side, we're writing about -- on the personal insurance within Aspera, we write in 10 states. So most of that's going to be Southwest -- I'm sorry, Southeast, Gulf Coast exposure.

Adam Klauber
William Blair & Company L.L.C., Research Division

Okay. And then as far as competition, obviously, Lloyd's and AIG are having a really positive impact on the market. Are you seeing any new competitors pop up in the last 3, 6 months or so?

Brian Donald Haney
Senior VP & COO

This is Brian Haney. I would say we are not seeing anybody making sort of a noticeable splash. So I think we've heard of a few people either starting up or considering a new deal, but we haven't seen an effect from that in the market yet.

Operator

And our last question comes from the line of Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Looks like a lot of my questions have kind of already been covered, but with the growth in the property, what percentage of your overall book of business is property now?

Brian Donald Haney
Senior VP & COO

I think the commercial property is around 5%. And then Aspera as a whole is around 6%, and most of that is property related, so long term.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

So 10-ish, 11-ish, somewhere in there. Got it. And then as far as on the investment portfolio, new money yields, how are those tracking relative -- I mean, I know you keep a pretty short duration, so it's probably not that challenging. But any pressure there?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

No. This is Bryan Petrucelli. New money yields are right around 3%, Mark.

Operator

All right. And we do have a follow-up question with the line of Mark Hughes with SunTrust.

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

Yes. Refresh me on what your underwriting leverage multiple kind of a target or bogey might be. You talked about that perhaps you need to raise capital or look to raise capital later in the year. Where are you comfortable and beyond what level would that become more of a necessity?

Michael Patrick Kehoe
President, CEO & Director

We have an A- rating from A.M. Best, and that's the capital level we manage to. We need to protect that rating, that's very important to us as a business. I think, Bryan Petrucelli, I think we're running -- we're currently around a 1.2:1 net written premium to stat surplus?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Yes. That's correct.

Michael Patrick Kehoe
President, CEO & Director

And we probably have a little bit of room above that. I think the issue with capital is, hey, we're in this very attractive trading environment where we're not only able to grow at kind of an exaggerated rate, but we're also able to push up our prices. So we're expanding margins, and we're growing at a really healthy clip. And our goal is to always be capital-efficient, but we also want to have enough capital, if you will, enough dry powder that we can execute our business plan and operate our business and maintain some degree of financial flexibility. So that was the gist of my comments in the introductory section of our call today. We had said in the past that we were looking more toward 2020 for an equity raise, and we've kind of reconsidered that and advanced that to be something we're considering this year.

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

And then commercial auto, I think I've heard you comment on pricing relative to what you would think would be adequate. Is that getting any closer these days?

Michael Patrick Kehoe
President, CEO & Director

Well, clearly, commercial auto pricing has risen dramatically. It's still a very modest kind of 1% to 2% of our book of business. It's essentially within our excess casualty unit. It's where we write some excess commercial auto. But Brian Haney, I think maybe you can comment on our appetite there.

Brian Donald Haney
Senior VP & COO

Yes. I think it's -- we're going to look at it. I don't know if the rates are where they need to be yet, but it's something we are going to take a harder look at.

Operator

And that does conclude today's question-and-answer session. I would now like to turn the call back to Kinsale's President and CEO, Mr. Michael Kehoe, for any further remarks.

Michael Patrick Kehoe
President, CEO & Director

Okay. Thank you, operator, for handling today's call, and thanks for everybody for participating, and we look forward to speaking with you again here in the next quarter. Have a good day.

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