Tiptree Inc. NasdaqCM:TIPT

Earnings Call

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Call Participants

EXECUTIVES

Michael Gene Barnes
Executive Chairman of the Board

Scott T. McKinney
Chief Financial Officer

ANALYSTS

Sidney Schultz
Raymond James & Associates, Inc., Research Division

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Presentation

Operator

Greetings, and welcome to the Tiptree Second Quarter 2023 Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Scott McKinney, Chief Financial Officer. Please go ahead.

Scott T. McKinney
Chief Financial Officer

Good morning, and welcome to our second quarter 2023 earnings call. Joining me today are Michael Barnes, our Executive Chairman; and Jonathan Ilany, CEO.

A copy of our earnings release, investor presentation and 10-Q are on our website, tiptreeinc.com.

Some of our comments today will contain forward-looking statements, and actual future results may differ materially. Please see our most recent SEC filings, which identify the principal risks and uncertainties that could affect future performance.

During the call this morning, we will discuss non-GAAP financial measures, which are described in more detail in our presentation. Reconciliations of these measures and other associated disclosures are contained in our SEC filings, the appendix to our presentation and posted on our website.

With that, I will turn the call over to Michael.

Michael Gene Barnes
Executive Chairman of the Board

Thanks, Scott, and good morning to everyone. Tiptree completed a strong first half of 2023 led by our specialty insurance business, Fortegra, which continued to build upon its history of exceptional growth by posting record results year-to-date.

As we enter the second half of the year, Tiptree's balance sheet remains well capitalized with no holding company debt and substantial cash for future deployment.

Tiptree's revenues for the year increased to $786 million, up 18% from the prior year, while contributing adjusted net income of $41 million.

As just mentioned, Fortegra posted a record first half with gross written premiums and equivalents of $1.6 billion, up 34% from the prior year. Excess and surplus lines and services offerings were the largest contributors, and the pipeline of future growth remains strong in those sectors of the insurance markets.

For the year, the Fortegra team delivered a combined ratio of 91% and an adjusted return on equity of 30%. These results are a testament to the company's strategy of disciplined specialty underwriting and maintaining a scalable cost structure focused on improving the agent experience through technology.

The markets for specialty P&C risk remain favorable, driven by years of capital shortfalls, inflationary pressures and a higher frequency of catastrophic events. Given this backdrop, we anticipate the hard market environment will extend Fortegra's expansion as it has over the past several years.

Fortegra's investment portfolio grew 22%, ending the quarter with $1.2 billion of investable assets. We are continuing to invest the growing book of paid-in premiums in high-quality, shorter-duration liquid securities to take advantage of the attractive returns. Portfolio duration was just under 2 years at quarter end, which gives us the opportunity to modestly extend duration as we anticipate interest rate increases will slow in the near term.

In Tiptree Capital, we have over $200 million of capital deployed across our mortgage operations, cash and publicly traded equities for which we take a long-term view.

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Our mortgage origination and servicing business experienced a modest loss for the first half of the year, but the appreciation of our servicing book and management's proactive cost controls produced positive returns in the second quarter and kept the business near breakeven over the past 12 months. As mortgage rates appear to stabilize with monetary policy nearing an inflection point, we maintain a positive outlook for our mortgage business.

At Tiptree, we continue to look for opportunities to generate long-term absolute returns. Having no set holding period and the ability to take very long-term views, we believe we have a distinct competitive advantage to others seeking to allocate capital. With a strong start in 2023, we are well positioned to continue our growth and we maintain a positive outlook for the company.

With that, I'll let Scott take you through the financial update.

Scott T. McKinney
Chief Financial Officer

Thank you, Michael. I'll just reiterate another strong quarter at Fortegra. Record revenues and income levels were driven by growth in specialty premiums, particularly excess and surplus lines.

For total Tiptree, revenues were up 18%, excluding unrealized gains and losses, driven by growth in insurance underwriting and fee revenues. Consolidated net income of $6 million for the quarter was driven by growth in our insurance operations and positive contributions from our mortgage business, partially offset by lower shipping revenues from the sale of our 5 vessels in 2022.

Year-over-year comparisons were impacted by deferred tax charges of $3.5 million in the current quarter, compared to $25.5 million in the prior year, both related to the deconsolidation of Fortegra for tax purposes.

Adjusted net income for the quarter was $24 million, representing an 18% annualized adjusted return on average equity.

Our cash and capital position remained strong. We ended the quarter with over $370 million of cash and equivalents with roughly 1/4 of that figure outside the insurance company.

Turning to Fortegra's results for the quarter. Premiums and equivalents increased 44% year-over-year to $855 million. Revenues grew by 31% to $385 million, and the combined ratio improved slightly to 90.5%. Adjusted return on equity for the quarter was approximately 32% annualized. We were pleased to see growth in all lines of business. Submission activity and the pipeline of new underwriting opportunities remains strong.

The overall excess and surplus markets have seen significant growth, nearly doubling in size from $35 billion in 2018 to $76 billion in 2022. This is driven by many factors, including favorable pricing trends as well as an increased number of specialty lines moving from admitted to non-admitted markets. We, along with many of our competitors, believe these trends will continue through 2024 and potentially beyond.

The warranty services side of the business grew top line in the quarter by 19% yet faced margin pressures as inflation impacted the cost of replacement parts and labor rates in our vehicle services lines. We have and will continue to steadily increase rates to offset this inflationary headwind.

We include the next set of charts as a snapshot of Fortegra's trends over time. Gross written premiums and equivalents have increased 29% annually since 2019 with the vast majority coming from organic growth.

Unearned premiums and deferred revenue on the balance sheet ended at $2.2 billion, up 22% year-over-year. This unearned premium provides a solid base for future earnings growth.

Many of Fortegra's products are multiyear policies where premiums earned over the life of the contract. As written premiums increase, earned premiums will likely lag and be recognized over future years.

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The combined ratio has been very consistent, moving from 93% to 91% over the past 5 years. The expense ratio has improved approximately 3 percentage points over that period, driven by efficiencies from leveraging technology, data-driven insights and the overall scalability of the platform. Even with that improvement, we continue to invest in people and technologies to drive efficiencies, improve underwriting results and support our growth objectives at Fortegra.

Turning to investments. The portfolio ended the quarter at $1.2 billion, up 22% year-over-year. 91% of the portfolio is invested in a combination of high credit quality, liquid securities and cash with an average rating of AA+. Book yield was 3.1% at quarter end, up nearly 200 basis points from the prior year, driven by improving yields on money market funds and short-duration fixed income securities.

With money market funds and short-dated treasuries offering yields above 5%, we held a higher-than-average cash and short-term investment balance in the quarter. The duration of our fixed income portfolio sits at 1.9 years, which positions us well as maturities roll and the portfolio grows to invest at a higher yield, all while maintaining our high credit quality rating.

In summary, over the last 12 months, Fortegra posted record premiums of $3.1 billion and record adjusted net income of $96.8 million. Its differentiated business model has delivered excellent returns from insurance lines alone at a 20% return on equity, and we continue to see a significant lift from the services side of the business, which contributed an additional 8 points to the ROE. Capital and liquidity remains well positioned for future growth. As we look ahead, we expect to continue to reinvest retained earnings and cash flow from operations into growing our specialty insurance lines.

Flipping to Tiptree Capital. Pretax income for the quarter was $2.8 million, driven by our mortgage business and income from investments in U.S. treasuries and other equities. Reliance delivered $1.3 million of pretax income despite mortgage volumes being down 26% in the second quarter.

Our mortgage servicing portfolio and cost management measures provided stability in the quarter, and we expect origination volumes and margins to normalize as we look ahead.

Each quarter, we highlight Tiptree's sum-of-the-parts value reflecting the impact of the investment in Fortegra. Based on the transaction multiple, implicit in Warburg's investment, Tiptree's ownership of Fortegra represents over $23 per diluted Tiptree share. Including our other holdings, we believe Tiptree's sum-of-the-parts value to be $28.69 per diluted share or more than $1 billion of value.

Now I will turn the call back to Michael to conclude our prepared remarks.

Michael Gene Barnes
Executive Chairman of the Board

Thanks, Scott. So to summarize, we are pleased with the first half of the year and are well positioned with dry powder and a strong balance sheet as we move forward.

Fortegra continues to produce record results, both from a growth and return perspective. Reliance returned to profitability in the second quarter and is now focusing on opportunities to grow its volume.

At Tiptree, we come to work every day, looking for opportunities to build long-term value for our shareholders, but we will remain patient when allocating capital and we'll continue to nurture our current businesses for future growth.
With that, we will open the line for questions.

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Question and Answer

Operator

[Operator Instructions] First question comes from Greg Peters with Raymond James.

Sidney Schultz
Raymond James & Associates, Inc., Research Division

This is Greg's associate, Sid, on. I wanted to start with the top line results at Fortegra. It looks like growth in premium and premium equivalents really accelerated in the second quarter compared to the first. So curious what drove the acceleration there? And maybe you could discuss what lines of business in the E&S market you're finding the most attractive growth opportunities right now?

Michael Gene Barnes
Executive Chairman of the Board

Thank you for the question. And yes, you're correct. We've continued to accelerate our growth and I'd say that these are -- some of what we're seeing here has been the result of seeds planted going back a few years ago. And based upon capital and our focus in certain areas of expansion, I agree we've seen that acceleration really take off.

Scott, do you want to drill into the questions of -- the specific questions in terms of what's driving the growth, et cetera? I'll hand it over to you.

Scott T. McKinney
Chief Financial Officer

Yes. Sure. Well, first, I'd just start off and say that the bread and butter of the business is really with doing E&S as well as admitted lines where the aggregate premium per year is less than $10 million per line. About 80% of our agents are less than that $10 million figure and we've continued to see strong submission flow there.

E&S lines, flashing back a couple of years ago, really made up very little of our overall premium. And as we sit today, over the last 12 months, that's close to $780 million. So that's been where we've seen the largest amount of growth. Within that bucket, it's a wide variety of both casualty-driven products as well as certain property lines, professional liability, general liability, contractors, various property lines as well are really all part of the growth drivers.

Within the services side of the business, we continue to see good growth in auto lines. We have seen a bit of softness on the consumer side, as you've probably seen elsewhere across markets. But those are really the key drivers of what's bringing in business.

Sidney Schultz
Raymond James & Associates, Inc., Research Division

Okay. Yes, got it. And then when I look at the expense ratio at Fortegra, it's been pretty stable over the last several quarters and you also discussed how you continue to make investments in the business. So I'm just curious your perspective on how Fortegra balances investing for future growth, while also maintaining the expense ratio and the strong returns you've seen there?

Michael Gene Barnes
Executive Chairman of the Board

Sure. Sorry, Scott, I'll just start and say, look, our management team has done an excellent job of focusing on monitoring expenses, particularly in times of inflation. As I said a few minutes ago that we started planting seeds of expected growth a few years ago and we're seeing the benefit of that pay off, particularly in an environment that's been, I think, very beneficial to the areas that we've selected to

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allocate capital. Both E&S business and European expansion has continued to really benefit, I think, as we've seen that growth really take off.

We expect to see an environment like this continuing for the foreseeable future. So we're in a very beneficial environment. I think our timing was superb. And I'll just reiterate, our management team has done a superb job of managing expenses through these last number of years.

Scott, do you want to -- I didn't mean to interrupt. Go ahead.

Scott T. McKinney
Chief Financial Officer

Sure. I would just say it's a balance of investing for growth, investing in technology and hiring additional underwriters to continue to feed the top line. You've probably seen over the last 5 to 6 years the combined ratio has averaged right at 91% and that's really driven by a very consistent underwriting and loss ratio as well as the scalability of the expense ratio. And so we really balance investing in that technology and additional underwriters, along with the overall scalability of the platform.

Sidney Schultz
Raymond James & Associates, Inc., Research Division

Okay. Yes. That makes sense. And then sticking with the expense management, but pivoting to Reliance. Just given how the macro environment has impacted top line over the last several quarters, can you talk about how expenses have been managed in the business in order to keep it near breakeven? And maybe you could remind us the historical ROE profile of Reliance or if you target a specific ROE for the business? That's my last question.

Michael Gene Barnes
Executive Chairman of the Board

Okay. Great. And very good question. And so Reliance -- when we acquired Reliance a number of years ago, it was based upon an experience of myself; the CEO, Jonathan Ilany; and our entire team. At Tiptree, with regard to our mortgage experience, we've got a long history of more than 3 decades, I think, on average, focusing on mortgage area. So it's an area we know well.

Any time you're going to be involved in a business driven by rates predominantly in the overall credit markets, it's going to be volatile. But our objective, I think -- and I'd say this goes for all of our investments, any time we can allocate capital and see a good return on equity in a stable market environment, but with the ability on the downside to control expenses to pull back quickly and have a management team who's experienced in doing that to protect downside. But more importantly, when the market opens up to have an embedded optionality that really untaps what we see as the hidden value in an asset like Reliance, we saw that extraordinary returns in the -- from 2020 and 2021 when rates then once again started going up.

What we've seen our management team do through this most recent period of -- really for 20-some years an unprecedented rate rise in the last 1.5 years here is actively control expenses by cutting back on personnel as needed as well as just cutting back expenses overall for operations. We also -- going back to when rates were low, we started a practice of retaining servicing as a master servicer. And that helped us go through this period as that appreciated in value as rates rose. So it served as natural hedge while producing ongoing cash flow for the business.

So I think our management team has executed extraordinarily well. But what I'm most excited about is with rates up where they are and with it likely nearing, I'd say, the expectation, you won't see the Fed taking a lot more action depending on where numbers come out in the foreseeable future here. So we see rates starting to peak, although we may see the curve continue to steepen a bit here.

But we've reloaded the embedded option in that business. So with that business, I can't say we have a targeted return for that business, but in good times like 2020, we've seen that business produce near 100% return on capital. Now as the capital base has grown, as our servicing book has grown, that capital base has gotten larger. But we would see an embedded optionality that should produce extraordinary

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returns as the market continues to grow with respect to new home originations, with respect to the refinancings.

And one thing you can't ignore is that the one asset that has really grown through an inflationary period is housing. And as people need to tap savings, the house is one place they're going to go to in spite of rates. If you need to send your kid to college, you may tap your house to do so. So we see that continuing to benefit our business.

So I look at our business returning to profitability in this last quarter as just tremendous, and I can't give enough compliments to our management team, Hugh Miller and his team are doing an excellent job through these last 18 months of an unprecedented rate rise.

So no targeted return, but we see it is producing exceptional return on equities when times are good and stable return on equities given their active management of expenses.

Operator

I would like to turn the floor over to Scott for closing remarks.

Scott T. McKinney
Chief Financial Officer

Thank you, Stacy, and thanks, everyone, for joining us today. If you have any additional questions, please feel free to reach out to me directly. This concludes our conference call.

Operator
Thank you. This concludes today's teleconference. You may disconnect your lines, and thank you for your participation.

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