S&P Capital IQ

CONTENTS

Kinsale Capital Group, Inc. NasdaqGS:KNSL

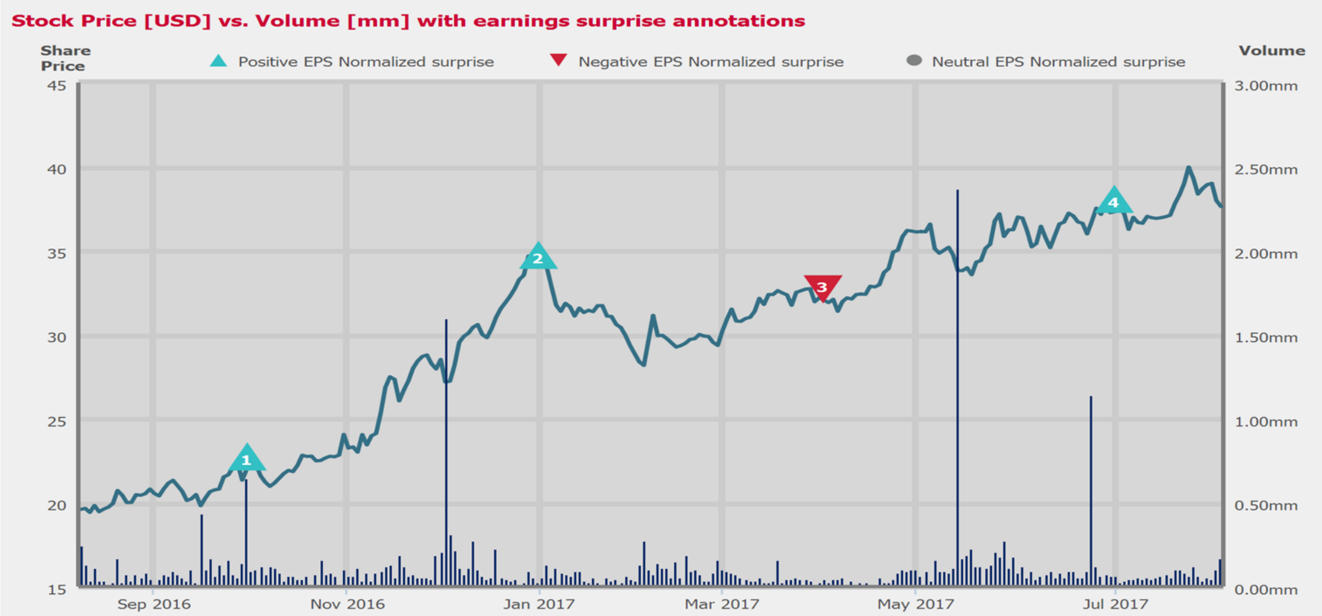
FQ3 2017 Earnings Call Transcripts

Friday, November 03, 2017 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.36	0.44	▲18.92	0.39	1.29	1.72
Revenue (mm)	48.99	47.84	▼(2.35 %)	51.24	188.42	217.86

Currency: USD
Consensus as of Nov-03-2017 3:12 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2016	0.25	0.38	▲52.00 %
FQ4 2016	0.26	0.32	▲23.08 %
FQ1 2017	0.31	0.29	▼(6.45 %)
FQ2 2017	0.32	0.40	▲25.00 %

Call Participants

EXECUTIVES

Brian D. Haney
Chief Operating Officer and Senior Vice President

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

ANALYSTS

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

Good day, ladies and gentlemen, and welcome to the Kinsale Capital Group Third Quarter 2017 Earnings Conference Call. [Operator Instructions] As a reminder, this conference call may be recorded.

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 2016 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 third quarter results.

Kinsale's management may make reference during the call to underwriting income, which is a non-GAAP financial measure of financial results. Kinsale's underwriting income represents the pretax profitability of the company's insurance operations.

The Form 8-K and press release are available at the company's website at www.kinsalecapitalgroup.com.

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

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Thank you, operator, and good morning, everyone. Kinsale reported net income of $4.2 million for the third quarter 2017 compared to $8 million in the third quarter of 2016. The drop in income for the quarter is due to a net after-tax catastrophe loss of $5.3 million. These losses arose principally from Hurricanes Harvey and Irma. Losses from Maria, Nate, California wildfires, et cetera, other recent catastrophes in the news, they're all immaterial to Kinsale.

As a reminder, Kinsale writes catastrophe-exposed property through its personal insurance and commercial property divisions. Both teams focus on careful and disciplined underwriting to make sure that we get paid properly for the risk we take. Being mindful of the volatility of that cat business, we combine the solid underwriting with a careful risk management strategy to reduce our exposure to extreme events. This approach allowed the company to achieve a profit for the quarter, notwithstanding the storm-related losses.

The other financial highlights of the quarter include a 7.3% annualized return on equity for the quarter and 11.5% for 9 months, a combined ratio of 94.5% for the quarter and 84.3% year-to-date, 16.3% growth in premium for the quarter and growth in our net investment income of 46% for the quarter.

Regarding the market outlook. We're optimistic given both the cat activity of late, combined with the deterioration of weaker competitors' casualty results. A more favorable trading environment would be nice to have, but it's a good reminder that it's not necessary for Kinsale to achieve its goal of competing and winning in the marketplace. The Kinsale strategy of disciplined underwriting, advanced use of technology and low costs provides the competitive advantage that allows Kinsale to achieve its goals regardless of market conditions.

And with that, I'm going to turn it over to Bryan Petrucelli, Chief Financial Officer, for Kinsale.

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Thanks, Mike. As Mike noted, in the third quarter, we incurred losses from both Hurricanes Harvey and Irma. And given the strength of those 2 storms and the fact that they impacted some concentrated areas of exposure for the company, we're pleased with the performance of our property book.

From a financial statement perspective, we incurred $5.3 million in losses, net reinsurance and taxes from those 2 events, which approximates 2.2% of the company's September 30 consolidated GAAP equity.

We reported net income of $4.2 million for the third quarter of 2017, down from $7.9 million for the third quarter of 2016. The company generated underwriting income of $2.5 million and a combined ratio of 94.5% compared to $10.9 million and 71.8% for the third quarter of 2016, excluding the quota share. The combined ratio for the third quarter of 2017 included 17.9 points from cat losses and benefited from 6.4 points of net favorable loss reserve development compared to 0 points of cat losses and 12.9 points from net favorable loss development last year.

On a year-to-date basis, the company generated underwriting income of $20.2 million and a combined ratio of 84.3% compared to $25.4 million and 77.3% for the same period last year, excluding the quota share. The year-to-date combined ratio included 6.4 points from cat losses and benefited from 9.2 points of net favorable loss reserve development compared to a negligible percent from cat losses and 11.2 points from net loss development from last year.

Gross written premiums were $55.6 million, representing a 16.3% increase over the third quarter of 2016. Year-to-date, written premiums has increased 17.9% over last year, with growth continuing to be generated from an overall increase in underwriting activity across most lines of business.

On the investment side, investment income increased by 46% over third quarter of 2016 as a result of continued growth in the investment portfolio. Annualized gross investment returns increased slightly to 2.4% from 2.1% last year. And although we continue to maintain a conservative approach to our investments in our strategy, we've modestly increased our allocation to preferred stocks and structured securities over the course of this year. Additionally, investment in common stocks has increased to approximately 5.5% at the end of the third quarter compared to approximately 4% at the end of 2016.

The company's effective tax rates for the third quarter and year-to-date were 20.1% and 30.5%, respectively, compared to 34% for those same periods last year. The reduction in 2017 was due to higher levels of tax-exempt investment income from muni bonds and a discrete item in the third quarter related to the recognition of tax benefits from employees exercising stock options. Excluding discrete items, we estimate that our effective tax rate should approximate 32%.

For the third quarter, basic and diluted EPS was $0.20 per share. Year-to-date basic and diluted EPS was $0.90 and $0.88 per share, respectively.

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

Brian D. Haney
Chief Operating Officer and Senior Vice President

Thanks, Bryan. As much as we don't like having a 94% combined ratio in any quarter, it does show the power of our low-expense model. If we had the same expense ratio as some of our competitors, we'd be closer to a 110% combined. As it is, we can still show some underwriting profit even in what will turn out to be the worst quarter for natural catastrophes in history.

With regards to our growth, premium grew 16% in the third quarter, which is just ahead of the pace in the second quarter. The growth is widely spread, with most of our 17 divisions showing positive change. Our Aspera business was up 46% for the quarter.

Submissions were up slightly better than 20%. We have noticed a gradual acceleration in this growth rate. This could be a sign that more business is flowing into the E&S market or it could just be increased market recognition for Kinsale. In any event, we see it as a good element.

Technical rates for the quarter were up slightly, although given market conditions, we expect somewhat larger rate increases going forward.

The market conditions for property have shifted in our favor since the hurricanes. In the overall market, price decreases of any kind seem to be much rarer even for non-catastrophe-exposed business. Insurers are pushing 5% to 10% increases for loss-free catastrophe-exposed accounts, and accounts with losses are facing 25% to as high as 200% rate increases, depending on how badly underpriced they were to begin with and how bad their loss was. To be clear, I'm talking about the market here and not Kinsale. We passed on a lot of opportunities because the market prices are inadequate, and some of the rate increases being pushed still aren't enough to bring prices to adequate. But we look at the market shift as a positive development for us.

Also, keep in mind that the storms are still very recent, and the effects that they will have on the market are still developing. The full impact of the catastrophes will become more clear over the next few quarters as more accounts and more reinsurance programs renew.

The market conditions for casualty seem to be improving, if less abruptly and less obviously. There's a steady and seemingly growing drumbeat of program business experiencing distress and competitors having to re-underwrite certain segments of their book. Some actors have been covering up their poor casualty results with overly optimistic reserving, but that is always a short-term fix. Eventually, overly aggressive insurers will have to true up their reserves, so I fully expect there is more bad news coming for the market for casualty lines. Again, to be clear, I'm talking about the market, not Kinsale. One reason we write so much less than most of our competitors and have grown more slowly than we might have liked is our conservative underwriting approach.

A final word about the hurricanes. Based on the catastrophe modeling, we would have expected a larger loss than we appear to be headed towards. We are materially outperforming the modeled results. We attribute this to sound, conservative underwriting, and we feel our performance in this quarter vindicates that approach.

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

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director
Thanks, Brian. Operator, we're now ready for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Mark Hughes of SunTrust.

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

How much interest would you have in more property, even on -- at very good pricing? What do you think your appetite is? I assume you want to have a model that's not quite so vulnerable to these kind of cat losses, but there are good returns out there. You'd like to grow that book. How are you thinking about it? Is there a upper bound that we should think about for property?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

I would say, number one, we're ambitious, and we're looking for ways to grow our business by writing good profitable accounts. Obviously, with the catastrophe-exposed property, there's a risk management piece that comes into play as well. But I would say we've got a big runway in front of us given our size, given how small the property book is relative to the overall book. I think it's running around 7% or so. So a more favorable pricing environment would allow us to accelerate the growth.

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

Is -- are we in that environment? And how high should that -- or could that 7% go?

Brian D. Haney
Chief Operating Officer and Senior Vice President

I would say, in the right market conditions, it could be 20% to 25% of the book. Right now -- it's going to take some movement -- additional movement in the market to get there, but...

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Yes. I think E&S, the E&S market roughly divides kind of 2/3 casualty, 1/3 property. So clearly, we could do quite a bit more than the 7%.

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

Did you indicate how much your pricing was up this quarter? I'm sorry if you did and I missed it.

Brian D. Haney
Chief Operating Officer and Senior Vice President

It was -- I said up slightly last 9 months.

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

Up slightly, okay. But your anticipation is that, that will get better or somewhat larger rate increases going forward?

Brian D. Haney
Chief Operating Officer and Senior Vice President

Yes.

Michael P. Kehoe

Founder, Chief Executive Officer, President and Director

Yes. The combination of the storm activity, but I think even more importantly, is the deterioration in the casualty business for a lot of companies. You're starting to see more adverse development, and I think that gives us a sense of optimism.

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

You said that submissions up 20%, which I think you have suggested is -- of the -- in an uncertain world as at least the best indicator you've got or that you're able to share regarding potential growth in written premium. That 20%, you said either maybe more in E&S or you're getting more visibility. Is there some reason to think you're getting more visibility at this point? Have you done something differently to help open up the flow? Or is this a broader phenomenon?

Brian D. Haney
Chief Operating Officer and Senior Vice President

That was just speculation. There was nothing specific we did in the quarter to increase our visibility. I just think as we grow and by virtue of being a public company, we are more well known than we were, let's say, 18 or 24 months ago.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

But Mark, I do think it's very plausible that the uptick in the submission growth that we've seen just recently, it could be indicative of, hey, more business moving into the E&S market from the standard market.

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

Right. And so the standard program, they're doing poorly, and you're a beneficiary of that. Is that possible -- plausible?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Yes, it's certainly possible. Obviously, as Brian said, we're speculating. We don't know definitively, but it would certainly be expected that a company that's running into some financial distress because of the underperformance of their book of business is going to be a little bit more discriminating going forward about how they price and accept risk. And that uptick in caution on the part of a big standard lines company certainly would force more and more accounts into the nonstandard market.

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

Is that -- would that potentially bring larger accounts more into your focus? I think you have made the point that you tend to be a smaller account underwriter because that's where you get better returns, but you would certainly be eager to move up market a bit if you got adequate returns. Could that be a near-term dynamic?

Brian D. Haney
Chief Operating Officer and Senior Vice President

Yes, we are actually seeing more larger, particularly distressed accounts. So we're not binding as much of it as we're seeing more of it. So we're seeing a lot of stuff that's -- has bad loss history, is having a tough time finding a home and growth. So I think we will see more of that going forward. Certainly, the trend has been pretty remarkable.

Michael P. Kehoe

Founder, Chief Executive Officer, President and Director

I would just follow that up with, in past hard markets, you definitely see an uptick in your average premium because larger accounts that were underpriced, now you're able to get an adequate return on them. So that would not be unusual if we were, in fact, going into some sort of turn in the cycle.

Operator

Our next question comes from the line of Jeff Schmitt with William Blair.

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

It looks like the -- I think accident year loss ratio ex cat was up about 100 basis points. Is that normal volatility? Or are you seeing any uptick in trends there, similar to some of your competitors?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

I think we -- this is Mike Kehoe. I think we would attribute that to just the normal variability. In a 90-day period, I think if you look on the -- I think the year-to-date numbers are a little bit more stable than the quarterly numbers. But that's how we see it.

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

Okay. And then favorable development was down a fair amount from what we've seen over the last year or 2. Is there any more color you can provide there? And is there maybe any change in levels going forward?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

I think it's the same dynamic, right? Whether it's the current accident year or whether it is the prior accident years, there's a little bit of volatility and variability in terms of how the losses come in and are adjusted and closed out. And I think if you look at the quarterly numbers, the prior year development dropped compared to the prior year. If you look at the 9-month numbers, that they're -- it's -- I think it's pretty close to -- I think they're fairly comparable. So really, it's just -- it's kind of the normal variability in the business. I wouldn't see it as a trend of any sort.

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

Okay. And then I think you said Aspera was growing at 46%. What's driving that? Are you just adding more brokers? Is it geographic expansion? Or what are the components there?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Yes. Just a reminder, Aspera is our affiliate company-owned broker that we distribute some of our product lines through the retail channel. So for instance, our personal lines business goes exclusively through Aspera to retail brokers. And the 46% growth is partly adding new brokers, it's partly geographic expansion, it's partly broadening the product line. And candidly, a lot of it is -- say it's a small premium base, so the -- it's moving from, I think, 3.5% of our business to 4% something. We're encouraged by the growth, but it's still a modest part of our overall book of business today.

Operator

Our next question comes from the line of Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Couple of questions. On the cat losses, could you give us just a generalized split on what of that was personal as compared to what was the commercial business? Really just trying to understand kind of the nature of the exposures, not so much for this loss but for anything that might arise in the future.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Yes. Harvey, which is the Texas storm, was probably 2/3-1/3, just roughly speaking, 1/3 commercial, 2/3 personal. I think Irma would be more heavily skewed toward the personal lines side, coming in on the West Coast to Florida the way it did.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful. On the tax rate commentary, did I understand you to say you continue to view 32% as the correct kind of run rate, that the impact in the quarter was mainly the stock option impact?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

That's right, Mark. Obviously, we're going to have some level of stock option exercising. Going forward, it's just difficult to predict. So the 32% is just sort of backing out that discrete item, but it does include sort of the anticipated level of tax-exempt income going forward.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

It does not include our prognostication on the tax reform.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Well, good luck with that if you could do it.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

But we're keeping our fingers crossed.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Yes, indeed. The last question that I had. I think it was in Brian's comments. The -- you mentioned -- well, 2 kind of questions really, though. One, as you mentioned, program business and distressed, you guys don't do any particular amount of program business, do you?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

No. We -- it's -- we're fairly dogmatic on that point. We maintain absolute control over the underwriting of our business, which we mean -- what we mean by is that our underwriters, company employees underwrite and price every single account that hits our books. The program model is -- for some companies, it can be quite effective. For some, it's been a challenge. But it does create a little bit of an -- misalignment of interests when your underwriters that you -- when you outsource the underwriting to be able to get paid based on volume. That's a misalignment of interests that has to be overcome with good management and the like. And we've just seen plenty of examples of programs that get into harm's way, and companies have to change course, change their guidelines. And it's not unusual to see them canceled, and it creates a little dislocation in the market. I don't if you want to...

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. Then the last question in that regard, and this kind of follows up on Mark Hughes' questions. Within the property business, just very helpful commentary about how the market seems to be moving so far. As kind of a general comment, I mean, how much would you like to see prices increase before you kind of got to the good stuff? Is that 20%, 50%? What would it take to kind of keep the competitive juices flowing and add some enthusiasm there?

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Mark, keep in mind, there's a lot of heterogeneity in the business we see, so it's tough to really distill it down to one number. I mean, we're -- we write a decent volume of property today, and we think that's well-priced business that's going to prospectively look to throw up at a very attractive return for the company. When I think about pricing increases, it's more around growth opportunity. Certainly, if you saw, in general across the board, 20% rate increase, we'd have more opportunities than we have today. But kind of to Brian's point, I mean, some businesses are so underpriced that a 20% rate increase would not increase our appetite.

Brian D. Haney
Chief Operating Officer and Senior Vice President

Yes. I would just agree with that. It's more about -- it's kind of just a spectrum. The better prices get, the more we'll be able to write at our prices. But we are writing stuff at profitable prices right now. We're just writing the little we can at profitable prices.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

It's analogous in some ways to the commercial auto market, right? There's been -- we had one of our brokers describe that market as being in shambles, but it's in shambles because the rates people were getting were so -- they were below the barn cost in a lot of instances, right? The losses are exceeding the premium for some companies. And hey, that's an area where rates have moved up dramatically. In our opinion -- and it's just our judgment. It's not automatically correct. But in our judgment, hey, these rates are still too low. So we're going very slowly in the commercial auto space because we don't think the time is right. That's an underwriting judgment, and we'll have to see in the future whether that's correct. But...

Operator

I'm showing no further questions in queue at this time, I would like to turn the conference back over to Mr. Kehoe for closing remarks.

Michael P. Kehoe
Founder, Chief Executive Officer, President and Director

Okay, thank you, operator. I just want to thank all the participants on the call and, of course, all the Kinsale employees and associates whose hard work has really allowed us to achieve the results we have so far in 2017. And hopefully, for our stockholders and related persons on the call, you get a sense of our optimism for the business with our commentary this morning. We feel really good about the position of Kinsale in the market and feel very optimistic about our opportunity going forward. So thanks very much. Have a good day.

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