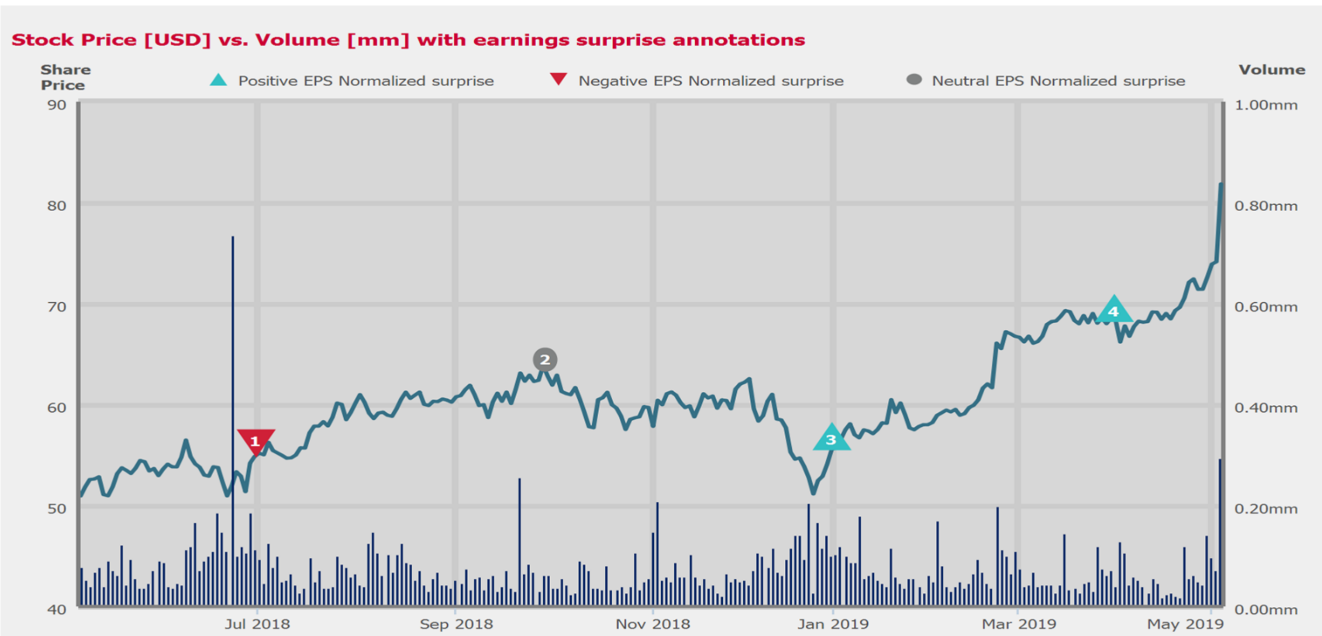
S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL
FQ1 2019 Earnings Call Transcripts
Friday, May 03, 2019 1:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ1 2019-			-FQ2 2019-	-FY 2019-	-FY 2020-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.50	0.64	▲25.49	0.60	2.50	2.55
Revenue (mm)	63.99	72.18	▲12.81	66.68	271.42	311.89

Currency: USD
Consensus as of May-03-2019 10:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2018	0.49	0.46	▼(6.12 %)
FQ3 2018	0.49	0.49	0.00 %
FQ4 2018	0.43	0.46	▲6.98 %
FQ1 2019	0.50	0.64	▲25.49 %

Table of Contents

Call Participants	....	3
Presentation	....	4
Question and Answer	....	7

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

Good day, ladies and gentlemen, and welcome to the Q1 2019 Kinsale Capital Group Inc. 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 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 first 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 conference over to Kinsale's President and CEO, Mr. Michael Kehoe. Please go ahead, sir.

Michael Patrick Kehoe
President, CEO & Director

Thank you, operator, and good morning, everyone. Joining me today are Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer.

I'm going to start the call with a few introductory comments, and then Bryan Petrucelli will follow with our financial results. And then Brian Haney will follow him to discuss Kinsale's underwriting results and provide some market commentary. And then we'll conclude with a Q&A.

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 the claim management process and do not outsource those functions to external parties, all of which help drive Kinsale's attractive loss ratios.

In addition, Kinsale uses proprietary technology and automation to operate at a significant expense advantage over many larger competitors. As we like to say, the combination of the disciplined underwriting and low costs is an end-game winner every time.

For the first quarter, Kinsale posted strong profitability and growth. The combined ratio for the quarter was 80.3%. The annualized operating return on equity was 20%. These numbers are comfortably above our forward guidance of a mid-teens ROE and a mid-80s combined ratio. The growth we experienced in Q1 reflects the success of the Kinsale business strategy, in addition to the rising level of dislocation within the E&S market. For comparison purposes, the 32.5% Q1 growth was up from 27% in Q4 2018 and 23.5% for the calendar year 2018.

Brian Haney is going to have some additional comments on the E&S market here in a moment. But first, over to Bryan Petrucelli for the financial report.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

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

We reported net income of $18.7 million for the first quarter of 2019, an increase of 157% when compared to $7 million for the first quarter of 2018 due primarily to growth in the business, higher favorable development on prior accident year loss reserves and increases in the fair value of our equity investments. Net operating earnings increased by 69% to $13.8 million compared to $8.2 million for the first quarter of last year. Our effective income tax rate was 17.9% for the first quarter of 2019 and relatively consistent when compared to 17.3% last year.

The company generated underwriting income of $12.1 million and a combined ratio of 80.3% compared to $6.9 million and 85.9% last year. The combined ratio for the first quarter of 2019 included 10.4 points from net favorable prior year loss reserve development compared to 2.7% last year. Cat activity was negligible both this year and last year. Annualized operating return on equity was 20% for the first quarter of 2019 compared to 13.7% last year and as Mike noted, above our mid-teens or higher guidance.

Gross written premiums were $84.6 million, representing a 32.5% increase over last year. Increases continue to be generated by an overall increase in underwriting activity across most lines of business and due to the reasons Mike already mentioned, including continued improvement in marketing conditions. And Mike -- Brian Haney will discuss that in a little more detail here in a bit.

On the investment side, net investment income increased by close to 40% over the first quarter last year, up to $4.5 million from $3.2 million last year as a result of continued growth in the investment portfolio and higher interest rates. Gross investment returns increased to 3.2% from 2.7% last year. And diluted operating EPS was $0.64 per share compared to $0.38 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 32.5% in the first quarter. 16 out of our 17 divisions grew. We are seeing particularly strong growth in our construction, commercial property and management liability divisions, but the growth is widespread across many different divisions and classes of business. Our Aspera unit was up 39% for the quarter.

Submission growth surged in the first quarter to 30%. We appear to be seeing substantial profitable increases in submission volume. We are not sure if the first quarter surge is a harbinger of things to come, but it is an excellent sign for us.

At this point, the growth in submissions is such that it is now a bigger challenge for us to deal with the current flow of business than to find ways to accelerate that growth. As a result, we are, from an operational perspective, prioritizing process improvements and incremental efficiency gains over product development or increasing distribution. That's not to say we are not researching new products or adding new brokers, just that we are giving those initiatives less priority relative to other projects that will help us address the flow of business opportunities while maintaining our superior customer service.

And as premium and submission growth have accelerated, we continue to be assertive in seeking more rate increases. We would prefer to grow through higher rate with greater margins and purely by increasing transaction count. While it can be problematic to reduce all the rate movements in a book as heterogeneous as ours to what number, if I had do that, I'd say we're somewhere in the plus 5% to plus 7% range.

An important thing to keep in mind about our growth, we have not grown by changing our business model or by getting more aggressive on price nor have we become more lax on underwriting standards. We are still executing essentially the same business plan we have been executing these past 10 years, including some recent years like 2015 and 2016 where growth was much harder to come by.

Our hit ratios, the proportion of quotes we issued that result in policies, haven't increased. In fact, they're lower this year than last. What seems to have changed is the market. We can't know how things will change from here. It's possible the market gets even more favorable or it's possible it might reverse course. We don't know. But we will keep executing the same successful business model at low expenses

[contrary to an] underwriting and superior customer service that has gotten us to this point and trust that whatever the condition of the market, we will continue to generate an attractive underwriting profit.

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

Michael Patrick Kehoe
President, CEO & Director
Thanks, Brian. Operator, we're now ready for Q&A.

Question and Answer

Operator

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

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

Yes. I think I might have missed this, but did you mention the submission growth in the first quarter?

Brian Donald Haney
Senior VP & COO

Plus 30%.

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

Plus 30%?

Brian Donald Haney
Senior VP & COO

Yes.

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

How much of that -- I mean just thinking about the movement from the admitted market to the E&S market. Could you talk about potential shifts that way? Or is it just more underlying activity in the broader economy? How do you parse that if you even count?

Michael Patrick Kehoe
President, CEO & Director

It's Mike Kehoe. Obviously, it's going to be a little bit speculative. We don't know definitively. But some of the early statistics on growth in E&S in 2018 indicate about an 11% growth for the market. So clearly, the E&S market overall is growing. Part of that is the economy, part of it is shift of business from standard to nonstandard. And then the other element that's pretty positive for us is the fact that you've got a lot of companies dealing with maybe substandard results and retooling and reunderwriting books of business. And so I think that's also a big positive.

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

Yes. I think Lloyd's had come up in a prior conversation. Any comments on their apparent CAGR in the market?

Michael Patrick Kehoe
President, CEO & Director

No. We don't have any comments about Lloyd's or -- specifically. But just that if you read some of the trade press, clearly, there's a lot of companies that are reunderwriting books of business. A lot of times, they've delegated underwriting programs or arrangements in particular, can be subject to some volatility if the results haven't been adequate. Kinsale focuses on small commercial accounts for the most part. Our average premium's between $10,000 and $11,000 a policy.

Candidly, I think we're one of the very few companies that underwrites that size of account with its own underwriters. Most of our competitors pursue that account size by delegating underwriting authority to either a program administrator or a wholesale broker. And so I think some of those delegated arrangements are being refined right now. And again, we're seeing the benefit of that.

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

Then a final question. On the expense ratio, you sustained elevated top line growth. Would you expect the expense ratio to come down? Or you think you're going to kind of peg it here 24% or 25%?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Yes. Mark, it's Bryan Petrucelli. I think I would think that we would expect it to stay pretty steady.

Operator

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

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

Could you provide some more detail on Aspera? How many states are in there? And what the plans are and outlook is there?

Brian Donald Haney
Senior VP & COO

Yes. I would say I don't have the exact number, but I think we're in something like 12 states. A lot of what we write is coastal manufactured housing, so it's personal insurance. The plan is to keep expanding that. We also write a small amount of commercial insurance in that. So we would plan to keep expanding that.

The growth rate has been slightly above the rest of the company for a while. I think it's an important means of diversifying the business. So I think the plan would be to keep growing that, and I would expect to see its growth rate exceed that of the rest of the company for the foreseeable future.

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

Okay. And then just looking at the underlying loss ratio ex cat development, it was up a decent amount, 240 basis points. Is there -- obviously, that can bounce around a lot. There is -- is that being driven by kind of quarterly variability and business mix? Or what's driving that?

Michael Patrick Kehoe
President, CEO & Director

So I think it's -- yes. Jeff, it's Mike. Yes, I think, clearly, part of it is just the inevitable variability from quarter-to-quarter and then I think probably some additional conservatism in the reserving there as well would be the 2 reasons.

Operator

And our next question comes from Mark Dwelle of RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

About once every 5 years, I give out a "Great quarter, guys." This one looks like it's probably worthy of that. So good job.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Thanks, Mark.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Brian, my first question, you mentioned that, I guess, 16 of the 17 business segments showed growth. Which one didn't and why do you think that was?

Brian Donald Haney
Senior VP & COO

I don't have this exact -- I don't -- I think it was the health care division. I think the health care division writes nonstandard doctors. That's an -- I think that area has been challenged by Obamacare, which sort of created this impetus for smaller doctors -- doctor officers, which is what we would have focused on to join larger practices or to become associated with a hospital. So when they do that, they kind of go out of our market. So I think that's probably one of the reasons, although I'm speculating a little bit.

Michael Patrick Kehoe
President, CEO & Director

I think it's a boutique division for us within the company. It's pretty modest.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That's helpful. Any other areas that just -- where -- between a combination of pricing or otherwise that don't seem to be stacking up as well as the broader flow that you're seeing?

Michael Patrick Kehoe
President, CEO & Director

No. I think the general takeaway is that we're seeing a very broad, across-the-board opportunity not just to grow the business but to push rate and improve margins at the same time.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

That's helpful. With respect to the surgeon, the submission flow, obviously, kind of a high-class problem, anything that you just didn't -- in kind of diagnosing that, any particular geographies, any particular types of wholesaler that you're seeing better flow from? Or it's just the pipeline has gotten fatter?

Brian Donald Haney
Senior VP & COO

Yes. I would just -- the remarkable thing about it is, as we looked through the data, is just how diversified that phenomenon is. It seems to be in most places with most brokers, most states. And it -- the other thing that was remarkable about it is kind of the abrupt shift. If you remember the last few quarters we're on these calls, the growth rate in submissions has been increasing, but it's always been the kind of very modest increase. So we go from 19% to 20% or 20% to 22%. But for it to go from 22%-ish to 30% just that abruptly was pretty interesting, yes.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. Then the last question. And I know I've asked this on prior calls, but just to kind of get an updated thought. I mean with the growth rate that you're fortunate to be achieving, how much runway do you have before you would need to consider any type of capital actions or just something to make sure you keep your -- or space capital ratios and everything in the right place?

Michael Patrick Kehoe
President, CEO & Director

Right. Obviously, the stronger the growth, it starts to challenge our capital position, something that we monitor very carefully. Depending on how the growth, it -- with this kind of growth for the year, I think we're not -- we would not need additional capital in 2019. If that -- if this kind of growth rate carried forward a year or 2, we'd -- almost certainly, we will. And that could be a combination of debt and equity.

Operator

[Operator Instructions] Our next question comes from Adam Klauber of William Blair.

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

Obviously, good results. In the core liability, what's your -- what's the rate of loss trend in general, loss cost inflation?

Brian Donald Haney
Senior VP & COO

I'll put around 2% to 3%.

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

Okay. Okay, great. And I always ask this one. Are you continuing to see a bit more tougher litigation legal environment today than maybe 2, 3, 4 years ago?

Michael Patrick Kehoe
President, CEO & Director

We're a smaller company, so we don't have the same worldview that a large insurance conglomerate might have. But what -- yes, in general, I think what we see is consistent with what's been reported here over the last year or so where loss costs are trending upward. And from time to time, you see severity issues with jury verdicts and the like.

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

Great. And then as far as market conditions, obviously, very strong growth and off -- a good market coming off year-end. As I've talked to 1 or 2 contacts in the market, it's early, but they said June, July, the market could even be getting, I guess, more firm in different areas than we saw at year-end. Are you getting some early signs of that?

Brian Donald Haney
Senior VP & COO

Things seem -- no. Things are rolling along, but I haven't noticed -- I haven't heard anything that would lead me to believe that there's an upcoming further abrupt positive shift in the market.

Michael Patrick Kehoe
President, CEO & Director

Yes. I think the general trend we've seen is, over the last 2 years, there's been a steady improvement. Keep in mind, Adam, our book doesn't have a lot of seasonality to it because we don't write large accounts. Again, our average premium's a little bit over $10,000 a policy. So I don't think June 1 or July 1 renewal dates are necessarily that impactful for us. But I think that's our view.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back over to Michael Kehoe for any further remarks.

Michael Patrick Kehoe
President, CEO & Director

Okay. Thanks, operator, and thank you, everyone, for participating this morning. And we look forward to speaking with you again here in a few months.

Operator

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