S&P Capital IQ

CONTENTS

Kinsale Capital Group, Inc. NasdaqGS:KNSL

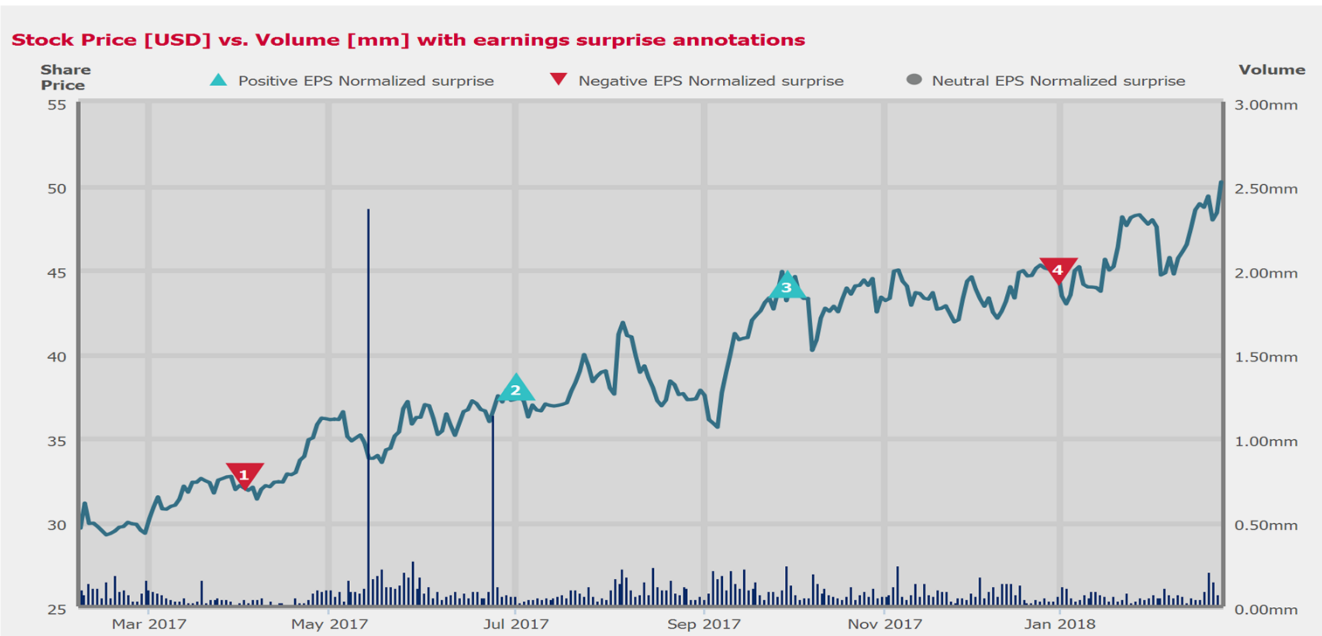
FQ1 2018 Earnings Call Transcripts

Friday, May 04, 2018 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2018-			-FQ2 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.37	0.38	2.70	0.53	2.02	2.31
Revenue	-	-	(2.83 %)	-	-	-
Revenue (mm)	51.59	50.13	-	53.46	216.99	246.81

Currency: USD
Consensus as of May-04-2018 1:30 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2017	0.31	0.29	(6.45 %)
FQ2 2017	0.32	0.40	25.00 %
FQ3 2017	0.36	0.44	18.92 %
FQ4 2017	0.39	0.36	(7.69 %)

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 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 would cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including 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 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

Thank you, operator, and welcome everybody to the Kinsale call. Also joining me this morning are Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer. Bryan Petrucelli is going to follow me to detail the numbers for the quarter, and Brian Haney will then follow-up with some color on the market and Kinsale's underwriting operation.

The Kinsale strategy is to combine disciplined underwriting and claim handling with technology enabled, low costs to deliver attractive returns in growth to our stockholders, even in a competitive market like we have today. Disciplined underwriting for Kinsale starts with a focus on a higher-margin segment like smaller account, excess and surplus lines. It includes our maintaining absolute control over the underwriting and claim handling process and not outsourcing those functions to external parties. It involves targeting hard-to-place accounts that frequently drive better risk-adjusted returns. It means carefully managing the coverage we offer and making sure to minimize inaccuracies in the underwriting process. All these elements of Kinsale's underwriting strategy helped drive the favorable loss ratios we've achieved.

On the expense side, Kinsale operates at a significant advantage over older legacy companies by using one end-to-end enterprise system to operate our business. Kinsale has no legacy systems that date back decades like many of our competitors do. The Kinsale enterprise system was built by our developers and analysts, specifically for our company. We own the source code. This technology and automation drives efficiency and accuracy in our business as well as superior customer service and data collection. More importantly, having one end-to-end system allows for the rapid rollout of new features and functions that continue to improve Kinsale's operating performance going forward. This system advantage, combined with our entrepreneurial business culture, allows Kinsale to operate at expense levels of 25%, in some cases 30% or even 35% lower than many of our competitors. Low costs allow Kinsale to offer more value to the customer, while at the same time providing robust returns to our stockholders. Combining disciplined underwriting with low costs is an end-game winner every time. Kinsale had a respectable start to 2018, with a combined ratio of 85.9% and an operating return on equity of 13.7%. Net operating earnings were up 30.3% over the first quarter 2017. And gross written premium was up almost 21%. So for more deep detail on our financials, I'm going to turn the call over to Bryan Petrucelli, Kinsale's CFO.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Thanks, Mike. As Mike noted, we feel pretty good about the first quarter results. At first, just want to start by pointing out the adoption of the new accounting standard this quarter, where we're stripping out -- we're -- our unrealized gains and losses associated with our equity investment portfolio are now recorded through our income statement. Previously, such changes were reported through other comprehensive income. So this increases a little bit of volatility through our income statement. Changes in unrealized gains and losses, associated with our fixed-income investment portfolio continue to be reported through other comprehensive income. So for purposes of comparability with previous periods, we've now introduced an operating and earning metric that normalizes for the unrealized gains that are flowing through our income statement. Calendar results for the quarter, we reported net income of $7.3 million for the first quarter of 2018, which is an increase of 16% over the 60 -- $6.3 million reported last year. Net operating earnings, increased by 30.3%, or $8.2 million compared to $6.3 million last year. Increases in net income and operating earnings were largely driven by an increase in net investment income and a reduction in the company's effective income tax rate. Our effective income tax rate was 17.3% for the first quarter of this year, compared to 32.4% last year, and was lower due to the impact of tax reform act that was enacted in December of last year and a recognition of tax benefits from stock options that were exercised during the period. The company generated underwriting income of $6.8 million and a combined ratio of 85.9%, compared to $7 million and 82.6% last year. The combined ratio for the first quarter of 2018 included 2.7 points of net favorable prior year loss reserve development, compared to 12.6 points last year.

There was no meaningful cat activity this year or last year for the first quarter. Annualized operating return on equity increased to 13.7% for the first quarter 2018, compared to 11.8% last year. Gross written premiums were $63.8 million, representing a 20.8% increase over the first quarter of 2017, and continues to be generated from an overall increase in underwriting activity across most lines of business, and Brian Haney will get into this in a little more detail here in a bit.

On the investment side, net investment income increased by 41.3% over the first quarter of 2017 to $3.2 million from $2.3 million last year, as a result of continued growth in the investment portfolio, rising interest rates and by taking a little more risk in our investment portfolio. Annualized gross investment returns increased to 2.7% from 2.3% last year.

From an EPS perspective, basic and diluted EPS, operating EPS was $0.39 and 38 per -- $0.38 per share, respectively, compared to $0.30 and $0.29 per share, respectively, 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 almost 21% in the first quarter. 15 of our 17 divisions grew, some of them substantially. Our commercial property division, in particular, grew strongly, due in part to the large influx of submissions we've seen since last year's hurricane. Our Allied Health Care division was also up nicely for the quarter. This market has seen a lot of dislocation, with a number of our competitors having to re-underwrite their books of business. On the other hand, the construction market was very competitive in the quarter and the healthcare space continues to be very soft. Submissions in the fourth quarter were up slightly less than 20%, which is right around where it has been for the last 3 quarters. We look at submissions as a good, leading indicator for where the business is headed, and so it's a positive sign that submissions are up in every one of our 17 divisions.

We continue to focus on improving our internal processes to drive down the time and cost of quoting. This allows us to quote more business and quote it faster. It also allows us to write smaller deals than our higher-expense competitors would be able to write economically. This emphasis on superior customer service is allowing us to grow, without compromising our margins, in what is still a very competitive market.

Moving on to rates. We continue to increase rates selectively. We pushed up technical rates on some classes in the first quarter and we expect to do more of that in the second quarter and throughout the year. It's still modest at this point. The rate increases by division are generally plus 5% or lower, but still positive overall. In general, the market seems to be in a state of flux, while prices are going up nicely, they're not quite going up as fast as we would hope or would have expected, but we are seeing more and more accounts, and in some areas the competition does seem to be less pronounced. Overall, the industry rate changes in the commercial property space, while positive and a good sign, are just not like what they ought to be. The industry, as a whole, needs more significant rate increases in commercial property and many other areas, and we think that eventually will have to happen. When it happens, we don't know, but we feel confident it will happen. And with that, I'll turn it back over to Mike.

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

Question and Answer

Operator

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

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

The -- in the Allied health area, is the -- are the loss trends relatively stable? Sounds like there's lot of dislocation, is that because of bad pricing? Or it's because the is the loss environment is volatile?

Michael Patrick Kehoe
President & CEO

I think there's been a lot of companies that got off track by being overly aggressive in the accounts that they pursued. And so we've seen some large MGA programs, either be cut back or been canceled. We've seen companies actually withdraw from the market in some respects. And so -- one area where, for a number of years, Kinsale didn't write any business, would have been skilled nursing homes. Now that we're seeing people exit that space, we're able to selectively find some accounts to write. So it's a large industry segment. I think with the dislocation there's a rise in opportunities for us to find attractive business to write.

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

Yes, current [ex-remedial] loss that was definitely down substantially from last year. I know there's some discussion of some seasonality in that, perhaps, that you were a little more conservative in Q1 and then as the year progressed, you reevaluated in that -- ended up last year being a favorable pattern. You started out lower this year. Could you talk about what you're seeing? What approach you're taking?

Brian Donald Haney
Senior VP & COO

Yes, I think the most -- most of the delta between the current accident year at the end of first quarter '18 versus '17 is just a variation in our reported losses. So again, you've got a certain amount of volatility and the case bases reserves and the claim payments in a 90-day period of time. I think, we ended 2017 right around at 60% accident-year loss ratio, and so we would still expect the first quarter number to trend down slightly over the course of the year.

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

And then, how about reserve development? Kind of a -- it definitely got back into the black after Q4, little more moderate pace than we might have seen historically, how are you seeing reserves?

Brian Donald Haney
Senior VP & COO

I think, we detailed some of that in our MD&A. The 2017 and '16 years developed favorably. There was a little bit of movement in some of the older accident years. I think it's important to reiterate that the Kinsale strategy, of course, is to be conservative in how we post reserves. We want there to be a greater probability that the reserves develop favorably than unfavorably. I think if you look at our -- we're in our ninth accident year today. If you look back over the history of the company, every accident year except one on an inception-to-date basis, has developed favorably. So I think we're on the right track. The fact that we see a little bit of volatility in some of those earlier and smaller accident years, doesn't change our evaluation of where we stand. We feel good about reserves.

Mark Douglas Hughes

SunTrust Robinson Humphrey, Inc., Research Division

And last question on pricing. I think you've suggested 5% or lower, generally speaking. And you'd like to see more but I think would -- you also said you expected to see more rate increases as the year progresses. You think -- is that to say would be in this kind of plus 5% range through the balance of the year? Or do you think it could get a little bit better?

Brian Donald Haney
Senior VP & COO

It's tough to say. I would say, definitely the industry needs to push rate more, and we're going to push -- we're more basically a price taker when it comes to the market like we're not big enough to drive rate ourselves. So the industry needs to push rate up more, so I would expect that to happen, and I would expect us to push rate of along with the industry. But the rates change we took, we think, we're -- we feel very comfortable with that. The market is bearing it and I think it's [indiscernible] to hit our targets.

Michael Patrick Kehoe
President & CEO

And I think Mark, it's also worth reiterating the fact that Kinsale operates at this fairly dramatic expense advantage of our -- a lot of our competitors, gives us a lot more flexibility to operate in a competitive environment and not compromise the returns that we're achieving for our stockholders.

Operator

And your next question comes from Jeff Schmitt with William Blair.

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

The adverse development, I guess, looks to be about $2.4 million for the 2011 through '15 accident years, which lines were those?

Michael Patrick Kehoe
President & CEO

We've got 9 -- I think, we have 9 or 10 statutory lines of business. We've got 9 accident years. So those estimates shift around from time to time. But in general, I would say, "Hey, there's really no pronounced trend that we're concerned about." As I said on -- to the previous caller, on an and -- on an inception-to-date basis, all of those accident years except one have developed favorably. The one year that developed unfavorably is the 2011 year. And I think we originally kind of put the size of the book of business back then in context, and we originally booked those reserves at, I think, it was about $12.4 million, and I think they've developed up to about $14.5 million, give or take. So it's a, again -- it's a very -- some of those early years were very modest in size. But there's no concern around pernicious trends. They've all developed favorably, except the one year on an inception-to-date basis. And we feel very positive about how conservative the company's reserves are stated.

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

Okay, and then, how was growth of Aspera looking? And what's besides that book now?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

I think that's a disclosed in the K or the Q, It's a little bit under 4%. But it's growing rapidly from, obviously, a small base. A lot of that growth is geographic. So, we expanded in new territories, some of it is expansion of the line of business into new products. But Aspera, I think, plays into the Kinsale growth story in that its driving some diversification in our distribution channels.

Jeffrey Paul Schmitt

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

Okay, and then I guess the tax rate lower than we would have expected. What do you see that as to going forward? I mean, will it be closer to 21%?

Brian Donald Haney
Senior VP & COO

I think, it's going to be a little less than that. I think, the impact from the stock option exercises was about 2%. So that would get you to about 19.5%, I think, on a run-rate basis. And you know, we're going to have some stock-option exercises every quarter just a little difficult predict. But I think, if we strip that out it comes out to that 19.5%.

Operator

And your next question comes from Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Apologize if I -- if you went over this a little bit, I would have been bouncing between a couple of different calls here. And your current accident year, that improved by about 4 points, give-or-take. Is that primarily a mix question? Or are you -- because of better pricing? Are you be able to make lower loss picks? Can you just talk through the process there a little bit?

Michael Patrick Kehoe
President & CEO

Yes, Mark. It's Mike. A little of it may be mix, right? Because we're seeing some fairly rapid growth in our property lines, that's the commercial property, that's the personal lines book, which is a homeowners for manufactured homes. It's already in the marine book. But most of it is just a variation over a 90-day period of time in the reported losses, right? So it's case reserves and its paid claims over a 90-day period is going to be a little bit -- it's going to bounce around a little bit. So that's the most significant piece of it. I think we finished 2017, if you just look at the accident year, right around a 60% loss ratio. In terms of where we see that trending, that's where we'd hope to trend again this year.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That's helpful. And then the second question I have is, I mean, obviously, your growth has been excellent over the last several quarters. You're up to, kind of, a gross premium run-rate in, call it, mid-$60 million kind of range. As you look ahead, if you continue -- if you're able to continue at that sort of a growth rate for the balance of the year, triangulate to maybe $250 million of annual premiums, at what point do you start to become capital constrained as far as a gross premium-to-surplus ratio? Or you'd need to consider whether it be debt or any other type of an instrument to try to get a little bit more capital underneath your growth?

Michael Patrick Kehoe
President & CEO

Yes, I think, obviously, we monitor and manage the capital very carefully, with an eye towards maintaining our A.M. Best rating of A-, that's critical to us. I think given the primary proceeds we raised in our IPO in the middle of 2016, we're still in good shape throughout 2018. But I think there's a chance we would borrow some money beyond that. We think having a little bit of financial leverage in our balance sheet will help boost returns, and that's a fairly inexpensive form of capital for us, even with rates rising a little bit of late.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, and I guess the last question I had, you mentioned in your opening comments by adding a little bit of risk to the investment portfolio and so forth. Can you just elaborate there a little about what you're thinking about?

Michael Patrick Kehoe
President & CEO

Last year, we took out our duration a little bit. I think where it used to be around 3 years.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Now, we're closer to 4 years.

Michael Patrick Kehoe
President & CEO

Now we're running about 4 years on the duration. I think we had a small allocation to preferred stocks from structured securities. It's still a very conservative portfolio. I think its AA credit quality on the fixed income. And then in terms of common stocks, I think we've got, may be a 5%, 6% allocation there. So it's just that it’s kind of incremental expansion in the risk appetite, just trying to augment returns a little bit.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, yes. I mean, I definitely agree it's still a very conservative portfolio. Is the 4-year duration now that is -- that's probably pretty close to your liability duration?

Michael Patrick Kehoe
President & CEO

Yes.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Yes.

Operator

And I'm showing no further questions at this time. I'd like to turn the call back over to Michael Kehoe for closing remarks.

Michael Patrick Kehoe
President & CEO

Okay, thank you, operator. Thanks everybody for joining us on the call and look forward to speaking to you again in a few months.

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