Kinsale Capital Group, Inc.

NYSE:KNSL

Earnings Call

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Call Participants

EXECUTIVES

Brian Donald Haney
Executive VP & COO

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Michael Patrick Kehoe
President, CEO & Director

ANALYSTS

Andrew E. Andersen
Jefferies LLC, Research Division

Casey Jay Alexander
Compass Point Research & Trading, LLC, Research Division

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Unknown Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by. My name is Brent, and I will be your conference operator today. At this time, I would like to welcome everyone to the Kinsale Capital Group First Quarter 2023 Earnings Conference Call. [Operator Instructions]

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 2022 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. We will follow our familiar format for today's call, where in Bryan Petrucelli, Kinsale's CFO; and Brian Haney, Kinsale's COO and I will each make a few comments, and then we'll move on to any questions you may have.

In the first quarter, 2023 Kinsale's operating earnings per share increased by 50% and gross written premium grew by 46% over the first quarter of 2022. The company posted a 78% combined ratio for the quarter and an operating return on equity of 29%. These favorable results are being driven by the Kinsale business strategy of disciplined E&S underwriting and technology-enabled low costs, which allow us to generate attractive returns and to take market share from competitors at the same time.

Adding to the Kinsale results for the overall favorable P&C market conditions with a strong and steady flow of business into the E&S market from the standard market, which allows us to expand margins and accelerate growth at the same time as we have been doing for several years now. The Commercial Property market continues to be an area of opportunity and rapid growth for Kinsale. As we discussed last quarter, we balanced the expected strong returns on the property business we write with a variety of controls to limit the increase in volatility.

Specifically, we restrict the concentration of business geographically. We model our portfolio regularly. We manage our individual policy limits very carefully, and we purchased a substantial reinsurance program. Although our commercial and personal lines property premium amounted to 26% of our net written premium volume in the first quarter. The property premiums subject to any material hurricane exposure is just over 10% of Kinsale's total premium. Further, our expected losses relative to operating income in the event of a major storm, have not materially changed even with the considerable growth in premium. Part of achieving long-term success in the P&C business is to consistently establish conservative estimates for future losses.

Kinsale has done just that over the years, and we continue to do so, setting up reserves for future claims that we believe are more than adequate, creating the likelihood that those reserves develop favorably over time. In a period of time with heightened inflation, such an approach is even more important. And as a consequence, investors should continue to maintain a high level of confidence in Kinsale's reserve position and overall balance sheet.

Finally, our overall view of the E&S market continues to be positive. The property market, in particular, is in a state of distress, while the casualty market is more orderly and subject to more competition, but still allows for positive rate increases and strong premium growth. We are optimistic for the balance of 2023 and we have a rising sense of optimism about next year.

That being said, we also believe our business model of disciplined underwriting and technology-driven low costs will allow Kinsale to deliver best-in-class returns and to take market share even when the competition increases at some point in the future. In a more competitive market, Kinsale will continue to deliver strong returns, but our current growth rate will give way to something more modest, perhaps in the low to mid-teens.

With that, I'll turn the call over to Bryan Petrucelli.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. Again, just a really strong quarter for all the reasons that Mike just mentioned, with 46% growth in written premium, and net and operating income increasing by 76% and 51%, respectively. The 78.2% combined ratio for the quarter included 3.8 points from net favorable prior year loss reserve development compared to 4.7 points last year with less than a point from cat losses in either period.

Most of the improvement in the quarterly expense ratio of 19.6% compared to 21.6% in the first quarter of last year, related to ceding commissions from the company's casualty and commercial property proportional reinsurance agreements and is also in line with our 19.9% expense ratio in the fourth quarter of last year.

On the investment side, net investment income increased by 128% over the first quarter of last year as a result of continued growth in the investment portfolio and higher interest rates with a gross return of 3.7% for the quarter compared to 2.5% last year. We continue to monitor Fed actions and any related impact on inflation and interest rates. And given the current inverted yield curve, we're continuing to invest new money in the shorter duration of securities with new money yields averaging close to 5% during the quarter, and our duration decreasing slightly to 3.4 years down from 3.5 years at the end of last year.

We did have a preferred stock position in SPB Bank and recognized a $4 million realized loss on the sale of that security during the quarter. Book value was positively impacted in the first quarter from a combination of net income and an increase in the fair value of our fixed income securities during the quarter. Notwithstanding the positive Q1 movements, our fixed income portfolio continues to be an overall unrealized loss position resulting from the higher interest rates or so over the past year or so. The company continues to generate strong positive operating cash flows, which gives us the ability to hold these securities to maturity and the higher interest rate environment allows us to invest new money at better yields that I just touched on.

As it relates to capital, we continuously monitor our needs as market conditions change. Given the continued favorable market conditions and related premium growth, there's always the possibility that we'll need additional supporting capital. The support could come in the form of debt or equity with a bias towards debt given our current modest debt to capital position and with any decisions to be made in the second half of the year consistent with our historical approach.

And lastly, diluted operating earnings per share continues to improve and was $2.44 per share for the quarter compared to $1.63 per share last year.

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

Brian Donald Haney
Executive VP & COO

Thanks, Brian. As mentioned earlier, premium grew 46% in the first quarter, consistent with the last several quarters and representing a continuation of the previous 4 years where we averaged just over

40% growth annually. Overall, the E&S market remains favorable with strong growth across most of our product line. The property market continues to be hard and in the wake of Hurricane Ian the contraction in industry capacity is continued.

In addition to our Commercial Property division, we are seeing continued strong growth in our Inland Marine book as well as across most of our casualty divisions. Our energy, general casualty and entertainment divisions, in particular, continued to grow at a significant pace. There are some pockets of business that are more competitive and flat or slower growing, such as management liability and product liability.

I want to speak for a moment about the property market in particular. The last few years, the industry has experienced some significant losses. Five of the top 10 costliest natural catastrophes in U.S. history have happened in the last 6 years and 2 of the top 3 have occurred in the last 2 years. This has resulted in carriers dramatically pulling back cutting capacity and raising rates. It has presented a historic opportunity for Kinsale because we came through that same period with record profitability. So now we have the ability to write business at extraordinary rates and terms. The current property -- the current market and property is as hard as we've ever seen, and the rates and terms are as good as we've ever seen.

As Mike said, we are mindful of volatility and so we carefully manage and limit our accumulation of aggregate insured value in order to keep our volatility with an acceptable balance. Submission growth continues to be strong in the low 20% range, which represents a modest acceleration from the previous quarter, but generally consistent with most of 2022. As a reminder, we view submissions as a leading indicator of growth, so that submission growth rate is a positive signal for our market opportunity. We sell a wide range of products and the rates of those products do not move in lock step. But if we boil that all down to 1 number, we see real rates being up a little over 7% in the aggregate during the fourth -- first quarter, a very slight improvement over the fourth quarter.

The property market is certainly boosting that number. The rate changes for property would be well higher than the average. The rate changes for casualty divisions were very greatly, but overall, it will be less than the average, but still positive, which indicates that the combination of rate changes and premium trends are exceeding loss cost trend. It's important to stress that rate change and rate adequacy are 2 different things. As our results demonstrate, our rates are more than adequate. We are continually reviewing these rates and adjusting them based on a number of considerations such as our target combined ratio, our target return on equity, the market opportunity and shift in the competition.

It's also important to note that we've been getting rate increases in excess of trend for several years now. We feel the business we're putting on the books today as the best rate adequacy we've seen in our history. We do continue to keep an eye on inflation. We feel we're in a good position, but we monitor the situation continuously and make adjustments as necessary. The market conditions as I said are generally favorable across the board. For the most part, we see competitors either retrenching or behaving in a stable, rational manner.

There are a few new market entrants, particularly among MGAs and fronting deals, that are offering wide open coverage and prices too cheap for their carriers to hope to make any return. But this phenomenon isn't impacting our market opportunity at the moment, and we believe economic reality will eventually catch up with those competitors. When it does, there will be further market dislocation and opportunity for the rational actors and that ultimately will be good news for Kinsale. Overall, clearly, a good quarter, and we are happy with the results.

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

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

Question and Answer

Operator

[Operator Instructions] Your first question is from the line of Mark Hughes with Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Mike, you have, in the past, referred to some commentary about the inflation and the impact on loss development among competitors, I think you have alluded to kind of reinsurers speculating about loss development being more severe than expected. Any update on that? How do you see the impact of inflation on your competitors? And what does that mean for growth in the E&S market?

Michael Patrick Kehoe
President, CEO & Director

Well, I think on your longer tail lines, they're the most exposed to the increase in inflation. I think we've seen it in our own book of business where building supplies have gone up in price, labor costs have gone up in price. And so a claim that may have been settled 2 or 3 years ago for [100,000] is probably being settled for a considerably higher number today. We always like to belabor the fact that it's a very fundamental part of our business strategy to set conservative reserves for future claims. And I think that conservatism gives us some insulation but clearly, if you go back to the -- for Kinsale the 15 through 19 years, yes, inflation has impacted those years. I think all those years have developed favorably on an inception-to-date basis, but it has probably eroded the conservatism a little bit.

Given the rate increases that Bryan mentioned from 2020, '21, '22 and now '23. We think we're in a great position in terms of conservatism overall but it does have an impact. And it's going to impact all of our competitors the same way. Not every company takes the same conservative approach to reserving. So the more optimistic a company is at the beginning of that process. I think the more painful the inflation can be. But I think the net takeaway is it should extend the favorable pricing environment for the E&S market.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Then on construction. Refresh me how much of your book may be exposed to construction? What do you think about the potential slowdown related to the banking crisis. Are you seeing anything like that, any early signs?

Michael Patrick Kehoe
President, CEO & Director

No. We're -- I think we're seeing good growth in construction. It's about 25% of our business, if you include everything under that broad umbrella. So I mean, that could include commercial and residential contractors. It can include home repair businesses, janitorial, landscaping, all sorts of things fit under that umbrella, but that's a bread-and-butter E&S class for the industry and it is for Kinsale as well. But I think we're seeing good growth across all our casualty lines at the moment with the 2 exceptions that Brian talked about, management liability in particular.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. And then 1 other question, Bryan Petrucelli. The ceded premium ratio with property increasing. Actually, I think it was down a little bit sequentially this quarter. What do you think a good run rate for 2023 would be on ceded premium ratio?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

I think, Mark, looking at what we have for the first quarter is probably a good indicator of what we have going forward. That is going to change depending on the mix of business. We talked about that in the past. But I think if you're trying to put something in a model, I think looking at what we did for the first quarter is as good of an indicator as I can give you.

Operator

Your next question is from the line of Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Mike, you mentioned that expected catastrophe losses as a percentage of operating income have not changed even with property writings going up. Can you help quantify that a bit? And anybody how to do it, whether it's a percentage of premiums or earnings or just sort of any numbers around that expectation?

Michael Patrick Kehoe
President, CEO & Director

Well, I think the best way to look at that because I mean it gets into a very technical array of numbers when you look at a probable maximum loss curve across a variety of different return periods, but if you look at Kinsale's experience now over 5, 7, 9 years, every major storm, when there's a major storm, we have losses, but they're very manageable in terms of -- maybe look at the third quarter of last year as an example, our run rate on combined ratios, I think, was in the high in the third quarter when we had some losses related to Hurricane Ian, hey, the combined ratio ticked up into the low 80s, right?

So that's generally how we're trying to manage the volatility. We see a tremendous opportunity in the property business at the moment. As Bryan said, we've never seen a more favorable market for the risk bearer. And so we want to take advantage of that, but we're also mindful of volatility. And so all the things we've done over the years to balance the return prospects against the volatility, we continue to do that. That's kind of the message we wanted to convey. But we don't have a specific number to give you that you could pull everything down to one statistic.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Understood. That was helpful context, Mike. And then the second question, I just wanted to follow up on your comment, and this is something new that you've said, right, you said this before. But longer term, you think growth for Kinsale's in the low to mid-teens. I guess the question around that is based on your experience of cat cycles in the market. How do you see that normalization playing out, right? Do you think there's going to be a steep decline to that more run rate level? Or do you think the process will be more gradual maybe even over a couple of years?

Michael Patrick Kehoe
President, CEO & Director

I think it could be gradual over a couple of years. As I said in my comments, we're very optimistic today. I mean we just -- we've been growing at an extraordinary rate now for 4 years. The distress in the property market. I don't think we'll go away anytime soon. Inflation has an impact on the industry's reserve position. So that has yet to manifest itself. We continue to have a very, very dynamic tort system in the United States, which, of course, is a challenge for the industry. So there's a lot of reasons, I think, for the market to continue to be favorable. It's just a recognition that a 40% or 46% top line growth in a mature industry like insurance is extraordinary. And at some point in the future, it will abate somewhat. But beyond that, we think our business model is a little bit unique, and it should allow us to continue to grow at a very healthy rate and take market share even in a more competitive environment.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Understood. And then the last 1 for me is for Brian Haney. Apologies if I missed this, but you had mentioned something about MGAs and fronting companies. I'm not sure if you referenced a specific line of business. But could you talk to, I guess, where these entities are over presented and maybe those entities having a negative impact on pricing and market dynamics. And apologies if I missed it, but I didn't hear specific lines associated with those.

Brian Donald Haney
Executive VP & COO

No, no, I didn't mention it, but I would say, in management liability, is probably one way you're going to see them in professional liability. They're going to be more common. They definitely then to focus on large deals, which is why it's not having that big of an impact on us. So if you've heard market commentary from some of our competitors about what's going on in, let's say, D&O, right? That's going to be going on in the large public company D&O space, which we're not in. So that would be the lines we tend to see them then. [indiscernible], but we don't really write cyber.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

And in property, sorry, are they less common in property sort of like the syndicate deals or...

Brian Donald Haney
Executive VP & COO

Yes, I would say, with the market the way it is now in property, yes, they're less common. Like right now, you wouldn't have to use MGAs to write a lot of business in property. But they certainly are in that space.

Operator

Your next question is from the line of Andrew Andersen with Jefferies.

Andrew E. Andersen
Jefferies LLC, Research Division

Just considering the growth in property over the last couple of quarters, any impact on the underlying loss ratio from what I would think would be a lower attritional loss ratio business? And if not, would it be fair to think of some coming in the second half of the year?

Michael Patrick Kehoe
President, CEO & Director

It's true that the property business we write, that's got a pronounced cat exposure will run at a much lower attritional loss ratio. But I would say, in general, given the uptick in inflation, the persistence of inflation, a lot of commentary around social inflation on certain claims. We continue to take a very cautious approach to reserving. And so I don't know that you'll see any kind of immediate benefit.

But that being said, even with our conservatism, I think we're in the high 50s for a loss ratio. And when you match that up with an attractive expense ratio that we're delivering really compelling returns even with the conservatism.

Andrew E. Andersen
Jefferies LLC, Research Division

Got it. And -- do the recent Florida market reforms change appetite in the state relative to maybe where it was a few months ago? And could you also just remind us of appetite in the state of whether residential, commercial and maybe geographic?

Michael Patrick Kehoe
President, CEO & Director

We were kind of exempt from a lot of the AOB issues that were plaguing the standard homeowners writers in Florida. We do have a small homeowners book in the Southeast United States that we're actually kind of reducing concentration there. We had an Ian loss that was a little bit larger than we hoped. But Florida is a big state for us on both the property and the casualty side. Obviously, again, we have strict limits on concentration. So yes, we're going to write in Miami Day County, but we have limits as to how much we'll write there. But most of our exposure, I think, is on the commercial side.

Operator

[Operator Instructions] Your next question comes from the line of Scott Heleniak with RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Just wondering if the -- if there's any point to particular, which has obviously been strong for a while, it looked like that upticked a little bit. But is there any area where you're seeing more dislocation or pull back from some of your peers, I would think, obviously, property. But is there anything else that you can point to where you're just getting a lot more looks at business as competitors retrench?

Brian Donald Haney
Executive VP & COO

Yes. I mean obviously, property is 1 area we're seeing a lot more submissions. I would say it's pretty across the board. Like there's very few areas where we're not seeing good growth in submission. And to the extent that we are, those are the areas that are not growing as much like product liability and management liability. So it kind of ties with the growth rate in premium.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. Pretty broad-based. All right. And just moving on to the -- you guys have, if I'm not mistaken, you have the commercial property quota share reinsurance treaty that renews at June 1. Any thoughts on renewing that the current form, whether you expect any changes on that in pricing and whether you expect to keep it that as a quota share versus excess loss. Anything you can add on that?

Michael Patrick Kehoe
President, CEO & Director

Yes, Scott, this is Mike. We're going through the reinsurance renewal for our whole program at the moment. But the intent is to renew the commercial property quota share. We currently see 42.5% of that. We're going to push that up to 50%, but we don't expect any deterioration or improvement for that matter in terms I think it will be per expiring.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Yes. Okay. Just had a question to you. We've heard a lot of talk in the quarterly conference calls about just given customers are seeing large rate increases, adjustments to the premiums to reflect the higher insured values. Are you seeing a meaningful shift in some of your terms and conditions, just the deductibles and limits pretty across their book as some customers just are struggling with the rate increases, and so you have an opportunity to change deductibles and limits there?

Brian Donald Haney
Executive VP & COO

The short answer is yes. So I mean we're seeing generally more favorable terms because people are looking for a way to save money. So it could be through purchasing lower limits, having higher deductibles, living with sublimits, things like that.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Is that a big change versus last 6 to 9 months? Or is that just kind of gradually headed that way?

Brian Donald Haney
Executive VP & COO

That's been going on kind of as the hard market has been evolving. So no, it's not a significant change. I would just say it's -- in certain areas, it's pretty pronounced like again, property.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. And then just lastly, anything on the favorable development that you said in the Q, it's from more recent accident years, 2021, 2022. Is there any particular areas that you can call out on that, that you can point to where -- lines of business where that's coming from?

Michael Patrick Kehoe
President, CEO & Director

Yes, I don't think there's anything we can point to on the call other than I think we're seeing good experience across the portfolio. We write a good mix of short, medium and longer tail lines. And so there's probably a disproportionate percent of those dollars that come from the shorter versus the longer tail. But I don't -- we don't have anything specific to point to. The results are a combination of setting conservative loss picks but also getting some very dramatic and persistent rate increases that had a loss cost trend now for a number of years in a row.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. And was there any favorable development from Ian that was worth calling out?

Michael Patrick Kehoe
President, CEO & Director

No.

Operator

Your next question is from the line of Mark Hughes with Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. I was just going to ask anything on the audit premium front, anything that would speak to the economy. Are you -- is there anything you see that suggests maybe some slowdown even in the midst of all the other good news?

Brian Donald Haney
Executive VP & COO

Yes. I mean I think you got to keep in mind when we talk about the economy slowing down, that it's in an inflationary environment. So the audit premium is going to be based on nominal sales, not real sales and not adjusted sales. So we haven't really seen that big an impact on it. I guess the 1 thing I would say is we did use to see kind of outsized COVID-related audits a year or 2 ago that we aren't seeing now. But now we're still seeing a good flow of audit premium.

Operator

Your next question is from the line of Casey Alexander with Compass Point.

Casey Jay Alexander
Compass Point Research & Trading, LLC, Research Division

Just kind of a maintenance issue. In the investment portfolio, is there any additional regional bank exposure of note, particularly any common preferred or debt exposure to First Republic? And also any commercial mortgage exposure?

Michael Patrick Kehoe
President, CEO & Director

I'll do them in reverse order. We do have a healthy allocation to mortgages through the, I guess, residential and commercial. I think they're almost all AAA rated. So we're in a pretty cautious position there. In terms of the First Republic, I don't think we have any exposure. In terms of regional banks, I think it was about 4% of the portfolio, and again, pretty highly rated bonds across a variety of regional banks.

Operator

[Operator Instructions]

Michael Patrick Kehoe
President, CEO & Director

Operator, it looks like we have 1 call pending.

Operator

Yes sir. Your next question comes from the line of Tommy Johnson, a private investor.

Unknown Analyst

Mike and Brian, this is a voice from your past and I can't ask an intelligent question, but I want to say as a shareholder from day 1, you're an example of what Warren Buffett talks about "If you're lucky in life, you invest in a couple of great companies and you hang on", and you guys have proven that to be true. And this is just a stockholder saying you have an incredible track record. Your explanation on the phone, while I can't follow it demonstrates your knowledge of the business, and I just want to express my appreciation for your -- both of your leadership throughout the time. I remember when you set my office, Mike and laid out your business plan, and I don't know that any of us thought you would exceed it the way you have, but it's been a great ride, buddy.

Michael Patrick Kehoe
President, CEO & Director

All right, Tommy. Well, thank you for the kind words, and thanks for the better confidence over the years.

Operator

There are no further questions at this time. I will now turn the call back over to Mr. Michael Kehoe.

Michael Patrick Kehoe
President, CEO & Director

Okay. Well, thank you, everybody, for participating this morning, and we look forward to speaking with you again here in a couple of months. Have a great day.

Operator
Ladies and gentlemen, this concludes today's conference call. You may now disconnect.