S&P Global
Market Intelligence

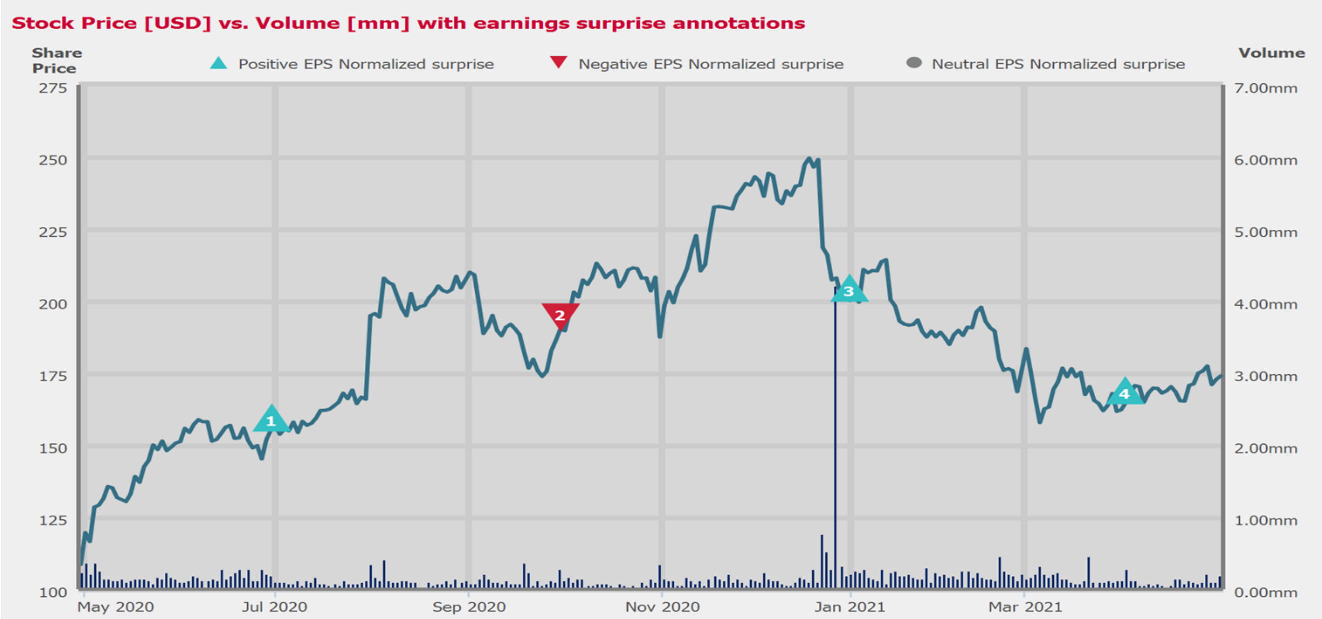
Kinsale Capital Group, Inc. NasdaqGS:KNSL
FQ1 2021 Earnings Call Transcripts

Friday, April 30, 2021 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ1 2021-			-FQ2 2021-	-FY 2021-	-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.84	1.11	▲32.14	1.06	4.30	NA
Revenue (mm)	128.90	138.28	▲7.28	138.36	575.61	NA

Currency: USD
Consensus as of Apr-30-2021 8:26 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2020	0.69	0.84	▲1 21.74 %
FQ3 2020	0.74	0.42	▼2 (43.24 %)
FQ4 2020	0.78	1.14	▲3 46.15 %
FQ1 2021	0.84	1.11	▲4 32.14 %

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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

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

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Rowland Juran Mayor
RBC Capital Markets, Research Division

Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the First Quarter 2021 Kinsale Capital Group, Inc. Earnings Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded.

Before we get started, let me remind everyone that through the course of the teleconference, Kinsale's management may make comments that reflect our 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 2020 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, and thank you for joining us on the call today. Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Kinsale's Chief Operating Officer are on the call with me. Each of us will make a few comments in turn, after which we will take any questions.

Last night, Kinsale reported operating earnings of $1.11 per diluted share for the first quarter of 2021, an increase of over 48% from the first quarter of 2020. Gross written premium was up over 36% for the quarter. The company posted an 80% combined ratio and a 17.6% annualized operating return on equity for the quarter, well ahead of our guidance of a mid-80s combined ratio and a mid-teens operating return on equity.

A quick recap of the Kinsale strategy is appropriate, given that it is the principal driver of our results. We focus on small to medium-sized accounts in the E&S market. We control our own underwriting, unlike almost all of our competitors, which, at least in part, contract out underwriting to outside parties. And we operate at a significant and technology-driven expense advantage over most competitors. The disciplined underwriting and low costs is a powerful combination.

Kinsale results are also benefiting from continued dislocation in the market. We are still seeing some carriers working through the process of correcting problems within their books of business. Some programs are being canceled, capacity withdrawn, or standard business being pushed into the nonstandard market, et cetera. This process has been going on for the last 2 years or so, and we expect it to continue for the duration of 2021 and possibly longer.

For Kinsale, the dislocation is allowing us to grow rapidly and expand margins at the same time. Brian Haney will provide some additional color on this topic here in a moment. As we have said in the past, when this period of dislocation abates, possibly in 2022 or 2023, Kinsale will continue to grow and take market share, given the power of our business model, but we'll do so more slowly, likely in the low double-digit range.

From an operations standpoint, we moved our employees back to the office early in the fourth quarter, and we continue to benefit from that step, especially in terms of providing our brokers superior customer service and better training to new employees that we've been hiring to accommodate the strong premium growth, rolling out new technology innovations, et cetera.

Speaking of technology, we continue to invest in improving our core enterprise system by rolling out new features and functions that improve productivity, customer service, accuracy, and data collection. Owning our core enterprise system, not having legacy systems to maintain, is a competitive advantage that we are working hard to exploit.

One measure of our commitment to this initiative is that we now have 8 agile development teams at work, up from 7 last year and 5, 2 years ago. A little over 20% of our employees work in IT-related positions, and none of them work on maintaining legacy systems from the 1990s or 1980s and prior because we don't have any.

Now I'll turn the call over to Bryan Petrucelli.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. The results for the first quarter continue to be strong and driven by solid premium growth, favorable loss experience, and disciplined expense management. We reported net income of $32.1 million for the first quarter of 2021, representing an increase of 531% when compared to $5.1 million last year, due primarily to a $10 million increase in underwriting income and a $35 million increase in investment returns, driven by favorable equity market value movements in 2021 compared to 2020, where we saw significant unfavorable equity market movements resulting from a reaction to the pandemic.

Net operating earnings, which excludes the volatility from equity investment gains and losses, increased by 48%, up to $26 million from $17 million in the first quarter of last year. The company generated underwriting income of $24.6 million and a combined ratio of 80% for the quarter compared to $14.4 million and 83.9% last year, with improvements to both the loss and expense ratios. The combined ratio for the first quarter of 2021 included 5.7 points from net favorable prior year loss reserve development compared to 3.3 points last year and with negligible cat losses in either period.

We continue to see a slower pace of reported losses from limited operating capacity in the courts and other judicial inefficiencies related to COVID-19. As a result, we continue to take a conservative approach in our reserving in this area. We believe there is likely some permanent benefit there. However, we believe it's prudent to take a wait-and-see approach as the courts open and normalize operations before recognizing any related redundancy.

Additionally, our current accident year loss ratio decreased slightly in recognition of ongoing favorable pricing trends resulting from the market dislocation that Mike previously touched on. The expense ratio benefited from economies of scale related to our premium growth and from a slightly lower relative net commissions as a result of shift in mix of business in lines that are subject to reinsurance and where we receive ceding commissions.

Annualized operating return on equity was 17.6% for the quarter and again, ahead of our mid-teens guidance. Gross written premiums were approximately $170 million for the quarter, representing a 36% increase over last year due to the market dislocation that Mike mentioned and our super interior service standards.

On the investment side, net investment income increased by 16.5% over the first quarter last year, up to $6.9 million from $5.9 million last year. Annualized gross investment returns, excluding cash and cash equivalents, was 2.6% compared to 2.9% in 2020. And diluted operating earnings per share was $1.11 per share for the quarter compared to $0.76 per share last year. With that, I'll pass it over to Brian Haney.

Brian Donald Haney
Executive VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 36% in the first quarter, up slightly from the fourth quarter of 2020. While there's still plenty of competition, the market is still very favorable, and the rates and terms we are getting are still very attractive. Growth was particularly strong in our commercial property, environmental, and product liability areas, although most areas were up significantly.

Commercial property space continues to harden as a result of major industry events. Last quarter, the uptick in COVID cases led many states to reimpose restrictions, particularly California and New York, which are 2 of our bigger states. With the widespread vaccine distribution and dropping cases in the first quarter, we're seeing restrictions loosening, which has provided us some tailwinds, particularly in areas like construction and general casualty.

Submission growth was in the mid-teens in the first quarter, down from the high teens in the fourth quarter, but we saw a resurgence late in the quarter as some COVID restrictions were loosened, and that resurgence has continued into the early second quarter, giving us a good sense of optimism for the full year as respect to submission and premium growth and general market opportunity.

As for rates, we continue to push them up in response to market conditions. As a reminder, we have a very heterogeneous book of business, which complicates reducing all the rate movement to one single number. But that all being said, we see rates being up in the low teens range in the aggregate during the first quarter, generally consistent with the fourth quarter.

Even beyond getting pure rate, we are tightening terms and conditions, which should contribute even more to the bottom line. Keep in mind, unlike many of our competitors, we are raising rates to further improve margins, not to correct former poor decisions or to rectify money-losing books of business.

With all that said, we feel like the rate increases we're getting are well in excess of trend. So we expect some margin improvement gradually over time.

Lastly, as Mike mentioned, our employees have been back in the office since October of last year, and that's been a great help to us in terms of training new employees, providing superior customer service and instilling our corporate culture.

Starting in January, we resumed making marketing trips to see our brokers in person where the lockdowns would permit. We're seeing an advantage in that many of our competitors have not returned the office yet and are not doing any in-person marketing. We're very much in the vanguard on this front. But we find there really is no substitute for in-person, face-to-face interaction, whether it be in marketing, training new associates or just working in general.

Our competitors will ultimately, I suspect, return to the office and eventually resume their marketing trips, but until then, we will enjoy this temporary advantage they have ceded to us. And with that, I'll hand it back over to Mike.

Michael Patrick Kehoe
President, CEO & Director
Thank you, Brian. Operator, we're ready to take any questions that are in the queue.

Question and Answer

Operator

[Operator Instructions] Your first question is from the line of Jeff Schmitt with William Blair.

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

Yes, growth obviously continues to be really good. You had mentioned you continue to see dislocation in some areas. And rate increases were obviously a couple of years in, they've been high for a few years, kind of has a compounding effect. Where are you still seeing that dislocation? And is it getting close to adequacy there? Or what is your view on that?

Michael Patrick Kehoe
President, CEO & Director

Yes. I think we were adequate back in 2018. And right? So of course, we monitor profitability very closely, and we're always adjusting technical pricing to stay abreast of trend. But we generally manage our book of business to that mid-teens operating return on equity or greater.

And so the rate increases in 2019, 2020, partly into 2021. That's the point, I think Brian was trying to make is these are opportunistic rate increases that we're getting that are expanding our margins, not filling in a black hole from underpriced business in the past. So it's a pretty interesting opportunity for us.

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

And then a question on favorable development. And it looks like it all came from 2020 or I guess, $9 million was in 2020, and there was some, I guess, adverse in some prior accident years. Is that right? What years was that from? And what lines was that from?

Michael Patrick Kehoe
President, CEO & Director

Yes. I don't think we're ready on the call to get into that level of granularity. But what I would say is we saw an increase in favorable development from the prior years, right, on a year-over-year comparison. So first quarter 2020 versus first quarter 2021, I think we went from 3 point something percent, up to, I think, 5.7% favorable development.

Our goal that we've talked about frequently is to post very conservative reserves that are highly likely to develop favorably over time. I think we've achieved that goal. Every single accident year, except one, which was our first full year in business back in 2011. Other than 2011, every single accident year has developed favorably on an inception-to-date basis.

Occasionally, you'll see a little bit of volatility in those reserves as they develop over the years. But in general, they've all developed favorably. And given the rate increases, the margin expansion we've been talking about, the fact that we've been able to sell slightly more restrictive coverage terms from time to time. The growth in the business is giving us a little bit of that economy of scale effect on our expense ratio. Clearly, we're seeing some very interesting margin expansion.

The only caveat there would be, hey, our conservative reserving sometimes creates a lag between when we write the business and when those reserves will come down and we'll recognize that profitability. But in general, it's pretty solid news.

Operator

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

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. Can you talk about frequency in the quarter? I think you talked about the courts are openings slowly, but I just wonder, your frequency seemed like it was down last year. How has that progressed here into the Q1?

Michael Patrick Kehoe
President, CEO & Director

Yes. Mark, this is Mike again. We kind of characterize it as reported losses. Reported losses were lower than we expected last year, and that's continued in Q1. Clearly, some of that, we think, is related to the disruption in the court system, but it creates a little bit of uncertainty as to whether there's going to be a bounce-back in those claims or whether it's a permanent advantage for us.

And that was -- those are the comments Brian was trying to make, just that, hey, we're taking a very cautious approach there. We're fully reserved as those claims are going to revert to normal. If they don't, that's great news, and we'll recognize that redundancy over time.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

When we think about cat losses, why did you do so well relative to the winter storm Uri in Texas? You did have some hits in 3Q around the hurricanes. But the magnitude of the dollar losses were pretty substantial industry-wide for both. What about your book of business puts you in a better position now versus 3Q?

Brian Donald Haney
Executive VP & COO

So -- yes, this is Brian Haney. So on the personal insurance side, we do write a fair amount in Texas, but it's concentrated towards the coast where the freezing would have been not as bad. And then on the commercial property side, we do write a fair amount in the areas that were affected by freezing, but a lot of it would be shared and layered excess deals with very restrictive terms and conditions. So we ended up, for whatever reason, not having a lot of commercial property losses.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then the submission activity, I think you said it slowed from high teens to mid-teens, but then reaccelerated late in the quarter and then that's continued into Q1. Do I have that correct? And then any way to break out how much is kind of the reopening or resurging small business versus mix shift into E&S?

Brian Donald Haney
Executive VP & COO

So the first part, yes, you are correct. You correctly described what I said earlier. And then there's really no way to break it out sort of beyond that. We don't know how much of it is related to like what particular effects, although pretty sure the COVID restrictions had something to do with it.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

So presumably, you're seeing more in California and New York where there were restrictions in place but opening up.

Brian Donald Haney
Executive VP & COO

I don't have the stats with me, it would not surprise me if that was true.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. And then, Mike, it seems like there's a lot of signs of inflation in the economy. How do we think about your business in the context of if inflation does kick up?

Michael Patrick Kehoe

President, CEO & Director

Mark, I would think of it this way. Most of our business is priced off of inflation-sensitive metrics, right? So if there's a general inflation in the economy, we're going to get the benefit of that in the form of higher premiums. On the other hand, hey, there's a lag between when we collect premiums and pay claims. So there is some exposure there.

And of course, to the extent that the Fed recognizes the inflation and it results in higher rates, there's an exposure there for our fixed income portfolio. I think we're very conservatively positioned from a fixed-income standpoint. I think the fact that we've been aggressively raising prices well ahead of loss cost trend going back to January of 2019 puts us in a great position to handle things like inflation, right?

I mean, the Fed is saying that they're -- that the CPI is pretty steady around 2%. There's tons of anecdotes that indicate that, that's not accurate. Time will tell what the real answer is there, but I think there's -- given the conservatism in how we priced our business, I think we're well positioned to handle any uncertainty that comes our way from inflation in general. Or there's a lot of commentators talking about social inflation impacting loss cost trends. I think we're very well positioned to handle that and the like.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then one final question. Since you mentioned that you have 8 agile development teams, what are they doing?

Michael Patrick Kehoe
President, CEO & Director

We have divided those teams into different verticals to focus on improving our system. We've achieved a lot in terms of technology over the 11 -- this is our 12th year in business. But we got a long way to go, too. I'd point to our expense ratio as in a high-volume business.

And just to put some numbers on that, Kinsale had about 460,000 new business submissions in 2020. I think that translated into directionally somewhere around 300,000 new business quotes, multiple tens of thousands of new business binders, tens of thousands of renewal binders, tens of thousands of various endorsements or transactions like cancellations, reinstatements, inspections, audits, et cetera.

And we finished the year, I think, with 305 full-time employees. So I think kind of indirectly, that speaks to the level of automation that we've been able to achieve over the years. But we've got a long way to go, too. And so we're looking to drive more and more repetitive tasks into the software to make our employees' jobs a little bit more automated. We want to have more support for our claims examiners, our underwriters, et cetera.

So it's a big initiative. It's an advantage, I think, clearly, and it's one that we think has some real durability to it, given the fact that I think we're one of the few companies that has taken this approach in terms of owning our core system and building an IT staff with the skills and capabilities, not just to build it, but to improve it over time.

Operator

Our next question is from the line of Rowland Mayor with RBC Capital Markets.

Rowland Juran Mayor
RBC Capital Markets, Research Division

First, a quick one. The premium retention ratio was down a bit year-over-year. Is that still the shift to more commercial property business? Or is there anything else in that?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

It's partly shift in business, and we did have a couple of million dollars in reinstatement premium during the first quarter that drove that down a little bit as well.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. And then this might be parsing your words a bit, but it sounded like competition might be a bit tighter than it was a year ago, and that's not saying a lot. But sort of as you reach the point where competition does begin to catch up on rate adequacy, is the -- should we expect the pace of margin improvement to slow before growth slows? Or sort of how do you balance the margin improvement that's opportunistic versus sort of the rapid growth you're seeing now?

Michael Patrick Kehoe
President, CEO & Director

Yes. I think we're pretty excited about the market opportunity, candidly, for the last couple of years, but really kind of for the near-term foreseeable future because we're getting both margin expansion and extraordinary growth. As competition heats up, we've got a lot of leeway in our pricing to be more aggressive.

And so we'll continue to balance both. Obviously, profitability is our principal goal. Growth is secondary. But given the expense advantage in our business model, we think we're going to be able to achieve both over the long term.

Rowland Juran Mayor
RBC Capital Markets, Research Division

And are there any sort of metrics you might be able to give on if competition has changed recently? Are your renewal retentions sort of flat to where they were a year ago? Or is the hit rate on when you're quoting still similar to where it was last year?

Brian Donald Haney
Executive VP & COO

Yes. Actually, I think you might have mis-parsed what we said. We were not implying that competition has heated up recently. I was trying to say it was pretty steady. And if you look at the -- we don't really share metrics about the competitive marketing stats we have. But generally, that's been pretty steady too. So we're not seeing any deterioration in those metrics because of competition. And we are not seeing anecdotally any increase in competition. It's just steady.

Operator

[Operator Instructions] Your next question is from the line of Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

I just wanted to follow up on the topic of favorable development, which was mostly from accident year 2020. I guess what drove the decision to release fairly early? And does that action have any impact on how you're thinking about loss picks for 2021?

Michael Patrick Kehoe
President, CEO & Director

Yes. Pablo, this is Mike. We have -- part of our actuarial assumptions, you have reporting patterns and -- that you anticipate, and they vary by statutory line of business. And it's those patterns that govern how reserves are released over a couple of years for short-tail lines like property, 5, 7, 9 years for some of the casualty lines, and it gets into the upper teens, I think, for our excess casualty, which is considered a longer tail line of business.

So it's a formulaic release. And those -- we do adjust those patterns annually based on actual claims activity that we compare to the assumptions. But in general, they're pretty steady. And I think that's what you're seeing.

There's also an effect because 2020 was dramatically larger than every accident year that came before it. So there's just more dollars in play each progressive year that we've gone along, especially given the robust growth rates. Does that help?

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Yes, yes, it does, especially the point about 2020 being a large dollar year. That makes sense. And then second question, you had referenced margin improvement given pricing exceeding loss costs in your remarks. I was wondering if you could provide some detail on that, whether -- where you see lost cost trending or maybe even the margin expansion you expect?

Michael Patrick Kehoe
President, CEO & Director

Yes. We've talked about that before where we see loss cost trend below 4%. And if you go back to 2019, I think we were raising rates around double that, around 8%. For 2020, we moved that up to low teens, kind of the 10% to 13% range. And that's -- as Brian said, that's steady in Q1.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then I just have a couple more, an expense question. So I think your net commission expenses held steady at about 13% of earned. But clearly, the other underwriting expense rate has come down considerably over time. So just given your growth, how should we think about that part of your -- the non-commission part of your expense base? So I presume some part of it will evaluate premiums, but other costs might be more fixed in nature, perhaps over the long term?

Michael Patrick Kehoe
President, CEO & Director

Yes. I would say we would expect it to be relatively steady. I think Brian commented earlier that we're getting some economies of scale there. But it's not going to be a dramatic improvement from quarter-to-quarter. The reason we talk a lot about technology and our expense ratio overall is because it's dramatically lower than most of our competitors, and we're working to be even more efficient in the future. But I see it more as an incremental and steady improvement as opposed to any kind of sharp drop.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

And then last for me, you guys have a decent-sized construction book. Any thoughts on what infrastructure bill might mean for your business?

Michael Patrick Kehoe
President, CEO & Director

I haven't thought about it, but I assume it would mean something positive for us. You're already seeing construction pick up and that's just going to further [indiscernible].

Operator

At this time, there are no further questions.

Michael Patrick Kehoe
President, CEO & Director

Okay, operator. Well, I just want to thank everybody for joining us on the call. And just a quick acknowledgment. We just posted the best results in our company's history and I think a lot of it goes back to the employees that come to work here every day. And it's a foundation of our business, and they're working very hard, and I think you're seeing the results of it. So kudos to them, and we look forward to speaking with everybody again here in a few months.

Operator
Ladies and gentlemen, this concludes today's conference. Thank you for your participation and have a wonderful day. You may all disconnect.