S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL

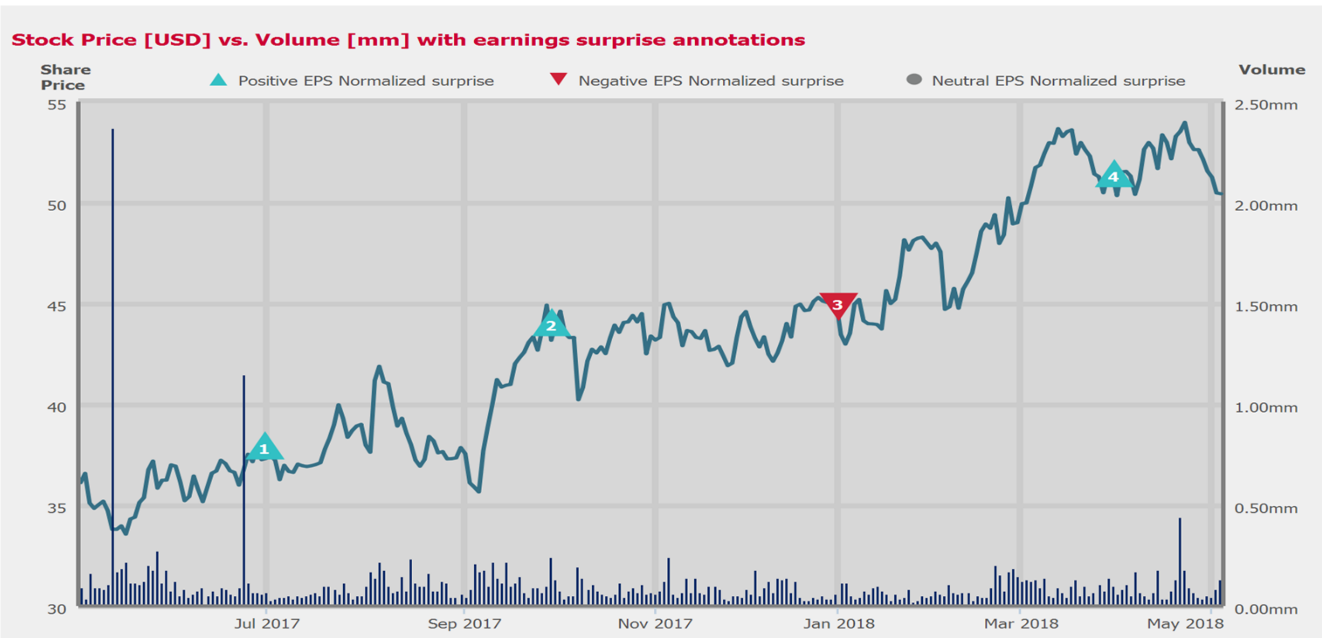
FQ2 2018 Earnings Call Transcripts

Tuesday, August 07, 2018 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.49	0.46	▲(6.12 %)	0.50	1.92	2.30
Revenue (mm)	54.94	54.95	▲0.02	55.86	217.62	250.47

Currency: USD
Consensus as of Aug-07-2018 1:30 AM GMT



- EPS NORMALIZED -			
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2017	0.32	0.40	▲25.00 %
FQ3 2017	0.36	0.44	▲18.92 %
FQ4 2017	0.39	0.36	▼(7.69 %)
FQ1 2018	0.37	0.38	▲2.70 %

Table of Contents

Call Participants

EXECUTIVES

Brian Donald Haney
Senior VP & COO

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Michael Patrick Kehoe
President & CEO

ANALYSTS

Adam Klauber
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 Q2 2018 Kinsale Capital Group, Inc. Earnings Conference Call. [Operator Instructions]

Before we get started, let me remind everyone that through the course of the teleconference, Kinsale 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 included in 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 second 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 also available at the company's website at www.kinsalecapitalgroup.com.

I would now like to 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 good morning, everyone. Joining me on today's call are Bryan Petrucelli, Chief Financial Officer for Kinsale; and Brian Haney, Chief Operating Officer. I'm going to make a few introductory remarks and then turn the call over to Bryan Petrucelli for some detailed financial information, and then Brian Haney will follow up with some color on our quarter and the market opportunity that we see in front of us.

Kinsale is a specialty insurance company that combines disciplined underwriting and claim handling with an advanced level of technology and low costs to deliver superior value to our customers and superior returns to our stockholders. At Kinsale, disciplined underwriting begins by our maintaining absolute control over the underwriting and claims management process, unlike most insurance companies that contract out some or all of their underwriting to external parties. It involves targeting small- to medium-sized hard-to-place accounts within the excess and surplus lines market to achieve superior risk-adjusted returns. It means managing the coverage we offer to minimize inaccuracies in the underwriting process. All of these elements help drive Kinsale's favorable loss ratios.

On the expense side, Kinsale uses its own proprietary end-to-end enterprise system designed and built by our analysts and developers to operate our company. Most competitors are at a disadvantage of using multiple systems, sometimes dozens of systems, to operate their businesses. Using a single advanced enterprise system that we own allows Kinsale to achieve a significant cost advantage, in addition to providing superior customer service, more accuracy and more data to manage the business than our competitors. The end result of this technology, combined with Kinsale's entrepreneurial business culture, is an expense ratio dramatically lower than our competitors', 20% lower or 25% lower, in some cases, even 35% lower. It's a powerful advantage in an industry where the buyer cares so much about the cost of the policy. Combining disciplined underwriting and claim handling with low costs is an end-game winner every time.

For the second quarter, net operating earnings increased by almost 17%. Premiums increased by 21%. Our combined ratio was 83.5%, and our operating return on equity for the 6 months of 2018 was 14.9%. The quarter and 6-month results are consistent with our forward guidance of a mid-80s combined ratio and a mid-teens ROE.

For further detail, I'll turn the call over to Bryan Petrucelli.

Bryan Paul Petrucelli

Senior VP, Treasurer & CFO

Thanks, Mike. As Mike noted, the results for the second quarter were in line with our expectations. Although slightly higher than last year, we believe the 83.5% combined ratio for the quarter is a market leader and continues to demonstrate the strength of our low-cost model, particularly in periods of intense price competition.

We reported net income of $10.1 million for the second quarter of 2018, an increase of 19% over the $8.5 million reported last year. Net operating earnings increased by 16.8%, $9.9 million compared to $8.5 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 18.2% in the second quarter compared to 33% last year and lower due to the impact of the Tax Reform Act that was enacted at the end of 2017 and the recognition of tax benefits from stock options that were exercised during this quarter.

The company generated underwriting income of $8.4 million and a combined ratio of 83.5% compared to $10.7 million and 75.2% for the second quarter of 2017. The combined ratio for the second quarter of 2018 included 3.6 points from net favorable prior year loss reserve development compared to 8.9 points from net favorable loss reserve development last year. There was no meaningful cat activity this quarter or the second quarter of last year.

Annualized operating return on equity increased to 14.9% for the first half of 2018 compared to 13.5% last year.

Gross written premiums were $69.9 million, representing a 21% increase over the second quarter of 2017, and continued to be generated from an overall increase in underwriting activity across most line of business, and Brian Haney will discuss that in a little more detail here in a bit.

On the investment side, net investment income increased by 55.5% over the second quarter of 2018, up to $3.8 million from $2.4 million last year. Annualized gross investment returns increased to 2.9% from 2.3% last year.

Basic and diluted operating EPS was $0.47 and $0.46 per share, respectively, compared to $0.40 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 21% in the second quarter, roughly the same from the first quarter, all but 2 of our 17 divisions grew.

Commercial property continues to grow strongly, and our Allied Health Care division was up 40% for the quarter. We are seeing more opportunities in the Allied Health Care space because a number of our competitors have reunderwritten their books of business.

On the other hand, we shrank slightly in our construction division due to a strategic push on our part for more rate. And our general casualty division, which operates in a particularly competitive part of the E&S space, was also down slightly. Our Aspera business was up 42% for the quarter.

Overall, commissions continued to increase strongly. Commissions in the fourth quarter were up 22% over the fourth quarter of 2017. We look at submissions as a good leading indicator for where the business is going, and the vast majority of our 17 divisions had a positive growth in submissions.

It's worth reminding you there are 2 things in particular about how we underwrite business that separate us from most of our competitors. First, we are 100% E&S. We don't write any admitted business. This gives us great flexibility by giving us the freedom to tailor rate some forms to the specific unique risks faced by our insurers.

Second, we don't delegate underwriting authorities to third parties. This, we believe, gives us greater control over the underwriting and risk selection and drives more profitable result.

Moving on to rates. We continue to push rates up selectively. We took some rate increases in our casualty business in the second quarter, which contributed, in part, to the construction division's modest shrinkage. The overall rate change for the book is still in the low single-digits.

One positive indicator with regards to market conditions is that we are seeing a handful of opportunities on large accounts, and we are converting on some of those opportunities. This is significant because large accounts and, by and large, I'm thinking accounts over 100,000 in premium, tend to draw irrational levels of competition. And so normally, it's difficult for us to compete given that we aren't willing to lose money just to get premium. So when we see more success on large accounts as we did this past quarter, that is, to us, an indication that the market is behaving more rationally, which is a good sign. That being said, the mainstay of what we write is still small to medium cat.

While we can't be 100% sure what is causing the increase in opportunity we are seeing, we are seeing it. The submissions continue to increase at a very healthy rate. And looking back now, it seems that the market has been trending in a favorable direction for us since 2016. Each quarter for the last 4 is at a higher growth rate than the previous quarter, and we are finding growth easier to come by than we were prior to 2017. So we feel cautiously optimistic about where this is heading.

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

Michael Patrick Kehoe
President & CEO
Thanks, Brian. Operator, we're ready for any questions that come in.

Question and Answer

Operator

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

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

The 22% increase in submission count, what period was that for again?

Brian Donald Haney
Senior VP & COO

That was the fourth quarter over -- I'm sorry, second quarter over second quarter.

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

Second quarter over second quarter. Okay. And then, I think you suggested that continues to be robust here in the third quarter?

Brian Donald Haney
Senior VP & COO

I don't know if we're supposed to mention that. I would expect it to continue at the rate it's going.

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

Okay. And then thinking about the favorable development, last few quarters have been more like flat to up kind of low single digits, a little bit behind your earlier pace in early 2017, full year 2016. How do you see losses developing in the book? Did you notice any kind of change in the trajectory there? Any inflation perhaps a little bit more? Or what is -- what's going on?

Michael Patrick Kehoe
President & CEO

I think, when you -- whenever you compare different quarters or different years, you have to acknowledge there's some variability in our results just based on the natural volatility in the business and the fact that, hey, it's a smaller company that probably exacerbates the volatility a little bit. I think if you're comparing second quarter '18 with '17, second quarter in 2017 was a bit of an anomaly. It was kind of an exceptionally good quarter. We think second quarter 2018 was exceptionally good as well but not quite as good. In terms of loss trends, I think there's definitely inflation in jury verdicts and damages and that type of thing, and it's something we address in our actuarial review, in our profitability analysis in all of our divisions, and it's just a normal part of how we manage our pricing to account for inflation on the claims front. But I don't know if there's anything exceptional underway today.

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

So you would say the inflation is similar to what you've seen in prior years? Is that -- has that picked up a little bit?

Michael Patrick Kehoe
President & CEO

I would say, it's similar to what we've seen.

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

And then the large accounts, you had mentioned you're seeing some opportunities that are emerging there. Is -- anything you can spot in terms of hidden markets or types of business or line that are creating that opportunity?

Brian Donald Haney
Senior VP & COO

It's across the board. I would say there's some more in the Allied space, Allied Health Care space, and the skilled nursing facilities. But it's -- many of our divisions are seeing these accounts.

Michael Patrick Kehoe
President & CEO

I would also emphasize that we're talking about a handful of accounts, right? So our strategy has been to focus on the small- to medium-sized transactions because, hey, we think in a competitive market, that's where the best margins are. And that's consistent today. I think Brian mentioned that on his remarks, more as an indication of a market trend that's becoming a little bit more favorable to the risk there. The fact that we used to see no opportunity for larger accounts, and now we might see 5 or 10 a month.

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

And just want to follow up, on those larger accounts, would you now may put up a higher loss pick associated with that? You're getting more volume, so the profit contribution is good, but it might involve a little higher loss ratio.

Brian Donald Haney
Senior VP & COO

We don't -- we're not going to reserve specifically for a handful of accounts. So we don't specifically address it in the reserving. I will say this, though, these accounts that come to us are distressed. So they have really bad loss experience, and they get a very high rate when they come to us. So I would expect new accounts, a handful of that we do write, I would expect them to actually have better loss experience.

Operator

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Mark Hughes took a few of my questions already. I have much to say on the results. I think -- I don't appreciate the market commentary that you've given. As you look at the areas where you're growing or where you're contracting, I guess, what portion of the growth would you say is primarily driven just by being a strong economy, which usually drives a lot more E&S volumes as compared to how much is because you continue to penetrate the market and expand your distribution relationships and so forth?

Michael Patrick Kehoe
President & CEO

I don't know that -- Mark, this is Mike Kehoe. I don't know that we actually have a precise answer to that. It -- clearly, part of our growth is driven by we got a very robust economy, and that's probably driving growth across the P&C industry. I think, clearly, the E&S segment is growing at the expense of the standard market, which is a long-term trend. Not every year but most years, E&S has been taking share, if you will, from the standard lines segment. And I think, clearly, with Kinsale's strategy and business model, we are taking market share from our competitors. Brian, I don't know if you have any...

Brian Donald Haney
Senior VP & COO

I think one way you could sort of guestimate that number is just to look at the growth in the E&S market as a whole and say that the difference between our growth rate and that average growth rate is probably our taking market share, which, I would guess, would be similar on half and half.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

In the Allied Health Care line that you talked about, I assume that's primarily a liability exposure. Can you just describe a little bit more about kind of what exposures you're writing there just by way of kind of understanding the risks?

Michael Patrick Kehoe
President & CEO

Yes, the Allied Health Care division at Kinsale focuses on essentially nonphysician, nonhospital health care risks. So it's everything from home health care agency, social service, drug and alcohol treatment, independent living, assisted living, skilled nursing homes. And the one thing we've noticed here in the last year or 2 is that the market for this liability insurance for skilled nursing homes has -- the pricing has firmed up. Up until about a year or so ago, we wrote no business in that segment because the rates have come down so low that it was not a favorable risk trade for us as a risk bearer. Now that you've seen the low prices beget losses in some companies, we've seen carriers withdraw from the market, there's a lot more dislocation in that segment. Still very competitive. It's not an area where we're writing a ton of business, but we're starting to see some opportunities, and that's it. So the big driver of losses in a liability book for skilled nursing homes would be resident injury, either improper medical care, it could be a fall, that type of thing.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful. The last question I had just in terms of the investment portfolio, obviously, it continues to benefit. Any changes or anything different that's happening there that is worth noting?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Mark, it's Bryan Petrucelli. Not really, no real changes in the strategy other than what we talked about in the past, still continuing to purchase some floating rates and CLOs, just take to advantage of some of the increases in interest rates that we've seen. But no dramatic changes there.

Michael Patrick Kehoe
President & CEO

Basically, the size of the portfolio, of course, continues to grow at a healthy clip.

Operator

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

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

How fast did Aspera grow? And how big is that unit now?

Michael Patrick Kehoe
President & CEO

I think it's -- did you say 42% growth for the quarter?

Brian Donald Haney
Senior VP & COO

42%.

Michael Patrick Kehoe
President & CEO

So it'll come in somewhere around 5% of our book this year, up from, I think, 4.25% of our book last year. So it's a small part of the business, but it's growing at a healthy clip.

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

Yes, yes. And then did you grow your property book -- how did the property book grow?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Don't have the exact figure. That was pretty strong.

Michael Patrick Kehoe
President & CEO

Yes, it's probably our strongest growth. We think the growth there has been driven by some of the catastrophe activity last year, but also just that was a highly competitive area for a long time. And I think, again, when prices get too low, it starts to drive adverse results for insurance companies. And as you see, poor results give way to carriers exiting the business, tightening up their underwriting standards. And that dislocation creates pretty good opportunities for a company like Kinsale that's in the E&S space.

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

Right. Right. Great. And then, I think you mentioned that, over time, clearly, E&S market has expanded at the expense of the standard market. Over the last 6 months, and I know it's market-by-market, but have you seen, I guess, more prevalence to the standard market coming out of E&S-like risk or more moving into E&S-like risks?

Michael Patrick Kehoe
President & CEO

I mean, it's just kind of anecdotal. But I will say right now, we're seeing business come into the E&S space. It's not that there's not a lot of business going the other direction. It's a pretty dynamic market, of course. But in general, we really feel a good sense of optimism not just for Kinsale's opportunity but kind of the broader E&S opportunity.

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

Okay, okay. And then in the last couple of months, have you brought on any new teams or started in new product areas?

Michael Patrick Kehoe
President & CEO

Nothing. No. No new teams. Obviously, we're always working on product enhancements. That's a normal part of what we do as an insurance company. But no new teams or new divisions in the last 6 months.

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

Okay, okay. And then finally, your expense ratio is doing very well this year. Do you think this is a sustainable level as you grow over the next -- as you grow?

Michael Patrick Kehoe
President & CEO

I think so. I think that 25% expense ratio, it's going to -- it's always going to have a little bit of variability to it. And I think as the business grows, there's an opportunity to drive that lower. But there's also an opportunity now to kind of invest more in the business. And I'm thinking particularly in the technology area because I think the payback on some of these technology investments is so powerful that -- that might be a little bit more of our focus in the near term as opposed to driving the 25% expense ratio to 23%. We like the idea of reinvesting in our business. We've made a lot of progress over the last 9 years in building our system, driving a really superior level of automation, but we also have a long way to go on that front. And we're -- I would say we're kind of balancing the 2, managing our expenses very aggressively but also reinvesting in the business to get even better in the future.

Operator

We do have a follow-up question coming from the line of Mark Hughes of SunTrust.

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

Refresh me on how much competition Lloyd's is relevant to your space as the kind of in the smaller end of the market. And then do you anticipate any impact on E&S? I think they're going through a restructuring or a strategic review, perhaps. Any observations about their behavior?

Brian Donald Haney
Senior VP & COO

Yes. Lloyd's is pretty significant in many of our lines. I think for the whole E&S space, they're about 23%.

Michael Patrick Kehoe
President & CEO

Yes. They're -- collectively, they're the largest E&S writer by far.

Brian Donald Haney
Senior VP & COO

So anything that significantly affects Lloyd's will probably significantly affect the market and then us.

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

Are you -- could it be you're getting some of those larger accounts that might have been Lloyd's accounts before or?

Brian Donald Haney
Senior VP & COO

The ones that I can think of specifically were not Lloyd's accounts.

Michael Patrick Kehoe
President & CEO

Mark, I think, typically, Lloyd's underwrites larger accounts directly in London. And the small accounts where Kinsale focuses, that -- we tend to compete with Lloyd's through -- Lloyd's delegates underwriting authority to its brokers to underwrite that business on Lloyd's' behalf. And that's not unique to Lloyd's. I would say, probably 3/4 of the business we write, we're competing with binding authorities from our competitors.

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

But that -- presumably for Lloyd's, would you think that probably has not been a great experience for them? Or could that be an area that they focus on, perhaps, for some retrenchment?

Michael Patrick Kehoe
President & CEO

We've seen a little bit of dislocation in the delegated underwriting authority space, whether you're talking about the contract binding business or larger homogenous programs. Personally, I haven't followed it closely enough to know that, hey, it's Lloyd's-specific or it's other carriers'. Obviously, we are very partial to our own strategy, which is very different, and that we manage and control the underwriting directly. We -- every piece of business on the books at Kinsale is underwritten by a Kinsale underwriter on our office. We think that's a better model that drives better risk selection and a better result. But Lloyd's is like every other carrier we compete with. They contract out the underwriting frequently because some companies struggle with the cost of underwriting small accounts.

Operator

We have no further questions at this time. I would now like to turn the call back over to Mr. Michael Kehoe for any further remarks.

Michael Patrick Kehoe
President & CEO

Okay. Thank you, operator. I think we're all done today. But I want to thank everybody for participating, and I look forward to speaking with you again in 3 months.

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