S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL
FQ3 2021 Earnings Call Transcripts

Friday, October 29, 2021 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2021-			-FQ4 2021-	-FY 2021-	-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.99	1.59	▲60.61	1.36	5.25	NA
Revenue (mm)	152.98	164.88	▲7.78	166.48	609.85	NA

Currency: USD
Consensus as of Oct-29-2021 7:37 PM GMT

- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2020	0.78	1.14	▲1 46.15 %
FQ1 2021	0.84	1.11	▲2 32.14 %
FQ2 2021	1.06	1.28	▲3 20.75 %
FQ3 2021	0.99	1.59	▲4 60.61 %

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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 Alan Dwelle
RBC Capital Markets, Research Division

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, 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 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 third quarter results.

Kinsale 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 call over to Kinsale's President and CEO, Michael Kehoe. Please go ahead, sir.

Michael Patrick Kehoe
President, CEO & Director

Thank you, operator, and good morning, everyone. We appreciate your joining us on the call today.

We will follow our usual format, with a brief introduction from me, then Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Kinsale's Chief Operating Officer, will each provide some additional commentary, and then we'll move on to any questions from any of you.

Kinsale's operating earnings for the third quarter 2021 were $1.59 per diluted share, a significant increase from the third quarter of 2020.

The gross written premium was up 36.5% for the quarter.

The company posted a 75.7% combined ratio for the quarter and 78.1% combined ratio for the 9 months.

Our operating return on equity for 9 months was 19.8%. Multiple years of significant rate increases, combined with our disciplined underwriting and low-cost model, is allowing for meaningful margin expansion over our long-term guidance of a 15% operating return on equity, and we expect to continue to run well ahead of that 15% goal.

Our catastrophe loss from Hurricane Ida was $4.6 million, net of tax. This relatively modest loss in light of the severity of the storm is consistent with our cat experience over the last 10 years. We do rate cat-exposed Property business through our personal lines and our Commercial Property books, and we think the margins in that business are compelling. But we also seek to limit the volatility of the business through a combination of good underwriting, strict limits on the concentration of business and a comprehensive reinsurance program. The relatively higher cat loss figure from the third quarter of 2020 compared to the third quarter of 2021 was mostly due to the occurrence of multiple events last year.

We continue to be optimistic about market trends and prospects for our business. Our own numbers remain strong, and our reserves are conservatively stated. In contrast, there was lots of commentary at a recent industry conference about Casualty reserve issues among some weaker competitors and the lack of returns on Property business, really for the whole P&C industry, over the last 3 to 5 years. Both of these examples were cited as reasons, among other things, for the robust pricing cycle to continue. Brian Haney will provide some additional commentary on our own experience here in a moment.

As we mentioned last quarter, we expect to consider borrowing some additional money next year in 2022 should we need any capital to fund our growth. Our debt-to-total capital ratio is about 6% today, and the longer-term goal is for that to approach 20%. Additional financial leverage should be helpful to our returns.

I'll now turn the call over to Bryan Petrucelli. Bryan?

Bryan Paul Petrucelli

Executive VP, CFO & Treasurer

Thanks, Mike. Just another nice quarter, with strong operating results continuing to be driven by solid premium growth, favorable loss experience and disciplined expense management.

We reported net income of $36.6 million for the third quarter of 2021, representing an increase of 146% when compared to $14.9 million last year, due primarily to higher earned premium, lower cat losses and net favorable loss reserve development.

Net operating earnings increased by 282%, up to $36.7 million from $9.6 million in the third quarter of last year.

The company generated underwriting income of $38.1 million and a combined ratio of 75.7% for the quarter, compared to $2.9 million and 97.3% last year, with improvements to both the loss and expense ratios. The combined ratio for the third quarter of 2021 included 5.9 points from net favorable prior year loss reserve development and 3.8 points from cat losses, primarily from Hurricane IDA, compared to 2.8 points of favorable loss reserve development and 15.4 points of cat losses last year.

Our current accident year loss ratio, exclusive of cat losses, decreased in recognition of ongoing favorable pricing trends that Mike previously touched on.

The 20% expense ratio for this quarter continues to benefit from some economies of scale, given that our earned premiums are growing faster than our operating expenses, and from slightly lower relative net commissions as a result of a shift in the mix of the business to lines that are subject to reinsurance and where we receive ceding commissions. Although it is possible that we'll continue to achieve a modest level of additional economies of scale, with some variability from quarter-to-quarter, we believe an expense ratio in the low to mid-20s to be sustainable over time.

Our effective income tax rate for the first 9 months of 2021 was 18.9%, compared to 12.8% last year, and higher primarily as a result of lower tax benefits from stock compensation activity this year.

Annualized operating return on equity was 19.8% for the first 9 months of the year and, again, as Mike mentioned, ahead of our mid-teens guidance.

Gross written premiums were approximately $198 million for the quarter, representing a 36.5% increase over last year due to the continuing favorable market conditions and our superior service standards.

On the investment side, net investment income increased by 15.5% over the third quarter of last year, up to $8.1 million from $7 million last year. Annualized gross investment returns, excluding cash and cash equivalents, was 2.5% for the year so far, compared to 3% last year.

Diluted operating earnings per share was $1.59 per share for the quarter, compared to $0.42 per share last year.

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

Brian Donald Haney
Executive VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 36.5% in the third quarter, down from 45% in the second quarter, but roughly consistent with the growth rates in the first quarter and the fourth quarter of last year. The increase is generally driven by increasing submissions, rate increases as well as economic growth, which drives up exposure basis.

Every one of our divisions was up for the quarter, led by our General Casualty division, which had been particularly hard hit by the lockdowns in 2020. The reopening of the economy and the robust economic growth is still providing us a significant boost. Submission growth was in the low teens in the third quarter.

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 in the aggregate during the third quarter, generally consistent with the past several quarters. The conditions that have driven the market hardening still exist. So we do not expect a change to the market in the near term.

We are paying close attention to inflation. At this point, we feel that the rate increases we are achieving are in excess of loss cost trend, and therefore, we should be building additional margin.

At our recent investor conference, I touched on several advantages Kinsale has over its competitors: our sole focus on E&S, our superior technology and our meaningful expense ratio advantage.

Another advantage has emerged during COVID. We are one of the few, maybe the only, surplus lines insurer that has been fully in the office, in person, 5 days a week. We came back to the office in person last October. We have to hire and train a lot of people to keep up with the growth, and we find that teaching and learning is just better in person. Also, we feel like you can only absorb the company culture if you actually see your coworkers face-to-face.

Our competitors are now going on their second year of attempting to recruit and train people via Zoom. It's just not a good way to train people, period. People don't learn as well remotely, and they don't pick up the company culture remotely. By being in person, we avoid the learning loss that you are seeing in academics and business that goes hand in hand with remote learning. This is a significant advantage for us in terms of our ability to train new staff and execute our plan.

In summary, we continue to be optimistic. We are producing truly extraordinary results, and the market conditions continue to favor us. Our business model works well in any market, hard or soft or in between, but the current market conditions are really excellent and we are working hard to make the most of them.

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

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

Question and Answer

Operator

[Operator Instructions] First, we have a question with Jeff Schmitt with William Blair.

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

Growth was obviously really strong in the quarter. And I was curious what you're seeing, how much of that is exposure growth across the book just with inflation and supply constraints worsening and kind of how much is that, I guess, offset by tightening terms and conditions.

Brian Donald Haney
Executive VP & COO

We don't have an exact answer for that, but if I had to break it, I would say that the effects of increased submissions, increased rates and increased exposure are all roughly equal. So let's call it 1/3 of the growth is increased exposure. But that's a guess.

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

Okay. And what level is that at, at this stage? I presume it's been moving up?

Brian Donald Haney
Executive VP & COO

Well, I just said 1/3 of the 36%.

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

Okay. I got you. Right. Okay. And then underlying loss ratio obviously moved down quite a bit, to 58%. And can you maybe speak to that? I mean, with that large of a drop, what drove that?

Michael Patrick Kehoe
President, CEO & Director

Jeff, this is Mike. Well, number one, we had an extraordinary quarter, right? So just very good loss activity for the months. But the bigger driver is we've been getting fairly significant rate increases for almost 3 years now, well above loss cost trend. We have over the years added to the conservatism in our loss reserves. But clearly, some of that pricing improvement is now showing up in terms of margin expansion. So that's it, in a nutshell.

Operator

Next, we have Mark Hughes with Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

The earned was quite strong in the quarter relative to what I might have expected, given the written. Was there any audit premium or other adjustments or timing issues that helped earned in the quarter?

Michael Patrick Kehoe
President, CEO & Director

Mark, this is Mike. I can't speak to that off the top of my head. Clearly, the big driver is we're writing more premium, and that's showing through in the earned.

We do audit most of our policies. And so there's always going to be a little bit of variability on that. There's also different retentions based on the mix of business that can have a little bit of impact quarter-to-quarter.

But the big driver is you're just seeing the growth in the business, again that we attribute to our model and to the general market conditions being as favorable as they are.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. And then, Bryan, the expense ratio, essentially 20%, you say low to mid-20s. Assuming your optimism around the market conditions hold, then you're going to be growing the top line, or one might assume so. Is there some reason why the expense ratio should go back up from here? Or is this more, I won't say pro forma guidance, but is that just more of a long-term guide you're giving us?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

I would just say, Mark, it does sort of vary from quarter-to-quarter. I would point you to the 9-month ratio of the 21.4% as probably the best guide at this point.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. Very good. And then the reserve gains in the quarter, the accident years that you drew from there, was that largely 2020?

Brian Donald Haney
Executive VP & COO

We kind of write that up a little bit in the Q. I think it's -- yes, I think it's largely from 2020. Again, I would -- the point I'd make for investors with respect to reserves is they should have a lot of confidence in the integrity of our balance sheet. We purposefully set up reserves that we think are conservatively stated, where they're more likely to develop favorably than unfavorably. And we see that as a real strength for our company. And long term, I think it inures to everybody's benefit.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then just one more question. You talked about potentially raising capital next year with debt. The underwriting leverage, refresh me on where you see your underwriting leverage now and what your kind of operational ceiling would be.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

I think net premium-to-GAAP equity is about 1:1. Our A. M. Best rating is predicated on net premium-to-statutory surplus, which lags GAAP equity by a significant amount.

The general point is that we don't expect to raise any additional equity capital, that we want to inject a little bit more financial leverage into the business, and we think that will be pretty helpful in terms of driving superior returns, going forward.

Operator

Next, we have Mark Dwelle with RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, Research Division

Just a couple of questions. You commented on the growth in submissions. Are there any particular lines of business that are seeing higher rates of submissions? And kind of in parallel with that, are you continuing to see good written migration of business from the standard lines towards the E&S lines?

Brian Donald Haney
Executive VP & COO

Mark, this is Brian Haney. So General Casualty is seeing an increase in submissions because they write a lot of premises-related business, and last year during the lockdowns that business had been severely affected. So that's one area where it's up.

There actually are a few areas where it's down because for our environmental business and our life sciences business they actually had a huge increase in submissions last year because of COVID. And then, yes, we are still seeing not necessarily -- we are seeing movement from the standard lines to our space, but we're also seeing movement from programs to our space. [indiscernible]

Mark Alan Dwelle
RBC Capital Markets, Research Division

The second question I wanted to ask about was you commented about getting more of the business -- getting higher ceding commissions, basically, I guess more of the business that you're writing is subject to reinsurance. Is that primarily in excess? I know you're not writing significantly more Property, which is well reinsured. Is it mainly Casualty excess?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

It's in 2 areas. It would be the Casualty excess, Mark. And also in our personal lines, homeowners product, we have a quota share agreement there that has some ceding commissions involved.

Mark Alan Dwelle
RBC Capital Markets, Research Division

Okay. And then just, in general, in terms of maybe a pricing comment, overall. Obviously, you guys have been seeing quite good rate increases. Are there any still areas of the market that are generally viewed as not well priced or not adequately priced at this point? I would think after the better part of 3 years those are becoming pretty scarce.

Michael Patrick Kehoe
President, CEO & Director

Mark, this is Mike. I think it's -- for the industry, yes, pricing is better today than it was a couple of years ago. But I think it's a reminder, too, that the E&S market takes a very different view of risk and pricing than the standard market. So if a risk is moving from standard to nonstandard, there will be a significant rate increase.

And I think just as a follow-on to Brian's answer a minute ago, the fact that a lot of delegated underwriting authorities are being adjusted in the last couple of years, that continues. And likewise, there is sometimes a very different pricing approach to that business. So I think in Brian's comments he said we're getting low-double-digit rate increases, low-teens rate increases across our portfolio. That's very significant increases, especially in light of the fact that we got similar increases the prior year and similar the prior year to that.

So it really, I think, speaks to the margin improvement that is starting to show up on the bottom line.

Mark Alan Dwelle
RBC Capital Markets, Research Division

So just to the extent that a customer is moving from, say, a standard policy to an E&S policy, you might be getting a 10% increase, but the customer might be getting a 30% to 40% increase.

Brian Donald Haney
Executive VP & COO

[indiscernible]

Michael Patrick Kehoe
President, CEO & Director

Yes.

Operator

Next, we have Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

So just a quick follow-up on the accident year loss ratio. Obviously, this quarter is pretty good. If you look year-to-date, I think you're running at about 61%, a little below 61%, which is better than last year. Is that a good level to think of when considering what might happen in the next couple of years, sort of like 61%-ish?

Michael Patrick Kehoe
President, CEO & Director

I think that's as good as any, Pablo. I think it's a good starting point. I mean, clearly, the pricing trends are quite favorable. Clearly, we're trying to set reserves that we think are likely to develop favorably over time, right? So there's always some conservatism in how we set those loss picks. But I think that's a good starting point.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Okay. And then, Mike, just on your -- just to follow-up on the reserve conservatism comment. So I think if you back off the reserve releases from accident year 2020 year-to-date, and assuming my math is correct, it seems like you overbooked the 2020 loss ratio by about 5 to 6 points. Was there anything unique about 2020? Maybe you were more conservative because of COVID? Or is that 5- to 6-point gap sort of emblematic of a normal conservatism you have in your loss picks on an ongoing basis? That is a pretty sizable number. So I just want to get a perspective on that.

Michael Patrick Kehoe
President, CEO & Director

I don't have the specifics in front of me to speak to the 5% or 6%, but I can tell you that the overarching trend for 2020 was a material reduction in reported losses relative to what we would have expected. Clearly, that had a lot to do with the pandemic, businesses being closed down, business operations shifting in all sorts of different ways to accommodate government regulation and the like.

And so, yes, we did set up additional loss reserves to offset that reduction in reported losses just to make sure that, hey, if there's a catch-up in loss activity in the future as the economy reopens and the court systems reopen and the like, that, hey, we're well positioned to cover that.

So that was kind of the big driver for 2020, just [reported] losses coming in [low].

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then just to follow up on that, would it be safe to assume that you probably won't unwind all the conservatism from 2020 just in 1 year? In other words, like, would it be reasonable to assume that if things go as they have been going, there should be further tailwinds in 2022?

Michael Patrick Kehoe
President, CEO & Director

Yes, I think that's -- yes, absolutely. We would not unwind all of our conservatism in 1 year. It would drift down little by little over the years ahead.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Okay. And then last for me, you had some comments about inflation. So I'm not sure to what extent [indiscernible] actual numbers, but I presume you've increased your loss trend assumptions because of inflation. If you could sort of speak to that and, I guess, to what extent has that eaten away at the gap between pricing and your loss trend assumptions.

Michael Patrick Kehoe
President, CEO & Director

Well, the loss trend assumptions are ticking up, with all the headlines we're seeing. But I think the important point for investors is Brian's comment, which is, hey, we're getting rate increases across our portfolio in the low teens. So whether -- I think, historically, we've used a loss cost trend maybe like 3% or 4%. I mean, it's a few points higher than that currently, but we're well north of even that.

Operator

Thank you. We have no further questions. Please continue, presenters.

Michael Patrick Kehoe
President, CEO & Director

Okay. Well, I just want to thank everybody for listening in, and I want to congratulate all the Kinsale employees that helped make this happen. And we look forward to speaking with you again here in a few months. Have a great day.

Operator
This concludes today's conference call. Thank you all for participating. You may now disconnect.