S&P Capital IQ

CONTENTS

Kinsale Capital Group, Inc. NasdaqGS:KNSL

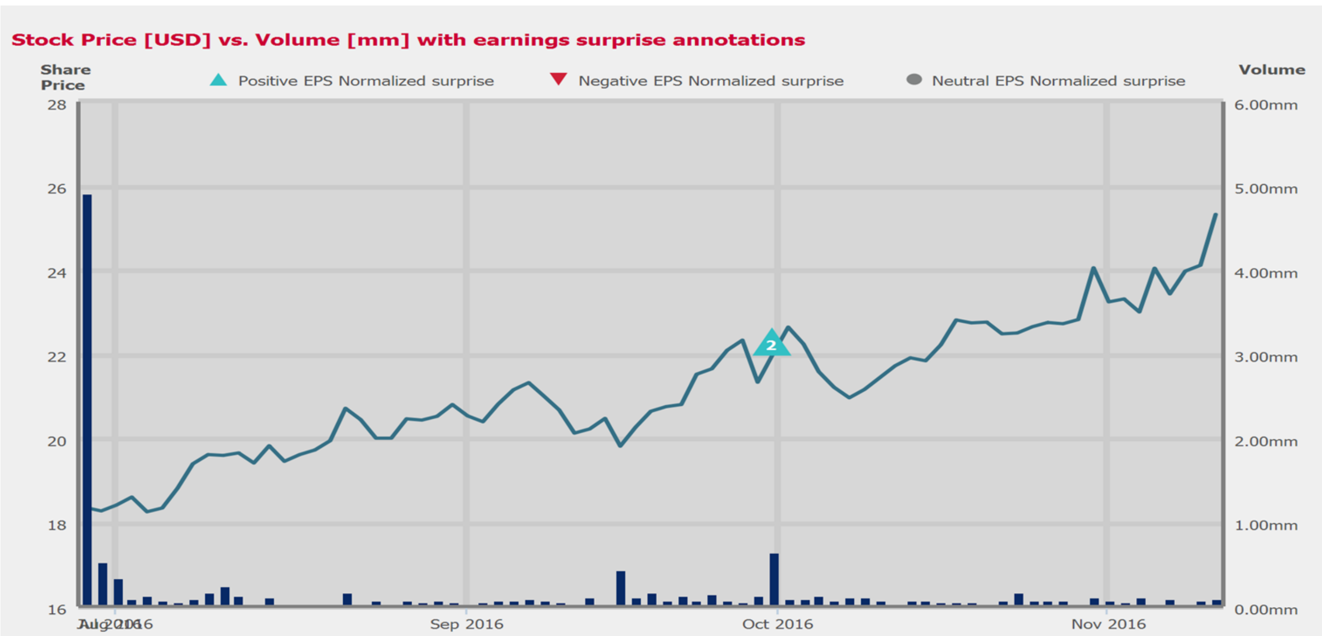
FQ4 2016 Earnings Call Transcripts

Thursday, March 02, 2017 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ4 2016-			-FQ1 2017-	-FY 2016-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.26	0.32	▲23.08	0.33	1.22	1.24
Revenue (mm)	36.50	40.35	▲10.55	42.56	137.80	141.62

Currency: USD
Consensus as of Mar-02-2017 8:30 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ2 2016	0.34	0.42	▲1 23.53 %
FQ3 2016	0.25	0.38	▲2 52.00 %

Call Participants

EXECUTIVES

Brian D. Haney
Chief Operating Officer and Senior Vice President

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Michael P. Kehoe
Founder, CEO, President & Director

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

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Presentation

Operator

Good day, ladies and gentlemen. 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 including the second quarter 2016 Form 10-Q, 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 fourth quarter and year-end results. Kinsale management may make reference during the call to underwriting income, which is a non-GAAP financial measure of financial results. Kinsale's underwriting income represents the pretax profitability of the company's insurance operation and is derived by subtracting losses and loss adjustment expenses and underwriting, acquisition and insurance expenses from net earned premiums. The Form 8-K contains reconciliation between net income and underwriting income. The Form 8-K and press release are 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 P. Kehoe
Founder, CEO, President & Director

Thank you very much for that. Good morning, everyone. Thanks for joining us. I'm the CEO of Kinsale and after my introduction, I'm going to turn things over to Bryan Petrucelli, who is the Chief Financial Officer, to provide some additional financial results and after that, Brian Haney, Chief Operating Officer of Kinsale, will provide some color on Kinsale's operations and the market in which we compete.

Last night, Kinsale reported favorable results for the fourth quarter, the highlights of which include the following: Net income of $6.9 million up 49% over the prior fourth quarter of 2015; annualized ROE of 13.1%; combined ratio of 75.3%; underwriting profit of $9.5 million and premium growth of 5.1%. Kinsale's strategy combines disciplined underwriting and claim handling with a technology-enabled, low-cost operation. And we think this is a powerful model in any market, but it's especially so during a highly competitive point in the insurance cycle, like we're in today. Kinsale's customers demand competitively priced insurance policies and the company is in a position to offer such terms without compromising its profit margin. Its costs are ranged from 20% to 40% lower than many of its competitors. With that, I'll turn it over to Bryan Petrucelli.

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Thanks, Mike. As Mike noted, the fourth quarter was another good quarter for Kinsale. As a reminder, the company's goal is to consistently generate a mid-80s or lower combined ratio and to produce a return on equity in the mid-teens over the long term. For the fourth quarter the company generated underwriting income of $9.5 million on a combined ratio of 75.3% and an annualized ROE of 13.1%. Underwriting income benefited from $3.8 million of net favorable prior year loss development for the quarter, that amount is $5.1 million after excluding effects of our quota share. Gross written premiums were $47.5 million representing a 5.1% increase over the fourth quarter of 2015. For the full year, gross premiums grew by 6.5%. Premium growth continues to be generated from an overall increase in policy count primarily from the small business division, personal lines and some of the company's new product offerings such as management liability, Inland Marine and Public Entity. We continue to be conservative on the investment side with an approximately 96% fixed income allocation, a AA average credit rating and a weighted average duration of 3.7 years. Investment income did increase by 29.8% over the fourth quarter of 2015 as a result of growth in the investment portfolio. Our gross investment returns continue to be in the low 2% range.

For the fourth quarter, basic and diluted EPS was $0.33 and $0.32 per share, respectively. As we discussed last quarter, the year-to-date EPS metrics are a bit difficult to interpret as GAAP accounting rules require that we recognize the capital structures in place before and after the IPO. On a normalized basis and assuming the company's current capital structure was in place for the entire year, basic and diluted EPS would have been $1.25 and $1.23 per share, respectively, for the year. With that I'll pass it over to Brian Haney.

Brian D. Haney
Chief Operating Officer and Senior Vice President

Thanks, Bryan. As Bryan just noted, premium grew 5.1% in fourth quarter. The submission growth rate was in the mid-teens. Over the long run we expect submission growth and premium growth to track more closely. Although the market is still highly competitive, we have noticed pockets in the industry where some of our competitors are pulling back due to adverse experience. The fact that some competitors are reporting stress in their results will be a positive for the trading environment, if it were to continue or accelerate.

Turning to product development. We feel that we already have a pretty broad product offering for a small boutique insurance company, but we're always looking for ways to expand what we offer. Late last year, we launched a private company D&O product in our Management Liability division and an educational institutional liability product in our Public Entity division. We also developed a med mal product for Pennsylvania and launched a small business commercial liability product for California in our [indiscernible] unit.

Moving on to rates, in the fourth quarter, our technical rates were essentially flat. Now I'd like to touch briefly on a few current topics facing the industry. Commercial auto is an area that has posed problems for some insurers. I just like to point out that we write an immaterial amount of commercial auto; less than 3% of our total volume, and for what it's worth the experience on that, small amount of business has been excellent. We also don't write business through delegated underwriting authority arrangements, what some people call programs. This is another area where some competitors have seen adverse experience. When carriers pull back from the program space, as some have recently, we tend to see an uptick in opportunity as those accounts look for new homes. And it's also worth noting, we are still 100% surplus lines; we don't write any admitted business, which is why we don't write any workers comp. And lastly, we did have some property exposed in Hurricane Matthew. At this point, it appears that losses will come in below $1 million pretax so we feel pretty good about how the property portfolio performs. And with that I'll turn it back to Mike.

Michael P. Kehoe
Founder, CEO, President & Director

Thanks, Brian. One final topic and then we can move on to questions. There was a steady rollout of newly completed technology projects in the fourth quarter including some of the new product offerings that Brian just spoke about a moment ago. Perhaps the most significant IT project that's been completed recently, was just rolled out here earlier in the first quarter of 2017 and it's the completion of the Kinsale Enterprise System. With the release of our new policy booking system earlier this quarter, Kinsale now operates a completely proprietary, end-to-end enterprise system that saves the company time and expense in processing its business, in developing new system features and functions and applications, in the maintenance of the system over time and of course, in licensing fees. Completing the Kinsale enterprise system will accelerate the rollout of new IT projects as we move forward and we believe it augments Kinsale's technology competitive advantage in a material fashion.
So, operator, with that, we're ready to take any calls that are pending.

Question and Answer

Operator

[Operator Instructions] And our first question comes from Mark Hughes from SunTrust.

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

Am I correct in thinking, I think your other expenses category is $1.1 million, is that largely nonrecurring? What is in that bucket?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Yes, Mark. Those were the cost that we incurred associated with our secondary offering.

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

Right, so you might say nonrecurring would be the other expenses plus the Hurricane Matthew?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Yes, I would think that would be accurate, Mark.

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

The commercial auto, is that something you would be comfortable pursuing? Sounds like your experience is good; rates are presumably going up. Would you look to increase your exposure there?

Brian D. Haney
Chief Operating Officer and Senior Vice President

It's tough for us to write commercial auto, much commercial auto because we write all not admitted, and much of that -- like you have to write primary commercial auto. For the most part, you have to be admitted. So we would look to expand into it, to the extent that we could do so not admitted.

Michael P. Kehoe
Founder, CEO, President & Director

I'll just add a little -- one more comment on that. If rates were to continue to trend upward, we would probably see an uptick in how much excess auto we write. So -- it is possible for future expansion depending on how the market develops. Right now we're still taking a very cautious view given where prices are.

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

You talked about submission growth in the mid-teens. Refresh me, is that an acceleration lately or do you think you'll be able to have an increasing rate of success with the submissions you're getting in?

Brian D. Haney
Chief Operating Officer and Senior Vice President

So that is consistent with what we saw in the third quarter and for much of last year in terms of the growth rate. I do think eventually we're going to see more success from those submissions. It's probably worth noting we are quoting a lot more of the submissions that do come in. So the submission growth -- and the growth rate in the quotes is well ahead of mid-teens.

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

Right, and why are you quoting more now, is that a systems issue? Appetite?

Brian D. Haney
Chief Operating Officer and Senior Vice President

Like, it's mainly process improvements and system work. We're trying to get more quotes out faster and the system and our technology is allowing us to do that.

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

And then final question on the -- your investments, your yields, low 2s. Do you feel like it's a time where you might take a little more risk in the investment portfolio and still have a conservative balance sheet, but maybe go out a little more on duration, or a little higher risk?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Yes, Mark, I think there is a potential of doing that. I think we're comfortable with our conservative approach to investments right now. But, we constantly reevaluate where we are. So there is the potential we could go out a little further on the duration, but I wouldn't expect anything significant here in the near term.

Operator

And our next question comes from Sarah DeWitt from JPMorgan.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

First, just wanted to ask on the ROE, it slipped a bit in the quarter to 13%, as expected, given the IPO proceeds and just wanted to get your latest thoughts on how long you think you could take to deploy the proceeds and get back to a run rate above 15%?

Michael P. Kehoe
Founder, CEO, President & Director

I think, Sarah, this is Mike Kehoe. Our long-term guidance, of course is mid-teens ROE or better, and right now we've got a little bit of a lag with the primary proceeds coming out of the IPO. The work we've done on broadening our product line, I think, the work we've done on improving our service standards, I think, our low-cost platform, all those things give us confidence that over time, we are definitely going to take market share and grow our business. Last year was kind of mid-single-digit growth rate. I think we ended the year at 6.5%. Our guidance always focuses on mid-teens combine -- I'm sorry, mid-teens ROE or better, mid-80s combined ratio or lower. We're focused there, obviously, on the profitability of the business. That's something we have a lot of confidence in. It's a little bit tougher to predict short-term growth rates because they are subject to some volatility. 2/3 of the way through the first quarter, I would say that growth has picked up a little bit and so I think we've been saying that after several quarters, we will be able to put that capital to work and I think we're still kind of in that mode of thinking. But growth principally is how we're going to get the ROE -- get back to an efficient use of capital and then revert to the mid-teens ROE or better.

Sarah Elizabeth DeWitt
JP Morgan Chase & Co, Research Division

Okay, great. And then you mentioned submission growth and premium growth would track over time. What's driving the divergence right now? Could you just elaborate on that? And how long would it take for those 2 factors to converge?

Brian D. Haney
Chief Operating Officer and Senior Vice President

One is, were a shift in the mix of business towards smaller account divisions, so our personal insurance and our small business divisions write smaller average premium and they are growing pretty well. I would say in the first quarter we've seen the numbers track more closely, so.

Michael P. Kehoe
Founder, CEO, President & Director

I think in general, too, it's just -- there is some volatility around the growth rate and we're in an intensely competitive market, where you have to proceed carefully and sometimes competition gets in the way of writing a piece of business and you have to move onto the next one. We did see some roll off of some larger accounts last year. I guess it was starting in late 2015, ending in mid-to-late 2016. We moved away from some hospitality business that we felt like we couldn't get the right price for. Offset in part with growth in other areas. As Brian just said, our personal lines unit was up a very healthy percent last year. But you know, when you net it all out, it ended up being mid-single-digit growth rate. Longer term, we are very confident around growth. Short term it gets a little bit more speculative. As I said a minute ago, 2/3 of the way through the first quarter 2017, the growth has picked up a bit. So -- I guess that's where we stand.

Operator

And our next question comes from Mark Dwelle from RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A few of the questions have already been covered, but on the expense ratio, you commented in the release a little bit on what drove that. I guess what I was trying to get a sense of is -- to the extent you have incremental public company costs, et cetera. How does that shake out across the expectations for the expense ratio going forward? Would we expect to stay around the 27 level or is that -- and are some of those kind of sufficiently temporary or timing oriented that it will level out over the course of the coming year?

Michael P. Kehoe
Founder, CEO, President & Director

Mark, it's Mike Kehoe. I would say, just as a reminder, our focus on expenses is really fundamental to our business plan. The 27 handle on that expense ratio, I think that goes back to the third quarter last year, fourth quarter. It's principally driven by the public company expenses and we are obviously working very hard to manage costs, given that we operate in a commodity business and our customers expect that of us. And I think the growth is going to solve some of that. Over time we would expect that number to drift back down. So the expectation is, we will do better than 27. It might be a couple of quarters till we get there.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful. The second question on the investment portfolio. The duration was up, I assume that's just putting the original cash -- continuing to put cash to work and rebuilding your duration. What would you expect to sort of your, I'll call it normalized duration, given how you have your liabilities stacked and so forth?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Well, I think the average duration on our liability side is 3 to 4 years, so I think we've looked to match our investment duration in that same range.

Mark Alan Dwelle

RBC Capital Markets, LLC, Research Division

So you are fairly close then, I guess, is this the bottom line?

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

Yes.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay, that's helpful. And then lastly, this was kind of referred to a little bit I guess in your last answer to Sarah's question, but I guess, if you distill out the businesses that you had been exiting, like hospitality and a couple of the others that you mentioned. Is there a way to see kind of what the -- call it the ongoing growth rate is? Obviously, it will be a little bit higher than 6.5 for the full year. Is it closer to 9 or 10 or is that not readily calculable?

Michael P. Kehoe
Founder, CEO, President & Director

Well, the hospitality -- we still write a lot of hospitality business, which is some segment within that broader book that we rolled off. I'm not sure that you could actually look at it that way, in a way that would really be helpful and meaningful. I think the best news on the growth is, hey, we've kicked off 2017. We are 2/3 of the way through the quarter and the growth rate has picked up. And long term, we're very confident in growth given our low costs. We can price our business slightly more aggressively than some of our higher cost competitors and still have more margin in that business, right? That puts us in a, I think, a very attractive position. But, short term on a 3-month period, it's just difficult to predict and accurately prognosticate where growth is going to be, especially when you're in a very competitive market like we are today. So I don't know if that really answers the question, but.

Operator

And our next question comes from Adam Klauber from William Blair.

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

A couple of different questions. The accident year loss ratio really trended better in the second half of the year versus the first half. Is that a result that you set your picks pretty conservatively and then you saw the business flow in and that was just more where the business was coming in?

Brian D. Haney
Chief Operating Officer and Senior Vice President

We haven't changed how we approached reserves, so all that is, is a function of just better experience in the second half than the first. If not -- there is no conscious change in the reserving methodology as a result of what we've seen. It's been pretty consistent.

Michael P. Kehoe
Founder, CEO, President & Director

It's just the normal volatility in how the claims come in and that type of thing.

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

Right. So as we think about '17, should we think about potential accident year more in line with '16? More in line with the first half of '16? Just directionally, how should we think about it?

Brian D. Haney
Chief Operating Officer and Senior Vice President

I would think it would be pretty consistent. I mean rates are basically flat, trends still pretty modest.

Michael P. Kehoe
Founder, CEO, President & Director

One caveat there is, I think our guidance is an 85% combined ratio and so I think that assumes a little bit of a higher loss ratio than what we experienced in 2016. Right? So we're trying to be cautious in how we offer guidance to the future. Just, hey, it's a volatile business. Not everything is completely predictable and we try to be a little bit conservative in the guidance we offer.

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

Okay, and then as far as you had a decent amount of favorable development really throughout the year. Is that coming from -- is that evenly spread throughout the past years or is that more some of the '12, '13, '14? Just given -- and are there certain products or lines you are seeing more favorable come through?

Brian D. Haney
Chief Operating Officer and Senior Vice President

All our lines had favorable development for the quarter in the year and it's coming from most accident years, basically 2012 through 2016. I'm sorry, 2015 and prior year.

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

Okay, that's helpful. Sounds like [indiscernible] is doing well. Can you say how big is that business and what was the growth rate of that unit on an annual basis, quarterly or annual basis?

Michael P. Kehoe
Founder, CEO, President & Director

Yes, I think as a percentage of our company, it's still very modest. I think it was just under 4% of our premium. The growth rate was just below 50%, so it's grown at a healthy clip. We see that continuing in the years to come. I mean we're working hard to expand our personal lines business into new states, new geographies and there's different ideas we're working on around product expansion.

Bryan P. Petrucelli
Chief Financial Officer, Senior Vice President and Treasurer

And the like [indiscernible]

Michael P. Kehoe
Founder, CEO, President & Director

We see that as being a bigger percentage of our book going forward.

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

Great. And you mentioned some new products coming in line as we go into this year. I guess 2 questions. One, did you bring on teams of underwriters with those new products? And of those, which 1 or 2 do you think could be more incremental in '17 versus going out a couple years?

Michael P. Kehoe
Founder, CEO, President & Director

I would say most of the hiring we do is in-house, right? We like to promote from within, but every now and again, we'll bring somebody in -- there is the individual that runs our Inland Marine division, moved from out of town to Richmond to take that role in Kinsale and the individual that runs our Management Liability division, same thing. But, in general, in terms of impact on growth, I think it's -- we've done a lot of work in the new product area. There is a lot of new products out there. A lot of them are enhancements to existing products, and so I think, it's material -- it's making a material contribution to our growth rate. I don't know that we can quantify it on the call but.

Brian D. Haney
Chief Operating Officer and Senior Vice President

No, I don't think we can.

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

Okay, that's fine. That's fine. But when we think about the I guess, some market trends overall, how are you seeing the legal environment? Would you say it's steady with a couple years or better or worse from your perspective?

Michael P. Kehoe
Founder, CEO, President & Director

I mean this is kind of anecdotal, but I would say it's probably deteriorating. I mean that is very anecdotal, right? It's just interaction with our claims team in terms of individual cases that we're either litigating or settling, what have you. But I think there is a general consensus that there has been a deterioration. I think if you read some of the commentary from different insurance companies that have reported some stress in their business, a lot of it is tied back to things like auto. Sometimes it's program business. I think AIG had some problems with workers comp, but a lot of it goes back to increases in severity. There's a -- perpetual upward pressure in terms of jury verdicts and the like. But in general I think, it's deteriorated.

Operator

We also have a follow up question coming from Mark Hughes from SunTrust.

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

Curious if you have any observations on the macro environment? Small business confidence, small business startups, anything that -- there that might be contributing to the submission growth?

Brian D. Haney
Chief Operating Officer and Senior Vice President

No, I mean, I think we're going to see that. It's kind of tough to tell. I would say submission growth has been consistent quarter-to-quarter. I would be surprised if we didn't see more of that because of the relaxed regulatory environment is going to mean a lot more business in things like coal mining, for example. So I expect we will be seeing it, but I think what we've been seeing so far is just an organic pick up in our business.

Operator

And at this time I'm showing no further questions.

Michael P. Kehoe
Founder, CEO, President & Director

Okay, well with that, I just want to say a special thank you to all the Kinsale's employees for the hard work that went into the results that we posted last night. And thank you for everyone listening to the call and we will talk to you again next quarter.

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