S&P Global
Market Intelligence

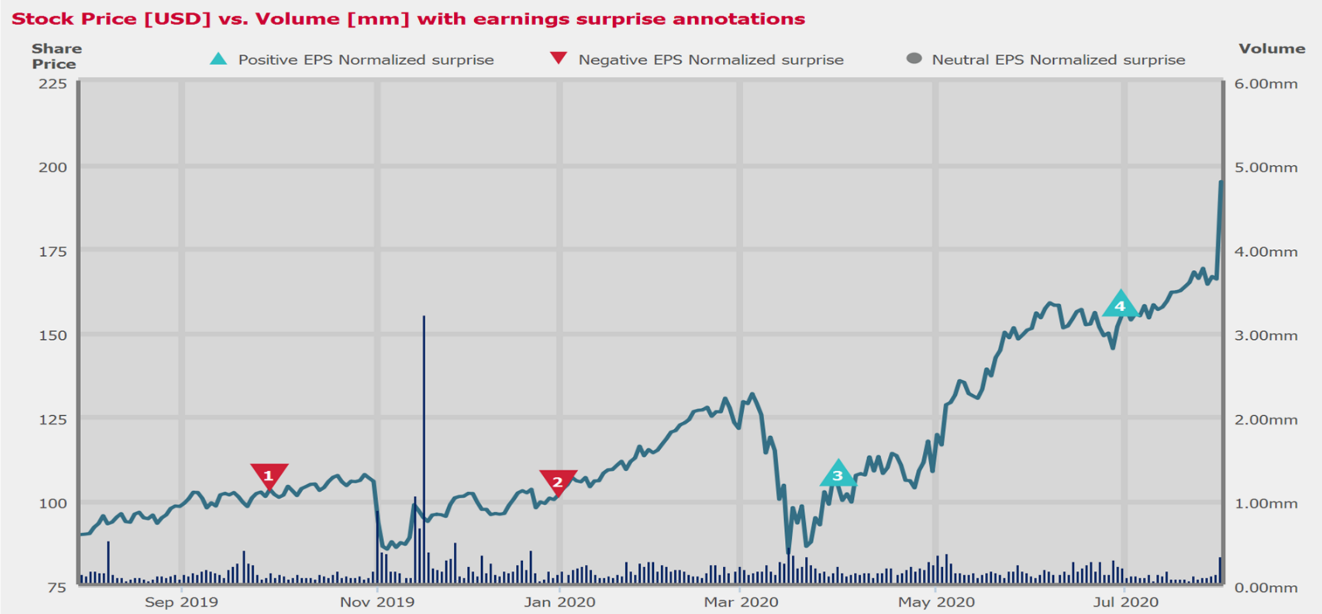
Kinsale Capital Group, Inc. NasdaqGS:KNSL
FQ2 2020 Earnings Call Transcripts

Friday, July 31, 2020 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2020-			-FQ3 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.69	0.84	21.74	0.75	3.11	3.50
Revenue (mm)	102.58	117.71	14.75	109.07	411.95	520.73

Currency: USD
Consensus as of Jul-31-2020 12:01 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2019	0.59	0.57	(3.39 %)
FQ4 2019	0.64	0.63	(1.56 %)
FQ1 2020	0.64	0.76	18.75 %
FQ2 2020	0.69	0.84	21.74 %

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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

Matthew John Carletti
JMP Securities LLC, Research Division

Rowland Juran Mayor
RBC Capital Markets, Research Division

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Kinsale Capital Group's Second Quarter 2020 Earnings Conference Call. [Operator Instructions]

Before we get started, let me remind everyone that through the course of the teleconference, Kinsale's management may make comments that reflect their intentions, beliefs and expectations for the future. As always, these forward-looking statements are subject to certain risk factors, which could cause actual results to differ materially.

These risk factors are listed in the company's various SEC filings, including the second quarter 2020 quarterly report on Form 10-Q and the 2019 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 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. Good morning, everyone, and thank you for joining us on the call today. With me are Bryan Petrucelli, Kinsale's CFO; and Brian Haney, Kinsale's COO. I will begin our presentation, and then Bryan Petrucelli will cover the financial performance for the quarter, and then Brian Haney will provide some color on the market and our underwriting operation.

Last night, Kinsale reported operating earnings of $0.84 per diluted share for the second quarter of 2020, up 47% from the second quarter of 2019. Gross written premium was up 41% for the quarter, notwithstanding the disruption of the COVID virus. The company posted an 83.8% combined ratio and a 16.9% annualized operating return on equity for the 6 months ending June 30, 2020.

The Kinsale strategy of disciplined and highly controlled underwriting, combined with technology-driven low costs and a focus on the E&S market, is propelling our profitability and growth and we believe will continue to do so over the long term. In addition to our own business strategy, our growth is being enhanced by a growing level of dislocation within the P&C market.

After many years of intense competition, some competitors are experiencing adverse results and are withdrawing capacity, canceling some programs, raising prices, et cetera. We expect this dislocation to continue, thereby allowing Kinsale to grow at an elevated rate perhaps through 2021. At some point thereafter, we expect the level of dislocation to abate and our growth rate to normalize perhaps in the low double-digit range.

Beyond the accelerated growth, industry dislocation is also allowing Kinsale to raise rates and in some cases, restrict coverage to further expand our profit margins. To take full advantage of this market opportunity, there is a possibility Kinsale could raise a modest amount of equity capital before year-end.

At the end of the first quarter 2020, we noted that we did not expect the COVID-19 virus to have a material impact on Kinsale's profitability or growth. 3 months later, we have the exact same position. The temporary drop-off in March and the growth of new business submissions reversed within a couple of weeks, and we have experienced a V-shaped recovery in submission activity and premium.

On the claims side, 3 months ago, we noted a small number of claims, wherein all policies involved had coverage exclusions that we anticipated would preclude any payout. We are essentially in a similar place today. A small number of claims against policies with coverage defenses in place, we don't see any material impact to either growth or profitability arising from the COVID-19 virus.

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

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. The premium growth and the profitability that Mike just mentioned is encouraging given the less-than-ideal economic conditions generated by COVID-19 in the second quarter. Just as a reminder, our primary goals as a company are to consistently produce mid-80s combined ratios and mid-teens operating returns on equity. And our second quarter 83.9% combined ratio and 16.9% annualized operating ROE are right in line with that guidance.

We reported net income of $30.3 million for the second quarter of 2020, representing an increase of 120% when compared to $13.8 million last year. Net income this quarter included $13 million or so in pretax unrealized gains on our equity investments as the financial markets came back our way and recovered nicely from the significant declines in the first quarter that were driven by the equity market's reaction to COVID-19.

Net operating earnings, which excludes the volatility from the investment gains and losses, increased by 54% up to $19 million compared to $13.5 million in the second quarter of 2019. The company generated underwriting income of $15.7 million and a combined ratio of 83.8% compared to $10 million and 84.8% last year. The combined ratio for the second quarter of 2020 included 3.7 points from net favorable prior year loss reserve development compared to 2.2 points last year.

Our effective income tax rate for the first 6 months of 2020 was 14.8% and again includes discrete tax benefits recognized from the exercise of stock options during the period. Gross written premiums were $134 million, representing a 41% increase over last year for all the reasons that Mike previously mentioned, including the continued market dislocation and sustained service levels.

On the investment side, net investment income increased by 38% over the second quarter last year up to $6.6 million from $4.8 million last year as a result of continued growth in investment portfolio. Annualized gross investment returns, excluding cash and cash equivalents, did increase -- did decrease, however, to 3% from 3.2% last year just given lower interest rate environment. Diluted operating EPS was $0.84 per share for the quarter compared to $0.57 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 41% in the second quarter. That is lower than the 47% growth rate in the first quarter.

There are 2 big competing factors that have been affecting our growth rate: the hardening E&S market and the COVID-related lockdown. The bulk of the effect of COVID was felt in the second quarter that peaked or bottomed out, depending on your perspective, in April. Since then, we've seen significant recovery in the growth rate.

Anecdotally, I could say that the growth rate in June was essentially the same rate as the growth rate in January. So while COVID is undoubtedly still weighing on economic growth and our opportunities somewhat, that effect is being overwhelmed by the impact of the hardening of the E&S market.

I would say, at this point, all of the markets we compete in are trending in the direction of [hard] than others. The Excess Casualty, Commercial Property and Allied Health spaces are probably in the vanguard of market hardening. Years of bad underwriting and overly aggressive behavior in the market have led to seriously poor results and forced the more undisciplined among the competition to significantly pull back.

Some competitors have been compelled to dramatically increase their rates, which had been inadequate for many long years of the soft market. They've also had to tighten terms and conditions, re-underwrite some books of business, reduce limits, exit some classes of business entirely and terminate some programs. All of this has led to more opportunity for us. We have maintained underwriting discipline throughout the soft market, so we are not now being forced to pull back in the hardening market.

Submission growth was 24% in the second quarter, down slightly from 25% in the first quarter. But as I mentioned earlier, the COVID effects were worse in April. Based on what we saw in June, we believe growth rates in submissions have essentially returned to pre-COVID levels even though there's undoubtedly still some ongoing effect from lockdowns.

As for rates, we are still pushing them up in response to market conditions. As a reminder, we have a very heterogeneous book of business, which complicates reducing all the rate movements to one single number. But that all being said, we see rates being up in the 10% to 12% range in the aggregate during the second quarter. What is not reflected in this 10% to 12% rate increase, however, are terms and conditions.

As the market has hardened, we have also been pushing more favorable terms and conditions. Even though that may not be reflected in rate changes, it does affect profit margins, so we expect that 10% to 12% might understate the change in profitability in the book.

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

Michael Patrick Kehoe
President, CEO & Director
Thanks, Brian. Operator, we're ready to open up the line for questions now.

Question and Answer

Operator

[Operator Instructions] And our first question is from Matt Carletti with JMP Securities.

Matthew John Carletti
JMP Securities LLC, Research Division

Mike, I was hoping -- I mean I appreciate your -- Brian's comments on that submissions and premium growth there are kind of back to pre-COVID levels. Could you just give us a little picture kind of during the quarter what you saw, kind of where it was, maybe in April, May, June? And then if you have an early look at July, if you could offer that? Just curious of the progression.

Michael Patrick Kehoe
President, CEO & Director

Yes. We touched on this the last conference call that, at its most severe moment, our growth rate in new submissions went from the high 20s to low 30s, down to about 2% to 5%, right? So we saw this dramatic drop-off in the growth rate, but that was for a couple of week period and then there was kind of the V-shaped recovery, if you will.

Premium was never that dramatic. I mean premium, we don't track the premium by day, and we don't have that detail to provide. But on a monthly basis, you didn't see nearly that kind of drop in premium.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. Great. And then just one other one. I had a question on the expense ratio. It was -- took a nice step down in the quarter. And just curious, are there any kind of onetime or -- we've seen at some other companies kind of COVID-related benefits there. Or is that just the leverage in the model as the earned premium catches up with the gross written, you're getting expense ratio leverage on the bottom line?

Michael Patrick Kehoe
President, CEO & Director

I'm going to let Bryan Petrucelli -- why don't you handle that one?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

? Yes, Matt. That's exactly what you're seeing. We are hiring folks in our underwriting and claims and IT area just to kind of keep up with our growth, but it's at a much lower rate than what we're seeing from a premium growth perspective. So I think you're just seeing some economies of scale there.

Matthew John Carletti
JMP Securities LLC, Research Division

Great. Well done and best of luck going forward.

Operator

Our next question comes from Mark Hughes with SunTrust.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. Brian Haney, you had suggested June was back to January levels or it's comparable to January. We assume that's sort of a 47% premium growth you had in Q1. Is that kind of what you're saying?

Brian Donald Haney
Executive VP & COO

We don't have those details to provide. I was just giving that just to put in context what Mike was saying about how growth rates had recovered.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Right. So June being better than the quarter as a whole and felt similar to January is your point?

Brian Donald Haney
Executive VP & COO

Yes. June was much higher than April and May, but...

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. And that same momentum presumably continues into July as you see it?

Brian Donald Haney
Executive VP & COO

I mean -- well, we're not going to -- I don't think we're going to comment on the third quarter yet. But I think, if you go back to the remarks I made in the intro, Mark, that we do have a certain sense of optimism as to where the hardening of the E&S market is going. And we feel like we've got a pretty strong opportunity certainly through 2020 and perhaps through 2021. But I'm not sure we want to get into specifics of the third quarter just yet.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Understood. How about in terms of claims activity, both new claims on the current year and then what you've seen on the older claims that they've developed through this period with the courts' shutdown, et cetera?

Michael Patrick Kehoe
President, CEO & Director

Yes. We don't have anything to report in terms of any kind of material changes. There have been -- I think the courts in general -- this varies tremendously by state and even sometimes within each state, exactly what the interruption is. But in general, yes, the courts have been closed down. We don't try a very large percentage of cases, but the slowdown in the court system probably has had some modest impact on the progression of claims being resolved.

Certainly, we try to account for those type of adjustments in our reserving. Keep in mind that we frequently talk about our focus on trying to post reserves that are conservative more likely to develop favorably than not. And we certainly think we're very much on track to do that. But yes, there probably is a slowdown at some level, although we're still opening new claims and closing old claims at a pretty good clip, so that would be my thoughts.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Understood. In Q1, you talked about putting some extra amount into IBNR, I think, related to the current accident year. Any dynamic like that this quarter?

Michael Patrick Kehoe
President, CEO & Director

We -- in the first quarter, we got into the weeds a little bit just because of the dramatic nature of the virus and its impact on the economy. And I think there was a lot of investor concern about its impact on the P&C industry. I'm not sure we're going to go into that level of detail every quarter. But what I would say is that the -- I think it was $5.4 million that we put up in Q1. That wasn't specifically COVID exactly. It was more or less a reaction to the uncertainty created by COVID, the impact on the industry, the shutdown and its impact on the economy, et cetera.

But in general, I would say, Kinsale, in general, has avoided the lines of business that are most exposed to litigation or claims coming out of the virus. I'm thinking of things like mortgage insurance, trade credit, event cancellation, things like that, we're not exposed at all. We do right property business, of course, commercial property, but it's heavily skewed toward more of an industrial exposure, so there's a -- most of our insureds were not shut down during the virus the way maybe restaurants and hotels were.

And then we have very strict coverage defenses in place that, if you look at the combination of all of those factors, I think that's how we conclude that we really don't expect any kind of material impact on the business in terms of our loss ratio or growth, too. But -- so that's probably the best way to address it.

We do always strive to be conservative in the reserving, and that goes for the second quarter, just like every other quarter.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Then one final question, if I might. The Excess Casualty, you said that was one of the lines where you're seeing a lot of opportunity. Would you anticipate outsized growth there? And does that have an impact on the ceded premium ratio?

Michael Patrick Kehoe
President, CEO & Director

I'm going to turn that one over to Brian Haney.

Brian Donald Haney
Executive VP & COO

To the extent that the growth there outstrips the growth in the rest of the book, yes. But I mean Allied Health is also growing. And so there's other lines that are growing pretty significantly, too. So it's tough to say. I mean it could.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

No obvious mix shift?

Brian Donald Haney
Executive VP & COO

No. Because I mean -- because basically, every line is growing. It's just a question of how fast.

Operator

Our next question comes from Rowland Mayor with RBC Capital Markets.

Rowland Juran Mayor
RBC Capital Markets, Research Division

So a couple of quick ones on the balance sheet. First, can you remind us within that other liabilities line why it's -- your other liabilities line, why it's gone from less than $1 million to $20 million this year?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Bryan -- yes, this is Bryan. It includes things like securities payable. There's some liabilities in there with respect to the building that -- our headquarters that's currently under construction. And that's really the majority of that.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. Makes sense. And that headquarters, is it still on track to be done sort of in Q3? And -- or has there been delays?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

No. We're largely on target. I think -- Mike, you correct me if I got this wrong. I think we're looking sort of mid-September-ish, mid-September or late September to complete that.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. And then one last final one. The investment portfolio duration is up a bit and the critical is down a bit from year-end. Anything notable going on there? And should we get used to that longer term?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

I think it's just a modest adjustment in our portfolio to take advantage of some of the dislocation that you saw in the markets related to COVID. I wouldn't expect any dramatic change in duration going forward.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. And is equities still about -- going to be about 10% of the portfolio? Or are you seeing opportunities there?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Yes, I wouldn't expect too much of an increase there. We did add to our position a little bit to take advantage of the severe decline in the market in the March, April time frame, but I wouldn't expect it to increase much more than 10%.

Operator

And our last question is from Jeff Schmitt with William Blair.

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

I apologize. I came on a little late. But did you touch on or could you touch on the rate increases you're seeing in some of your lines of business?

Michael Patrick Kehoe
President, CEO & Director

Yes. Brian Haney, do you want to take that one?

Brian Donald Haney
Executive VP & COO

Yes. I think what we said was rates are up 10% to 12% in the aggregate. We don't generally go into detail about differences in lines, but I would say that I mentioned that the Allied Health, Management Liability, Commercial Property, Excess Casualty spaces were more hard than others. So you can infer that those rates are going up higher than average.

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

Okay. And then you've historically been kind of conservative with loss picks in the first half. I mean it seems like that was the case here with Q1, in particular, and then you would see sort of lower picks in the second half. Is there anything that would change that this year? Or do you think that will be the case?

Michael Patrick Kehoe
President, CEO & Director

Yes. I don't know that we have any kind of real seasonality to our loss reserving. I think our goal is, of course, to put forth our best estimate, but tempered with a very strong measure of conservatism to account for the fact that it's -- it can be an uncertain business.

And we really strive to be conservative and cautious in how we set those estimates. We want investors to have a lot of confidence in our balance sheet. And in general, I think we've been successful. We're not a company that's been around for decades, but we are in our 11th accident year now. And all of our accident years, except for 2011, have developed favorably on an inception-to-date basis. So I think we've got a good track record, and we're looking to build on that. Bryan Petrucelli, would you add anything to that?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Yes. I think that's a good way to describe it, Mike.

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

Okay. And then what was the impact of exposure on GPW growth in the quarter?

Michael Patrick Kehoe
President, CEO & Director

Brian Haney, do you want to take that?

Brian Donald Haney
Executive VP & COO

Yes. We don't have those exact figures. I would just be speculating my answer. I would say it was probably -- had probably less of an impact -- or let's put it this way, exposure growth probably contributed less to our growth in the second quarter than it did in previous quarters because of the effects of COVID.

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

Right. But it wasn't negative. It stayed positive, you think?

Brian Donald Haney
Executive VP & COO

Yes, I think it stayed positive because I think the majority of the businesses we insure didn't actually shut down during the lockdown.

Operator

And this concludes our Q&A session for today. I would like to turn the call to Michael Kehoe for his final remarks.

Michael Patrick Kehoe
President, CEO & Director

Okay. Well, thank you, operator, for organizing the call, and thank you for everybody who participated. And we look forward to speaking with you again here in a few months. Have a great day.

Operator
And with that, we thank you, ladies and gentlemen, for participating in today's conference. You may now disconnect. Have a great day.