S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL

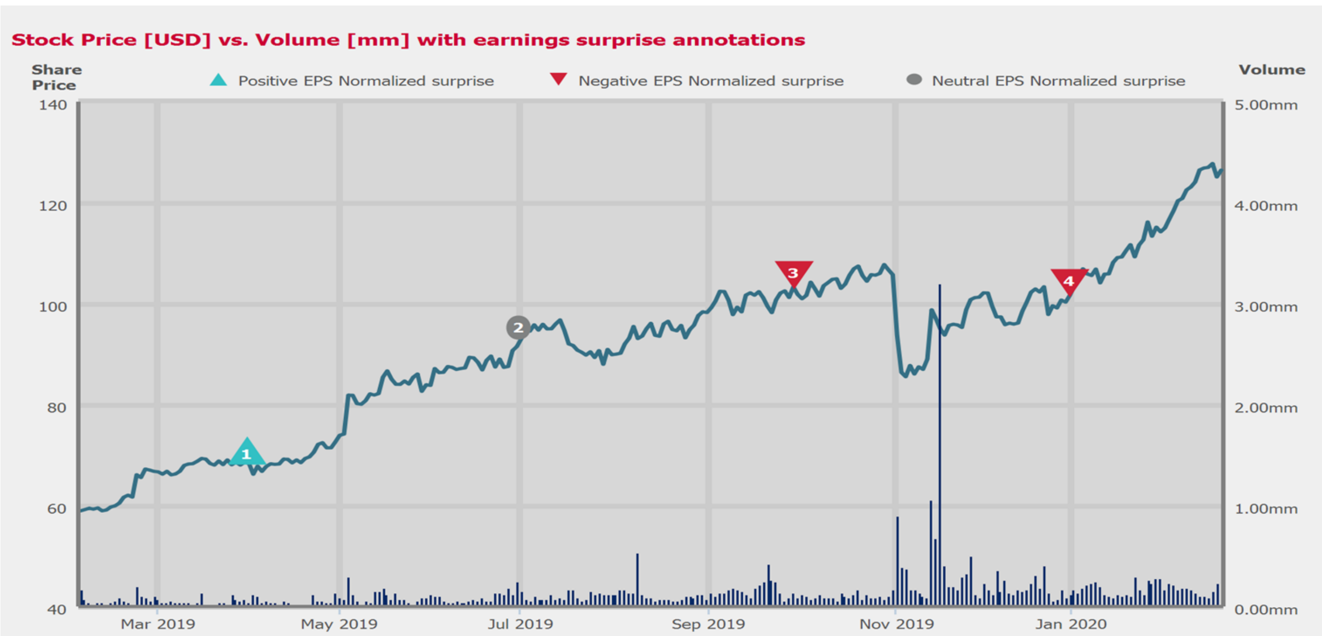
FQ4 2019 Earnings Call Transcripts

Friday, February 21, 2020 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2019-			-FQ1 2020-	-FY 2019-		
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL	
EPS Normalized	0.64	0.63	(1.56 %)	0.71	2.41	2.41	
Revenue (mm)	84.11	92.80	10.33	87.71	296.21	315.89	

Currency: USD
Consensus as of Feb-21-2020 8:30 AM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ1 2019	0.50	0.64	25.49 %
FQ2 2019	0.56	0.57	0.00 %
FQ3 2019	0.59	0.57	(3.39 %)
FQ4 2019	0.64	0.63	(1.56 %)

Table of Contents

Call Participants

EXECUTIVES

Brian Donald Haney
Senior VP & COO

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Michael Patrick Kehoe
President, CEO & Director

ANALYSTS

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

Matthew John Carletti
JMP Securities LLC, Research Division

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Presentation

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Q4 2019 Kinsale Group -- Capital Group, Inc. Earnings Conference Call. [Operator Instructions] Please be advised that today's conference is being recorded. [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 2018 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 fourth quarter results.

Kinsale's management may also reference certain non-GAAP financial measures in the call today. A reconciliation of GAAP to these measures can be found in the press release, which is available at the company's website at www.kinsalecapitalgroup.com.

I will now turn the conference over to Kinsale's President and CEO, Mr. Michael Kehoe. Please go ahead, sir.

Michael Patrick Kehoe
President, CEO & Director

Thank you, operator, and good morning, everyone, and thank you for joining us. Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer, are with me on the call today.

As a reminder, although Kinsale has many competitors, our business strategy is unique in several important ways that allow us to drive attractive returns and superior growth rates across all parts of the insurance cycle. Kinsale is the only company to focus exclusively on the excess and surplus lines, or the nonstandard market, with an emphasis on small- to medium-sized accounts. We are the only company to control our own underwriting and claims management and not outsource those functions to external parties. And we use proprietary technology and automation to operate with a significant expense advantage over many larger competitors.

One measure of the significance of our commitment to technology is that over 20% of Kinsale's employees work in the information technology area. It is our second-largest department behind underwriting. And keep in mind, none of these employees is engaged in maintaining legacy software from the 1980s and the 1990s since Kinsale doesn't have any. Instead, among many things, they are working on process improvement and automation to lower costs and allow us to handle ever-larger volumes of business without a commensurate increase in staffing.

Today's market conditions are characterized by a rising level of dislocation as some competitors experience poor results and react by reducing capacity, withdrawing from some markets and lines of business and by canceling some programs. As a company that maintained disciplined underwriting standards during the competitive period of the insurance cycle, Kinsale is in the attractive position of taking advantage of this favorable market opportunity to accelerate growth in the business and expand its profit margins at the same time. We expect these favorable trends to continue for a year or 2 before reverting to a normal level of competition and a more modest growth rate.

Kinsale's operating earnings increased by 42.1%, and gross written premiums increased by 55.4% in the fourth quarter compared to the same quarter in 2018. The combined ratio for the fourth quarter was 86.1%, and the operating return on equity was 15.9% for the year. With confidence in our strategy and a favorable market opportunity before us, we are optimistic about our business prospects.

Now over to Bryan Petrucelli for the financial report.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Thanks, Mike. As Mike mentioned, we had another real good quarter, with strong growth in both written premiums and operating earnings. We reported net income of $17.9 million for the fourth quarter of 2019, an increase of 301% when compared to $4.4 million for the fourth quarter of 2018, and driven primarily by increases in our unrealized gains on our equity portfolio and written premiums and from lower cat losses. Net operating earnings increased by 42% to $14.3 million compared to $10.1 million in the fourth quarter of 2018.

The company generated underwriting income of $11.5 million and a combined ratio of 86.1% compared to $7.7 million and 87.1% last year. Cat activity contributed 1.8 points to the fourth quarter of 2019's combined ratio compared to 8.7 points last year. The combined ratio for the fourth quarter of 2019 included 1.3 points from net favorable prior year loss reserve development compared to 2.2 points last year.

Our effective income tax rate for the full year was 16.7% compared to 16.5% last year. Operating return on equity was 15.9% for 2019 and in line with our mid-teens guidance.

Gross written premiums were $112 million for the quarter, representing a 55% increase over last year. And growth continues to be generated from increased submission flows from our brokers and firming pricing, driven by continued market dislocation.

On the investment side, net investment income increased by 21% or so over the fourth quarter of 2018 to $5.5 million, up from $4.5 million last year. Gross investment returns for the year, excluding cash and cash equivalents, increased to 3.1% from 3% last year. Diluted operating earnings per share was $0.63 per share for the quarter -- fourth quarter of 2019 compared to $0.46 per share last year and $2.41 for the full year 2019 compared to $1.79 last year.

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

Brian Donald Haney
Senior VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 55% in the fourth quarter. Our commercial property business again grew driven by a surge in submissions, significant rate increases and a concerted effort to service the business more quickly and quote more accounts. It's also worth noting that while we are doing this, we are becoming much more restrictive in the terms and conditions we offer, which should amplify the margin expansion in this line, although it's difficult to quantify the effect.

The growth is not limited to just one division. At this point, the growth is basically everywhere. Since we are exclusively E&S, we are seeing increased activity in virtually every area, including some areas like general casualty that had been slower to harden than some of the other areas. But for the most part, all the markets we are in are moving in a direction favorable to the risk bearer.

Our Aspera business was up 44% for the quarter, which, while a strong growth rate, actually lagged the rest of the company. So the proportion of the total group that Aspera comprises shrank slightly to just under 4%. Submission growth was 35% in the fourth quarter. This spiked up from the third quarter. I would expect this to be slightly lower in the first quarter of 2020.

There is a limit to how much we can grow transaction count without service standards starting to become a challenge, and we are nearing that limit. I expect, at some point, that growth will level off because these growth rates we've seen are pretty extraordinary.

We continue to push more and more on rate, in part to regulate growth, and in part to react to changing market conditions. As a reminder, we have a very heterogeneous book of business, which complicates reducing all the rate movement to a single number. But that all being said, we are seeing rates up in the plus 8% to plus 10% range in the aggregate. We are seeing higher rate increases for property business and lower increases for professional lines.

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

Michael Patrick Kehoe
President, CEO & Director
Thanks, Brian. Operator, we're now ready to take phone calls, if there are any -- or questions, if there are any.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Matt Carletti with JMP.

Matthew John Carletti
JMP Securities LLC, Research Division

Just had a few questions. One, just start with the favorable development for the year. I was hoping you might be able to break it out into which accident years it could have resulted from for full year '19.

Michael Patrick Kehoe
President, CEO & Director

Yes. We don't have that available on the call. I think that gets published in the K. So that will be out -- we'll file the K next week.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. I can wait for that. No problem. And then, I guess, 2 other quick ones. On -- I think Brian mentioned in his comments that commercial property's growing nicely. Obviously, with this amount of growth, there's always a mix shift taking place. Can you maybe talk a little bit about where some of that mix shift might be? How the book at year-end 2019 might look different than it was at 2018 by largest classes of business? And in particular, I've always thought of you guys as having a few percent property, kind of 96-ish percent casualty, a little bit of property. Has that changed in any material way? Or is that still pretty status quo?

Michael Patrick Kehoe
President, CEO & Director

Matt, this is Mike. Property did increase relative to the overall book, I think from a very high single digits to very low double digits. I think that's really just a function of market opportunity more than anything else. We -- when we opened the company over a decade ago now, we anticipated, I think, property might be 20% or so of our book of business. It lags significantly, mostly because the level of competition was so intense that we just had trouble growing the top line.

So I think that's normal in the E&S business, too, that -- we have 17 different underwriting divisions. The relative opportunity does ebb and flow from time to time, and we're seeing a little bit of that in the last several quarters with property. But I don't think there's any kind of significant shift in our strategy, certainly.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. And then, the last one, just wanted to ask you for your updated thoughts on how you're feeling about your capital. I mean these past 2 quarters, in particular, have been extremely strong growth. And it was pretty strong even before that. Just kind of an updated viewpoint of if these sorts of growth rates or even a little bit of a dial-back were to persist, kind of how you feel about capital.

Michael Patrick Kehoe
President, CEO & Director

Right. So obviously, capital is something we manage very carefully. We're especially sensitive around maintaining our A.M. Best rating. We think that's very important to us to be able to execute our business plan.

We did raise -- I think, our net proceeds from the August 2019 capital raise were about $66 million, so we're obviously putting that capital to work quickly. And with the strong return on equity, we're generating retained earnings, which helps as well. But the 55% growth in Q4, as that -- if that were to continue, obviously, at some point, we would probably be looking at additional capital and could likely be some form of -- it could be debt, it could be equity or it could be both. So it's certainly something we're monitoring.

Operator

Our next question comes from Mark Hughes with SunTrust.

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

The expense ratio was -- I think it's typically been a little lower in the fourth quarter, was a little lower this quarter. Is 25% still a bogey? Or can you get some leverage on that with this kind of growth?

Michael Patrick Kehoe
President, CEO & Director

25% is a general bogey. I mean there is some variability from time to time. Clearly, the top line growth does help somewhat. So I think 25% is something we feel confident we can generally hit on a go-forward basis. But as the company grows, it wouldn't surprise me if we outperformed in that area slightly.

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

I wonder if you might give a few more thoughts on the favorable development. The last couple of quarters, it's averaged about 1 point, and that's clearly below your historical norm. You've talked about some phenomenon of a little more coming out in the tail and, clearly, a lot of conversation last quarter about social inflation. How do we think about this kind of point? Should -- with this business that you're writing now, with this surge, should that improve as we go forward?

Michael Patrick Kehoe
President, CEO & Director

Yes. I think any time we talk about reserve development, I think it's worth restating our goal, which is to build a very conservative balance sheet. The loss reserves are a huge component of that, and our goal is to set those reserves in a conservative fashion so that they're more likely to develop favorably than unfavorably. And I think, generally, we've been very successful at that over the 10-year period we've been in business. All of our accident years, except one of the very early ones, have developed favorably on an inception-to-date basis. And that kind of conservatism, I think, gives our investors confidence in our financial results and our ability as managers of the business.

We have talked about the fact that some of our accident years developed a little bit later. And so the last couple of years, we've been injecting additional conservatism into the reserves. And that has had the effect of slowing down the release of IBNR, which I think is what you're alluding to here. I think a lot of that conservatism is -- that's in the numbers now. I think when you look at our market opportunity, where we're getting some very significant rate increases, that adds even more, I think, to our confidence in our balance sheet and in our reserves. I would say we've never been more confident in those numbers than we are today.

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

And then when we think about the submission growth, you said it might taper a little bit in 1Q. Is that more of a capacity issue? Or kind of timing on renewals? What informs that view that 1Q may be a little bit slower on submissions?

Brian Donald Haney
Senior VP & COO

I mean, I would say, part of it is the reaction to how significant the spike in the fourth quarter was. If you look at it, it was kind of out of line with the acceleration we saw, which have been sort of more incremental. So I think it's -- part of it is just -- that one number -- that one growth number was so far out of the norm, but I think it should be natural for it to come back to the long-term trend.

The other one is just, mathematically, growing at 35% is a very, very strong rate. That's almost doubling every 2 years. I just -- it's tough to -- for me, to picture a scenario where submissions keep doubling every 2 years.

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

And then one final one. Mike, I think you've -- you had suggested that you expect favorable trend to continue for a year or 2. What are the kind of the updated signals that you've seen in recent months or weeks that kind of inform your view of the potential longevity on the cycle?

Michael Patrick Kehoe
President, CEO & Director

Yes. So obviously, the numbers we just presented is a big part of that, right? Our own growth and the expansion of our profit margin gives us a lot of confidence. But then the headlines that I think we're all reading in the trade press corroborates that as well, right? There's a lot of companies that were much too aggressive in growing and in how they underwrote and priced business during the soft period of the insurance cycle. And the consequence of that lack of discipline can be -- it's painful, right?

So I think we're all reading the same headlines, and it's really -- that's what, I think, gives us the view that, hey, it's likely to be another year or 2 of this kind of very favorable trading environment that eventually will give way to a normal environment, where the competition increases and the growth rate slows down to something more in the maybe 5%, 10%, 15% range.

Operator

[Operator Instructions] Our next question comes from Scott Heleniak with RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Notice the growth is obviously significant -- has been significant the past couple of quarters and did pick up versus Q3. So yes, I imagine there's a lot more opportunities. You mentioned the submission count, the higher quote activity. But wondering if you could talk about some of the more specific areas. I know you kind of mentioned across the board. You did mention general casualty. But is there any other particular areas where you're seeing kind of an uptick in the dislocation versus Q3 and Q2, kind of any areas where there's a lot more opportunity for Kinsale than there has been that maybe didn't exist a couple of quarters ago?

Brian Donald Haney
Senior VP & COO

I mean this is going to sound like a little bit of a cop-out, but I mean, really, the growth is remarkable in how spread out it is. So it would be -- and I don't -- and there hasn't been like a significant -- to the extent that submissions spiked in the fourth quarter, they seem to have spiked pretty much for most divisions. So it's like, there's no one particular area I'd mention. I mean we've already covered property. Some of the allied health space has been challenged for a few years for some of our competitors.

Michael Patrick Kehoe
President, CEO & Director

Excess casualty.

Brian Donald Haney
Senior VP & COO

Excess casualty. But I mean it really is in most of the lines of business we write.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Yes. And so fair to say some of the same areas where you've seen strength, too, just kind of more of uptick in activity as well?

Brian Donald Haney
Senior VP & COO

Yes. That's a fair way to look at it.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Yes. Okay. And then the rate increases, you mentioned 8% to 10%. I think that was pretty similar to what you saw in the third quarter. So I would imagine that's outpacing loss cost inflation in most of the areas. So I wonder if you could touch on that and just on kind of where your thoughts are for accident year loss ratios, where those might trend in 2020.

Brian Donald Haney
Senior VP & COO

I mean I'll just address kind of the trend in the rate case. This is Brian Haney. 8% to 10%, I think, is above what we would consider trend for our book of business. And I would say, if I had to put a number for trend, it's probably in the 3% to 4% somewhere range. But then what that means in terms of accident year loss ratios and reserves, I'll leave that to you, guys.

Michael Patrick Kehoe
President, CEO & Director

Yes. I mean, like we were talking about a little while ago, we are very confident in our reserve position. The goal is to be conservative. So obviously, over the years ahead, as those claims are reported and adjusted and settled, we would expect those reserves to develop favorably. But at this stage, it's probably not appropriate to go much beyond that.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Yes. That's fair enough. And then just a last question on the net premium retention ratio. That's been kind of tracking a little bit higher in the high 80s the last couple of quarters. And just wondering if that's sort of a fair run rate to assume. And also on a related note, has there been any changes in reinsurance treaties? Anything new at 1/1 at all that you can comment on?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Well, we -- our reinsurance treaties renew on June 1. So we did increase our retention slightly upon renewal last year in June. So I think that's what you're seeing here in the fourth quarter in terms of the higher retention. So I think that, at least here for the foreseeable future, is a good guide.

Operator

And our next question comes from Mark Hughes with SunTrust.

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

Maybe just curiously, on the property, is that more coastal-focused? Or is that more geographically diversified?

Michael Patrick Kehoe
President, CEO & Director

Mark, it's Mike. The -- our personal lines book is coastal, and our commercial lines business is a mix but predominantly noncoastal.

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

And what's the mix of personal versus commercial within property?

Brian Donald Haney
Senior VP & COO

I think it's -- this is just a guess, but I think it's about 2/3, commercial; 1/3, personal.

Michael Patrick Kehoe
President, CEO & Director

Yes.

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

And is that -- the personal lines, is that -- is there mobile in that -- largely mobile homes?

Michael Patrick Kehoe
President, CEO & Director

Yes. It's exclusively manufactured homes on the southeast coast.

Operator

And I'm showing no further questions in the queue at this time. I'd like to turn the call back to Michael Kehoe for any closing remarks.

Michael Patrick Kehoe
President, CEO & Director

Okay. Thank you, operator. And thanks, everybody, for joining us on the call, and we look forward to speaking to you again here in a few months. Have a good day.

Operator
Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.