S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NYSE:KNSL

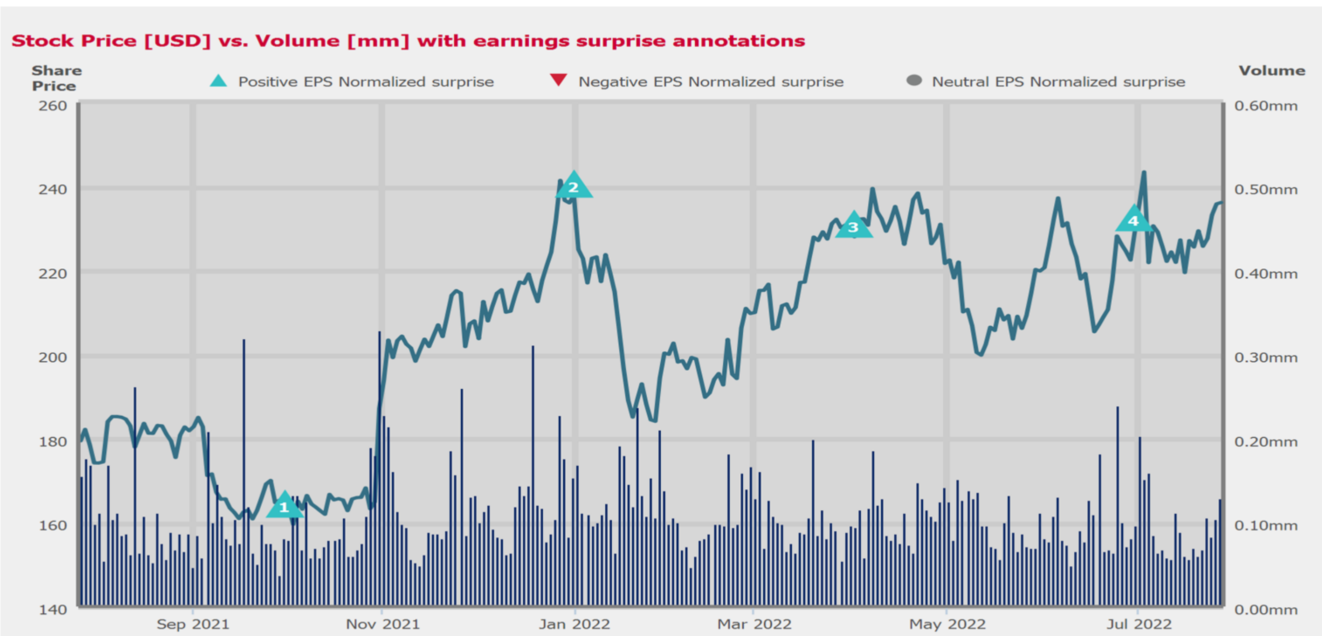
FQ2 2022 Earnings Call Transcripts

Friday, July 29, 2022 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.62	1.92	18.52	1.65	7.04	NA
Revenue (mm)	197.41	178.96	(9.35 %)	208.78	805.37	NA

Currency: USD
Consensus as of Jul-29-2022 3:49 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2021	0.99	1.59	1 60.61 %
FQ4 2021	1.38	1.76	2 27.54 %
FQ1 2022	1.52	1.63	3 7.24 %
FQ2 2022	1.62	1.92	4 18.52 %

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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

Casey Jay Alexander
Compass Point Research & Trading, LLC, Research Division

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Kinsale's Second Quarter 2022 Earnings Call. Before we get started, let me remind everyone that through the course of the teleconference, Kin sales 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 their 2021 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, and good morning, everyone. Welcome to our second quarter conference call. Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Kinsale's Chief Operating Officer, are with me on the call this morning. As usual, we will each make a few comments and then move on to any questions you may have.

Kinsale's operating earnings for the second quarter 2022 increased by 51% over the second quarter 2021, and gross written premium was up 43% for the quarter. The company posted a 77% combined ratio for the quarter and an annualized operating return on equity of 24.6% for the first 6 months of the year. This quarter's performance is similar to our experience over the last couple of years, where we have been able to raise rates to our customers above loss cost trend, and at the same time, grow our premium volume at a remarkable level.

This multiyear combination of profit margin expansion with outsized premium growth is extraordinary. It's allowing us to deliver better returns while continuing to build a strong balance sheet, especially with regard to loss reserves. Although there is much uncertainty in the economy today, especially with inflation, Kinsale stockholders should be confident that our reserves are conservatively positioned, and we're likely to develop favorably and unfavorably in the years ahead. We attribute this combination of higher insurance rates and rapid growth to 2 powerful drivers. First, a dislocated P&C marketplace, wherein weaker competitors continue to struggle, with sufficient loss reserves, inadequate margins, high costs, legacy software, work-from-home business models, general inflation, et cetera.

And secondly, our own unique business model, wherein we target the small account E&S market, maintain absolute control over our underwriting and claim handling and operate with a technology-enabled expense advantage over high-cost competitors. We continue to have an optimistic outlook toward growth in 2022 and 2023, but we also continue to expect the broad P&C marketplace to gradually return to a normal level of competition beyond that. A consequence of which would be an expected Kinsale growth rate in the low double-digit range in lieu of the 43% we saw this past quarter. Given the competitive advantages of the Kinsale model, especially our expense advantage, -- we do expect to continue to grow and take market share from competitors for the foreseeable future, in both hard and soft markets, and to deliver best-in-class margins at the same time. As we have said many times over the years, disciplined underwriting and low cost is an endgame winner every time.

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

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. Again, just another really strong quarter from an operating income perspective with a 43% increase in gross written premiums and a 51% increase in operating earnings for all the reasons that Mike just mentioned, including higher rates and our superior business model. We reported net income of $27.1 million for the second quarter of 2022, down from $35.6 million last year as a result of unrealized losses on equity securities, driven by the drawdown in the equity markets during the quarter. As mentioned, net operating earnings, which excludes the impact from fluctuations in equity values, did increase by approximately 51%, up to $44.4 million from $29.4 million in the second quarter of last year.

The company generated underwriting income of $44 million and a combined ratio of slightly less than 77% for the quarter compared to $29 million and 79% last year. The combined ratio for the second quarter of 2022 included 5 points from net favorable prior year loss reserve development compared to 6.6 points last year. Cat losses were negligible this quarter compared to 2.1 points last year. And our operating return on equity was approximately 25% for the year, and again, ahead of our mid-teens guidance. Book value did decrease by 4.7% in the quarter primarily as a result of unrealized losses on our fixed income securities resulting from higher interest rates. The company continues to generate strong positive operating cash flows, which gives us the ability to hold these securities to maturity, and the higher interest rate environment allows us to invest new money at better yields.

Just as a point of clarity there, the new money yields averaged about 3.84% during the quarter. Net investment income increased by 43% over the second quarter last year, up to $10.6 million from $7.4 million last year as a result of continued growth in the investment portfolio. Annualized gross investment returns, excluding cash and cash equivalents, were 2.6% for both this year and last. Diluted operating earnings per share was $1.92 per share for the quarter compared to $1.28 per share last year.

And lastly, I just wanted to comment briefly on the debt transaction that closed last week. We entered into a 12-year $125 million, 5.15% fixed rate note, which we used to primarily fund surplus at the insurance company level and pay down the balance on our revolving credit agreement. Concurrently, we amended our existing revolving credit agreement to extend the maturity date and to increase the limit from $50 million to $100 million.

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

Brian Donald Haney
Executive VP & COO

Thanks, Brian. As mentioned earlier, premium grew 43% in the second quarter, down slightly from 45% in the first quarter. Overall, the E&S market remains favorable with strong growth across our product lines. In particular, the property market continues to be hard, especially property accounts with material catastrophe exposure. We are also seeing significant growth in our health care, general casualty and energy divisions. Submission growth continues to be strong, right around 20%, up from the high teens growth rate in the first quarter and mid-teens in 2021. Exposure bases are going up, driven by economic activity and by inflation.

We saw rates up in the low double digits in the aggregate during the second quarter, consistent with the first quarter and consistent with 2021. We are continuing to keep an eye on inflation. We feel we're in a good position because we've been achieving rate increases ahead of loss cost for several years now. These increases combined with our strategy of conservative reserving further protect the company from the threat of inflation than some of our peers may be more exposed to.

The market conditions are generally favorable across the board. We see some limited pockets of overly aggressive behavior here and there, usually on the part of start-up MGAs, especially ones focused on big ticket items, but by and large, the market is functioning rationally.

Our IT department continues to make steady incremental improvements in our systems, which enable us to process business faster and at a lower cost. Our technology is a key differentiator for us, and that gives us a significant competitive advantage. And across the company, we continue to focus on continuous improvement in all areas so that we sustain our advantage in the market, providing best-in-class customer service and generating best-in-class returns for our investors. Overall, a good quarter, and we are happy with the results.

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

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

Question and Answer

Operator

[Operator Instructions]

Your first question is from the line of Mark Hughes with Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Brian, you talked about 20% submission growth in the second quarter. Did you notice any change in the trajectory throughout the quarter, month to month?

Brian Donald Haney
Executive VP & COO

Other than that it slightly accelerated from the previous quarter. That's a short answers now, just...

Mark Douglas Hughes
Truist Securities, Inc., Research Division

I'm sorry, what was your last comment there?

Brian Donald Haney
Executive VP & COO

The short answer is, not really. It was just a slight acceleration from the previous quarter. So there's no interesting trends in the month-by-month numbers.

Michael Patrick Kehoe
President, CEO & Director

And keep in mind, Mark, there's always a little bit of variability in those numbers quarter-to-quarter.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. Sure. And then anything you see from an exposure standpoint that would make you say the economy is slowing down, anything in your small account market that is catching your attention?

Brian Donald Haney
Executive VP & COO

Nothing we've noticed yet.

Michael Patrick Kehoe
President, CEO & Director

I mean we see the headlines, but I mean the numbers for our quarter were pretty strong and pretty consistent with what we've seen in the last couple of years.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. Okay. And then, Bryan, on the expense ratio, this is pretty good. I don't know whether this is the high watermark. Well, I guess, the 3Q last year was slightly lower, but how do you feel the expense ratio will trend on a go-forward basis? Is this a good kind of starting point?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

I think it is, Mark. Again, it does bounce around quarter-to-quarter a little bit. However, we're continuing to see some modest economies of scale with the earned premium increasing. But I think what you're seeing here, and I think if you look at it on an annual basis, that's probably the best way to look at it.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then Mike, I'd be interested in just a few more thoughts on what you think about the cycle here. Obviously, this has been going on for quite some time. It sounds like you're optimistic through this year and into 2023. You gave some points about weaker competitors continuing to struggle, but any more thoughts on the cycle, the durability of it? What's driving it would be interesting.

Michael Patrick Kehoe
President, CEO & Director

Mark, we don't really have any special insight into where the market will go over the next year. We're kind of extrapolating from what we're seeing today in terms of submission growth, rate increases, hit ratios on business and the like. And you put it all together, and it just -- it gives us a good sense of optimism here in the near term. That being said, it's almost certainly the market will kind of mean revert at some point, and we're ready for that, too. I think that's the one message I was trying to kind of communicate is, given our business model, focused on not just E&S but smaller accounts within the E&S market, hey, it's still can be quite competitive, but I think there's a little bit of a break from the intensity of the competition in a soft market environment. And then when you add in the expense advantage, we're confident we're well positioned to compete in hard or soft markets. So -- but that being said, we're kind of near term positive. Longer term, we would expect the market to kind of normalize.

Operator

Your next question is from the line of Scott Heleniak with RBC Capital Markets.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Wonder if you could first touch on -- your rate increases are significant still, obviously, up low digit double digits and outpacing loss cost trends. Just wondering if you could comment a little bit more on your loss cost trends? Where they are now? Where they've been? And how you're kind of thinking about that? You're still getting core margin expansion. But if anything you can comment there rate versus loss trend, any more detail would be great.

Michael Patrick Kehoe
President, CEO & Director

I would say that the loss cost trends that we use prospectively today average about 8%. They vary pretty widely by statutory line of business, right? So that's kind of a weighted average across our portfolio. There's a significant premium trend that we get because most of our business is priced on things like revenue or payroll that in and of itself is being inflated, right? I think the way we generally view it is that retrospectively, premium trend largely offset loss cost trend, maybe it's a point or too shy.

But in general, if we're getting a low double-digit nominal rate increase across our portfolio, the real rate increase might lag by a couple of points below that. So in general, we're getting very significant real rate increases but not just now, we've been getting them over the last several years. So it's a "rate on rate on rate on rate effect," and I think that goes a long way to explaining why the margins are as compelling as they are.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. That's definitely helpful. And it sounds like pricing is still holding up as well across the book. The next question I wanted to ask was just on the terms and conditions is something that you've talked about before, kind of working in your favor over the past year. Wondering if you can give an update on kind of what you're seeing in terms of limits and deductibles? Whether you've seen any shifts in that over the past year or so, anything that kind of sticks out? And any change in customer behavior as well due to the economy?

Brian Donald Haney

Executive VP & COO

Definitely seeing a trend towards carriers shrinking their limits that they offer. And so that -- and we've done that, too, just to sort of follow on with the market. It's definitely opened up opportunities for us because when you shrink limits, if the customer still wants to buy the same total amount of limit, they got to go to more carriers. We're not really seeing yet a big trend towards insurers buying larger limits. I think in some cases, especially in the harder parts of the market, affordability starts to become an issue, and there's -- at a certain point, they can't afford the limit that they might have bought in the past. So it's affecting behavior in that regard. But -- so generally, I would say limits have shrank deductibles on things like property exposures, in particular, are up and terms and conditions are tending to get tighter.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. That's good. And then you mentioned again dislocation, which I know is something we saw a lot in 2021, is that typically in the same areas, pockets and competitors? Or has that changed really much in the past years? Or is there -- I think you mentioned some new start-ups. But is there anything more you can talk about that, the dislocation? Because it seems like the dislocation would be kind of lessening out there, but I don't know what you're -- maybe you're seeing something different?

Michael Patrick Kehoe
President, CEO & Director

Yes. I would just remind you that the P&C market is quite large, and it doesn't really move monolithically. There's all sorts of submarkets and pockets, I would say, right now. Property -- in particular, property with an acute catastrophe exposure is a hard market. Capacity is hard to come by. Reinsurance for carriers is harder to come by. Prices are higher. Whereas, there's probably other areas of the market that maybe are a little bit more steady. But in general, if you just look at all the earnings reports and whatnot, I mean, there's plenty of examples of carriers that are still working through challenges in their business models and their financial results. And some of that bleeds into the E&S market and I think helps explain the market opportunity that we see.

Now candidly, the other half of our market opportunity is driven by our own business model. We're operating at a cost advantage that's just very material, and we operate in an industry where the customers care intensely about the price of the policy. It's a dramatic advantage that we have, and we're working hard to exploit them.

Scott Gregory Heleniak
RBC Capital Markets, Research Division

Okay. Perfect. And just one last one, just on your property business. I'm just wondering the rates there have obviously firmed a lot, everyone knows that over the past year. And wondering what your appetite is for growth there. What you're seeing year-to-date on that line? Are the rates good enough to really expand there? And anything you can talk about on that part of the book.

Michael Patrick Kehoe
President, CEO & Director

Yes. I would say that there is a very attractive market opportunity in property and we're working hard to take advantage of that. Given the state of the market, we are growing our property divisions rapidly. We've got a number of different areas. We've got a commercial property division. We've got a small business property division. We got Inland Marine division. We have a personal lines division that's principally property driven. So we're working very hard to grow and take advantage of the opportunity. I would caveat just -- one important way is, we've always been very mindful of the volatility associated with cat business, and we've got very strict controls on the concentration of business in any one geographic area. We model the portfolio regularly. We buy a lot of reinsurance. So yes, we're always going to balance, if you will, the volatility with the profit opportunity in that business, but we are running more than we have in the past.

Operator

Your next question is from the line of Casey Alexander with Compass Point.

Casey Jay Alexander
Compass Point Research & Trading, LLC, Research Division

Yes. You just answered my biggest question in that last one, but I'll ask one other. The equity securities as a percentage of your total investment portfolio, obviously, due to mark-to-market changes in the portfolio over the last couple of quarters have shrunk to where it's now somewhere below 10%. Would you guys consider increasing the allocation to equities to bring it back up to a more normalized level and take advantage of lower prices in the marketplace?

Michael Patrick Kehoe
President, CEO & Director

Yes. This is Mike. I would say that longer term, we think equities will play a bigger role in our investment strategy. In the next couple of months, we're digesting some pretty dramatic changes in Fed policy around short-term rates, quantitative tightening, how transitory inflation is, are we going into a recession, et cetera. So near term, I think we're not going to make any dramatic changes. Longer term, I think equities could play an incrementally larger role in our investment strategy.

Operator

Your next question is from the line of Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

So I think the top line benefit from higher pricing is pretty evident in your results. But I was hoping if you could shed more light on new business versus renewal -- the new business versus renewal dynamic behind your premium growth. So I guess how much of your written premium basis is new versus renewal? Or maybe you want to frame it another way, how does your in-force policy count compare against bond policies, right? I think in 2021, you bonded about 35,000.

Brian Donald Haney
Executive VP & COO

I guess one way to answer that would be, generally speaking, we buy -- we renew about 2/3 of the dollars of premium from 1 year to next. And so if that ratio holds steady in the long term, about 1/3 of our business should be new and about 2/3 of our business should be renewal. I don't have the exact figures. But since we've been growing more of our business is new than 1/3. But over the long term, that's what you should expect in terms of new versus renewal split.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then on investment income, I was curious, are you selling out of current securities that you have? Or is it operating cash flow that you're mainly investing at the higher newer yield? And I guess, like going forward, do you expect to get -- obviously, the investment base is growing fast, but you do expect to get a yield pickup as well in the investment?

Michael Patrick Kehoe
President, CEO & Director

Yes. We're essentially holding to maturity, all the fixed income, even if it's dropped in price. So it's new money coming in. It's pay downs from existing fixed income investments that we're talking about achieving the higher yields.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then switching to capital. So I appreciate the discussion of the financing put in place. Could you remind us again how much incremental net premiums current financing will be able to support? And I guess you can sort of frame it whichever you think is appropriate, but at least from where I'm sitting, like I tend to think about like a debt-to-capital ratio or target in the surplus ratio. But just broadly speaking, how much net premiums can the current financing support?

Michael Patrick Kehoe
President, CEO & Director

The debt to capital will be somewhere in the high teens -- well, pro forma. We closed the loan after the end of the quarter, but I think 17%, give or take. And what was the rest of the question, Pablo?

Pablo Augusto Serrano Singzon

JPMorgan Chase & Co, Research Division

Yes. It was more sort of the magnitude of net premium -- incremental net premiums that financing can support, right? And I think simplistically, like I tend to think of it as like maybe 1:1 or a little over 1, right, maybe I want to say 2? So if you did raise $125 million and you have the revolver that's actually $100 million then I think you can upsize both, right? Altogether, how much you are...

Michael Patrick Kehoe
President, CEO & Director

Yes, I would have to -- we'd have to get back to you on that. But the way we would look at it is, hey, we model our business all the time as part of our capital management process. And so we're kind of looking at this note and this debt as putting us in a comfortable position to finish up 2022 in good standing with -- AM Best, our principal rating agency. So to maintain our A rating, that's very important to us. But to break -- to itemize how much premium would be associated with that, I think we'd have to get back to you.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then last one for me. So just on the topic of loss trends. So I think this quarter, other companies have talked about updating the loss trend assumptions, I guess, given higher inflation and the evolving course might develop. Have there been any changes in your loss trend assumptions over the past couple of years, and I appreciate the disclosure you've given, prospective be the 8%, but has that number changed much over the past couple of years?

Michael Patrick Kehoe
President, CEO & Director

Yes, absolutely. I mean every quarter, we look at actual loss activity and actual economic statistics, especially around things like inflation and adjust all of our actuarial assumptions to make sure that they're as accurate as they can be. So yes, as we've seen inflation trend up the last year or so, we're certainly updating our actuarial assumptions accordingly.

Operator

[Operator Instructions]

Your next question is from Mark Hughes with Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

I'll follow up on that one. The -- you talked about 8% loss cost trends that you're setting -- I think you said prospectively, you're setting that based on those statistics that you see. I think historically, you've talked more mid-single-digit loss cost trend. Have you seen it pick up a little bit? Or you're just looking around and anticipating that or being conservative to make sure it doesn't sneak up on you?

Michael Patrick Kehoe
President, CEO & Director

Mark, this is Mike. Where we've seen inflation in the claims process at this stage is mostly in first-party claims, where labor costs, construction costs are inflating the value of a property damage claim. We've seen it a little bit in the construction defect area. That's property damage driven. And so it's not unusual if someone's made an estimate of x amount of damages over the course of the litigation. The estimate gets updated, and it increases because of supply chain issues, labor costs and the like. But I would say that 8% and our actuarial assumptions are really driven more by different statistics that we use to forecast and plan our business.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Is there -- if we think about your premium mix, is there a ceiling of how much property you wouldn't go above just to manage volatility?

Michael Patrick Kehoe

President, CEO & Director

Well, property is about 1/3 of the E&S market. And I think there's some classes of property -- I'm thinking of like primary habitational business where we're not targeting. So I think we would tend to lag well below the 1/3 mark. I think we're probably in the low 20s today, and we're very comfortable with that. It's -- there's no specific target, I think what I talked about a few minutes ago, just balancing the property we write and making sure that we're carefully managing the volatility associated with natural catastrophes. And we've got a good track record now over the last 13 years of doing that. Most of the big storm activity, we've had very manageable losses. And I think that's largely because of good underwriting, but also a good measure of conservatism in our risk management approach.

Operator

There are no further questions at this time. I will now turn the call back over to Mr. Michael Kehoe.

Michael Patrick Kehoe
President, CEO & Director

Okay. Well, thank you, everybody, for joining us. We're happy with the quarterly results, and I look forward to speaking with you again here in 90 days. Have a great day.

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