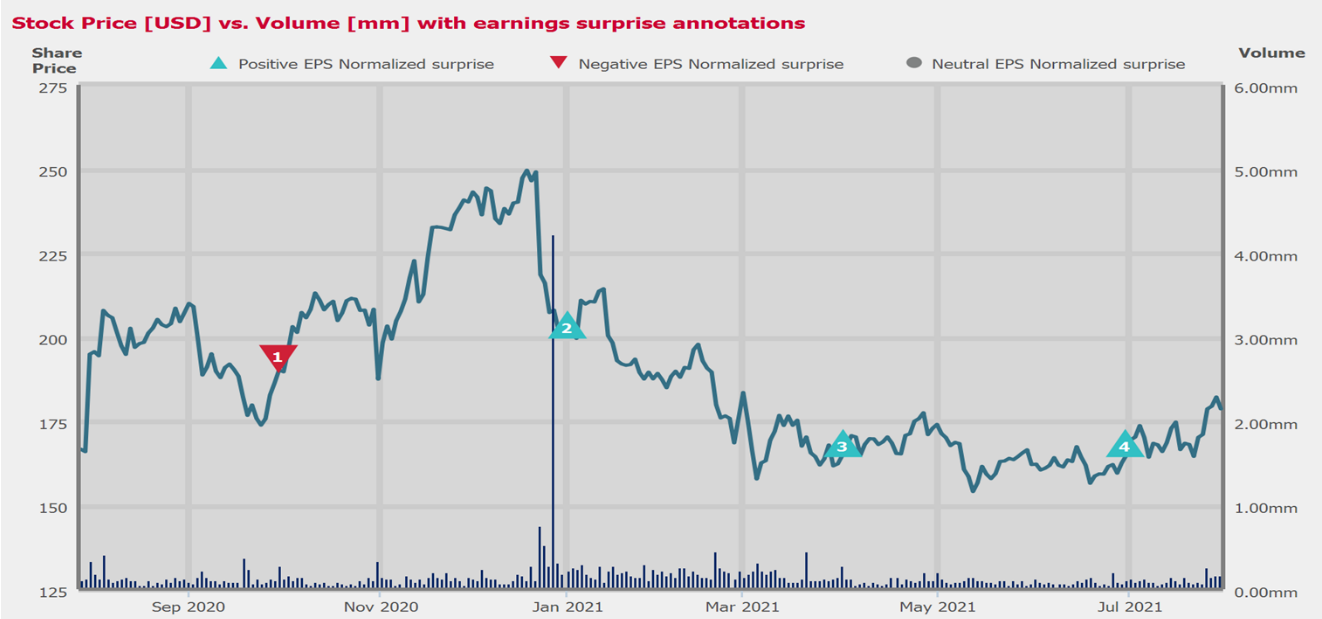
S&P Global
Market Intelligence

Kinsale Capital Group, Inc. NasdaqGS:KNSL
FQ2 2021 Earnings Call Transcripts
Friday, July 30, 2021 1:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ2 2021-			-FQ3 2021-	-FY 2021-	-FY 2022-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.06	1.28	▲20.75	1.08	4.72	NA
Revenue (mm)	138.36	153.01	▲10.59	153.00	600.56	NA

Currency: USD
Consensus as of Jul-30-2021 8:12 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2020	0.74	0.42	▼1 (43.24 %)
FQ4 2020	0.78	1.14	▲2 46.15 %
FQ1 2021	0.84	1.11	▲3 32.14 %
FQ2 2021	1.06	1.28	▲4 20.75 %

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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

James Inglis
Philo Smith & Co.

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

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Rowland Juran Mayor
RBC Capital Markets, Research Division

Presentation

Operator

Before we get started, let me remind everyone that through the course of the teleconference, Kinsale's management may make comments that reflect their intentions, beliefs, and expectations for the future. As always, these forward-looking statements are subject to certain risk factors which could cause actual results to differ materially. These risk factors are listed in the company's various SEC filings, including the 2020 annual report on Form 10-K, which should be reviewed carefully. The company has furnished a Form 8-K with the Securities and Exchange Commission that contains the press release announcing its 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. We appreciate you're joining us on the call today. Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer, are with me as well. After each of us make a few comments, we will then take any questions you may have. Kinsale's operating earnings for the second quarter 2021 were $1.28 per diluted share, an increase of 52% from the second quarter of 2020. Gross written premium was up over 45% for the quarter. The company posted a 79.5% combined ratio and an 18.2% annualized operating return on equity for the first 6 months of 2021. These numbers are well ahead of our guidance of a mid- 80s combined ratio and mid-teens operating return on equity.

Kinsale's results were driven by our unique business strategy that combines focus on the small account E&S market, control over our underwriting operation, and technology-enabled low costs, but they are also driven, especially the 45% growth rate in the second quarter from the continued favorable market conditions within the E&S segment. We continue to see steady growth in new business submissions, which we see as a bit of a leading indicator, and we continue to see low double-digit rate increases across the book of business which are positively impacting our margins. Brian Haney will offer some additional commentary on this topic here in a moment.

We are optimistic about market conditions for the balance of the year and perhaps next year as well. Regarding capital levels, the company is well situated currently, and we don't expect to need any additional capital this year, even with the strong growth rate. To the extent that we do need additional capital next year, we would expect to use debt in lieu of equity capital. I'll now turn the call over to Brian Petrucelli.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. The results for the second quarter continue to be strong and driven by solid premium growth, favorable loss experience, and disciplined expense management. We reported net income of $35.6 million for the second quarter of 2021, representing an increase of 17.8% when compared to $30.2 million last year and due primarily to higher earned premium and net favorable loss reserve development. Net operating earnings increased by 54% to $29.4 million, up from $19 million in the second quarter of 2020.

The company generated underwriting income of $28.7 million and a combined ratio of 79.2% for the quarter compared to $15.7 million and 83.8% last year, with improvements to both the loss and expense ratios. The combined ratio for the second quarter of 2021 included 6.6 points from net favorable prior year loss reserve development and 2.1 points from cat losses compared to 3.7 points of favorable loss reserve development and negligible cat losses last year. The cat losses this quarter were primarily related to development on losses from a couple of the Texas winter storms.

Our current accident year loss ratio, exclusive of cat losses decreased slightly in recognition of ongoing favorable pricing trends that Mike previously touched on, we expect there will always be some variability in our quarterly expense ratio and our 21.7% expense ratio for this quarter continues to benefit from some economies of scale, given that our earned premiums are growing faster than our operating expenses and from slightly lower relative net commissions as a result of a shift in the mix of business to lines that are subject to reinsurance and where we receive ceding commissions.

Our effective income tax rate for the quarter was 18.5% compared to 14.8% last year and higher due to lower tax benefits from stock compensation activity this quarter. Annualized operating return on equity was 18.2% for the first 6 months of this year. And again, as Mike stated, ahead of our mid-teens guidance. Gross written premiums were approximately $194 million for the quarter, representing a 45% increase over last year due to the favorable market conditions that Mike mentioned and also superior -- our superior service standards.

On the investment side, net investment income increased by 11.8% over the second quarter last year, up to $7.4 million from $6.6 million last year as a result of continued growth in our investment portfolio. Annualized gross investment returns, excluding cash and cash equivalents, was 2.6% for the year so far compared to 3% last year. Diluted operating earnings per share was $1.28 per share for the quarter compared to $0.84 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 45% in the second quarter, up 36%, up from 36% in the first quarter and 34% in the fourth quarter of 2020. The growth is generally driven by higher submission volume and rate increases as well as robust economic growth, which is driving up premiums. Every one of our divisions was up for the quarter, led by allied health, excess casualty, and commercial property. The reopening of the economy and the strong economic growth is providing us a significant boost. Submission growth was in the upper teens in the second quarter, which represented a rebound from the first quarter.

As for rates, we continue to push them up in response to market conditions. As a reminder, we have a very heterogeneous book of business, which complicates reducing all the rate movement to one single number. But that all being said, we see rates being up in the low teens range in the aggregate during the second quarter, generally consistent with the past 2 quarters. Some data suggest that the industry is past peak rate increases at this point but for whatever reason, perhaps mix of business, we feel that our rate increases have stayed high and not started to ebb.

It is worth discussing inflation for a moment. It's important to note that a majority of our policies are written on inflation-sensitive exposure bases, such as revenue or payroll. So as inflation goes up, premiums go up commensurately for the bulk of our policies. Inflation also affects losses, of course. And while our loss trends have been tamed, we are noticing a general price inflation for the businesses we insure and in the economy on the whole. It is a matter of time before that shows up in loss trends for us and the rest of the industry. The biggest components of our losses are medical cost, lost wages, construction costs, and legal costs, all of which are going to be affected by general price inflation.

We are aware of this and staying on top of it. Whatever the true inflation rate is and whether or not it is transitory, we are getting rate increases that are in excess of it, so we are implicitly building on what we're already strong margins. We feel that elevated inflation will prolong the hard market because it will erode the margin improvement that insurers were aiming for with the increased rates. We feel we are in a good spot because we are raising rates not to correct the problem, but to further improve our already strong returns. But in any event, the longer inflation remains elevated, the longer we expect the hard market will stay with us.

In summary, we are optimistic. We have a great team, great results as well as a strong balance sheet with conservative reserves. Our business model works well in any market, hard or softer in between, but the current market conditions are really good.

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 any questions that come in.

Question and Answer

Operator

[Operator Instructions] We have our first question from the line of Jeff Schmitt from William Blair.

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

Just curious how you handle inflation from a reserving perspective. I think you'd have to have a view on whether it's sort of transitory or not, you tend to be pretty conservative. Just wondering how you're accounting for that?

Michael Patrick Kehoe
President, CEO & Director

Yes. I mean, I think we've spoken about this many times that it's a fundamental part of our business strategy to post reserves that are much more likely to develop favorably than unfavorably. And we're constantly reviewing actual experience against all the various actuarial assumptions, including loss cost trends. And so as data comes in, we adjust our estimates accordingly. As Brian said, most of our policies are priced off of inflation-sensitive metrics. So to the extent inflation picks up, that flows through the revenue that our insureds experience and our insurance premiums are priced off that inflated base. But does that kind of get at your question?

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

Yes. No, I was just curious if you have to make a call on whether that's transitory or just how you handle that. But and then you had pointed out, I think, some of the areas of highest growth was allied health, excess casualty. I think those areas have -- that's been -- are they sort of the farthest from rate adequacy? Or is there just greater dislocation in those lines? Could you maybe touch on those?

Michael Patrick Kehoe
President, CEO & Director

Well, I would say, I mean the rates we're charging those are adequate, and we're earning like a really high margin. I would just say the industry has had some challenges in those areas. Commercial property has seen a lot of cat activity in the industry. Allied health there's just been a number of competitors that have sort of blown up writing that type of business. And excess casualty is a fairly common thing you would see in a market turn where people kind of get burned with soft market practices and then have to course-correct, and that's what we see going on. So -- but I would say we feel pretty good about our rates and our experience in this.

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

Right. Yes. And I was referring more to the market, are those areas where the market is farther off. I mean you've been rate adequate, obviously, for some time, but -- okay. Okay.

Operator

We have another question from the line of Mark Hughes from Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

The 210 points of development on the Q1 storms, was that inflation, material costs higher than expected? Or what drove that?

Michael Patrick Kehoe
President, CEO & Director

I think it was a couple of claims where we were in an excess position. And on a larger commercial schedule, there can be some ambiguity in the early days, hey, we think this loss is $30 million. And over the course of the adjustment process, it turns out to be a higher number. And if we're attaching excess of substantial retention or an underlying schedule. I think it was that type of thing. I wouldn't attribute it to inflation per se. I think it was just ambiguity in the adjustment process, and we were in an excess position.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Understood. How about -- when we think about social inflation, I think you've spoken to this a number of times. But do you see any movement in the court systems, anything in your book that's been impacted by that? I think you kind of stay away from most of that, but could you give us a sense of what's going on in terms of activity or court movement, let's say?

Michael Patrick Kehoe
President, CEO & Director

I think in general, I would say loss cost trend is real. We endeavor to stay well ahead of it. I think given our focus on smaller commercial accounts, the fact that we put up smaller limits, inoculates us a little bit from some of these nuclear verdicts and the like. I would say in terms of inflation, we -- as Brian indicated, hey, to the extent that there's a general price inflation, we're going to see that along with everybody else. And certainly, when property claims come in, material costs are up, labor costs are up. I'm sure we're seeing that in current estimates. But is it impacting our kind of macro trends across our whole book of business? No, I think things are going quite well for us.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then the reserve development in the quarter, the 6.6 points, how much of that was 2020? 2020 was obviously an unusual year in terms of frequency and severity, a little more depth. I know in some of your older accident years, you've had some less favorable development through time. How are you seeing that dynamic now?

Michael Patrick Kehoe
President, CEO & Director

Yes. I mean, we are conservatively positioned across all of our accident years. That's a huge priority for us as a management team and as a business. We've gotten some dramatic rate increases the last couple of years. And I would say some of those more current accident years are even more conservatively positioned. And then 2020 also has the added issue of COVID, where our reported losses were lower than we expected. And we offset that with higher IBNR, just to make sure that we were well-positioned in the case there were some sort of bounce back in reported loss activity.

Each quarter that goes by, we'll make modest adjustments to those assumptions to kind of normalize the 2020 accident year with the prior years. But in general, we're always -- every quarter, we're looking at actual loss activity and comparing it against all the various actuarial assumptions that we make and we adjust. But I think you're -- in general, I think from an investor standpoint, one thing I would note is, hey, we're seeing a modest uptick in the amount of redundancy that's coming out every quarter. And I think that's largely a function of the pretty dramatic increases in price that we've been able to charge the last couple of years. So we -- again, we feel very good about the reserves for the company. And we feel very good about the modest margin expansion we're starting to see on the bottom line.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Have you seen any bounce back off the 2020 accident year in terms of claim?

Michael Patrick Kehoe
President, CEO & Director

No.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. And then one final question. I'm sorry to drone on, but the Ryan Specialty's IPO was -- I think part of their discussion was that there is consolidation among the wholesale brokers. Any thoughts on whether that is the case, that there's consolidation that, that has any meaning in terms of your ability to get to the market?

Michael Patrick Kehoe
President, CEO & Director

Well, there's definitely been consolidation. Ryan has acquired a number of firms, but the others have as well, and it hasn't had any impact on us. We do quite a bit of business with all the large wholesale brokers. And -- but we work with a lot of smaller. We kind of characterize them as national brokers. Some are more regional, some are very local. There are some start-ups that have opened in the last couple of years. We work with them as well. But certainly, there's been a lot of acquisition activity, and as of today, it hasn't really impacted our business. So we do quite a bit of work with all those firms, and they're very good at what they do.

Operator

We have another question from the line of Casey Alexander from Compass Point.

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

I have a couple of questions for you. First of all, kind of from a high level, given the extraordinary growth rate that you're producing, to what extent does this eventually stress your manpower, your real estate footprint, and your need to add some expenses to support this growth? And also, and particularly in relation to the real estate footprint, how does work at home habits and work at home changes impact that dynamic?

Michael Patrick Kehoe
President, CEO & Director

Casey, this is Mike. Yes, we -- listen, we've been growing at a strong double-digit rate for a number of years now. And of course, it puts a lot of stress on your management team. We're recruiting and hiring a lot of people. There's a big training component and the like. But hey, that's what we get paid to do, and we've been working hard at it for a number of years now. So that's kind of business as usual. In terms of the real estate footprint, there's no stress there. We've got plenty of capacity in the building that we occupy. What was the third part of your question?

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

Well, just how this work at home habits impact that?

Michael Patrick Kehoe
President, CEO & Director

Yes. We're a work from the office team, and we did move 90% of our employees home when the virus first hit back in, I guess, it was March or April of 2020. But by October, we're basically back in the office, and given the number of new hires, the training component, we want those new employees to learn our culture, working together in an office facilitates communication. A big part of our business strategy is delivering best-in-class service to our brokers. And all that -- all those goals are furthered by having everybody work together in an office. And so that's how we're operating.

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

Okay. Great. And secondly, I would say, a year ago, the discussion during the quarter, you discussed that a decrease in the competitive environment and in the set of competitors was offered you kind of a clear vision towards accelerated growth over the course of the next year. How would you characterize the competitive environment now compared to what it was a year ago?

Brian Donald Haney
Executive VP & COO

I'd say it's pretty flat. So we've seen some new competitors, but they tend to be small, and we've still seen some pullback from larger competitors. So on balance, it's more or less the way it was.

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

All right. Great. I appreciate you're taking my questions.

Operator

We have another question from the line of Rowland Mayor from RBC Capital.

Rowland Juran Mayor
RBC Capital Markets, Research Division

When you guys talked about low teens rate increases, is that pure rate or the effects of changing terms and conditions included in that number?

Brian Donald Haney
Executive VP & COO

It's pure rate.

Michael Patrick Kehoe
President, CEO & Director

Not including the effect that -- not including the effect of inflation on the exposure base.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. And is there any way to quantify sort of the impact of your tightening terms and conditions and say, is that worth another 1 or 2 points? Or is it the equivalent of one or 2 points of pricing or any...

Brian Donald Haney
Executive VP & COO

It would be tough to quantify. It's worth something.

Michael Patrick Kehoe
President, CEO & Director

1 or 2 is probably as good a guess as any.

Rowland Juran Mayor
RBC Capital Markets, Research Division

Got it. That was really my following question. I guess just to double enough Casey's comment we've seen a lot of companies talk about dialing up growth. Do you have in the next coming quarters, is that -- that really hasn't worked down to you guys at all? It's not really entered your market yet higher competition?

Michael Patrick Kehoe
President, CEO & Director

I mean there's -- look, there's plenty of competition. I think Brian said it was steady from the prior year. Our hit ratio on new business submissions continues to be somewhere between 10% and 15%. It was the same last year. It was the same the year before that. So there's plenty of competition. It's just -- it's diminished from where it was 5 years ago or 4 years ago when we were in a very -- what I would characterize as a more intensely competitive market. It's a little bit less today, but that doesn't mean there's no competition.

Rowland Juran Mayor
RBC Capital Markets, Research Division

No, that makes sense. Those were my only 2 questions. Congrats on the quarter.

Operator

[Operator Instructions] We have another question from the line of Pablo Singzon from JPMorgan.

Pablo Augusto Serrano Singzon

JPMorgan Chase & Co, Research Division

So my first question, it seems like the improvement in accident year loss fix, call it about 1 point from the first half last year to first half of this year, is low in light of a gap we're getting between price increases. To your point, I think you said like low double digits in loss trends, which I think in the past, you've said it in the mid-single-digit range. Can you share your thoughts on that? And maybe is there an element of conservatism in the loss picture setting? And I guess, would it be reasonable to assume something to drift down in those loss picks over time?

Michael Patrick Kehoe
President, CEO & Director

Yes. Pablo, this is Mike. I would say there's absolutely an element of conservatism in those loss picks. And I think they're highly likely to develop down over the years as those losses come in and they're adjusted and settled out. And we're a relatively young company. It, It's our -- I think, our 12th accident year in business. But if you look back every accident year, but one of the very early ones have developed favorably on an inception-to-date basis. And so that's a really important goal for us as a management team. We want people to have a lot of confidence in our balance sheet. And so yes, absolutely. Conservative reserves, we're getting really good rate increases. And you match that up with a high-quality, very disciplined underwriting operation, and we expect the margin expansion to continue incrementally.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And along the same lines, could you speak about where you see the expense ratio trending? So obviously, passengers has been going down even, even as the company has been expanding, right? But just given the strong growth in premiums that would likely persist for at least the next couple of years, how do you see that expense ratio trending?

Brian Donald Haney
Executive VP & COO

We obviously are making investments in human capital and IT. As we grow, there's a possibility, you'll see a little more drift down in that expense ratio. But I think if you're looking over the long term, I think, seeing where it is now, the 21% to 22% to 23% range over the long-term is probably where we would see it. But over the short term, you could see a slight improvement in that.

Michael Patrick Kehoe
President, CEO & Director

Yes. Keep in mind that it's -- a lot of it is mix of business as Brian said earlier on his comments. We reinsure some lines of business where we get a ceding commission, which could help push that down if we saw an uptick in our excess casualty business, for instance. So that's one big component. I think the variable is mix of business and then headcount.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And then last question for me. Thanks for the update on capital, but can you remind us again what kind or what levels being leveraged you'd be comfortable running at? And I suppose, next year, your surplus could potentially be funded by debt and equity depending on how growth plays out. But I guess, just sort of big picture, what kind of leverage Kinsale would be comfortable running at?

Michael Patrick Kehoe
President, CEO & Director

Yes. I think it's a 20% debt to total capital is kind of our long-term target. I think we're about 6% today. So we got a ways to go. But that's why we made the comments about, really, as we need additional capital to grow the business, we would look to debt, not equity at this point.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. And premium leverage -- or actually, that was the question I should have been clear. Premium leverage, and I guess, depending on how you grow, right, that will affect your premium leverage. But -- and well to me affect how much of that you might have to raise, but what premium leverage would Kinsale be comfortable running at?

Michael Patrick Kehoe
President, CEO & Director

Yes. The AM Best BCAR model, I mean, it's a complex capital model. The big drivers within that are reserves and premium but that there's other charges for growth and investments, et cetera. And so there's no specific premium to surplus ratio that would be driven from the model, but we just guesstimate somewhere in the -- a little bit higher than 1.2:1 net written premium to statutory surplus. That's not GAAP equity and GAAP equity and stat surplus are correlated, but they're different numbers. So for what that's worth. Obviously, we're A-rated, A-rated, and AM Best is our -- that's our AM Best rating. That's a really important number for us, and we're going to maintain that A rating. So. 1.2 to 1.25 to 1, I think, is a good guess.

Operator

We have another question from the line of Jamie Inglis from Philo Smith.

James Inglis
Philo Smith & Co.

I'm interested in following up on your comments about inflation and how it helps you when it's your rates or your premiums are tied to revenue or payroll, et cetera, sort of allows you to participate in inflation on the revenue side. But how does it work? On the other side, because if we pay a claim today, the claims on a policy that was written a little while ago, and it could be quite a while ago, depending on the type of policy. So does the inflation today allow you to in a way sort of put more in the bank from a reserve point of view? Or does that -- is it not work that way?

Michael Patrick Kehoe
President, CEO & Director

This is Mike. I would say that this is going to be a very complex topic. How insulation works its way through our book of business. Clearly, if we collect a premium today and settle a claim in 3 years, that claim is going to be inflated, which is a negative. The fact that we write a policy for $10,000. And at the end of the year, the contractor that we're ensuring has charged higher rates because of inflation, we're going to collect and audit additional premium. That's an inflation benefit.

And there's a lot of those that work their way through our business. But I would say, in general, we'd like stable pricing. But given the inflation-sensitive pricing mechanism, it provides a little bit of protection. And then I think Brian was -- Brian Haney commented earlier that the conservatism in our reserve position provides additional protection. And then I would also say the fact that we tend to focus on posting lower limit policies probably provides another round of protection, right? But there's a lot of different things with inflation that would probably go either for us or against us.

Operator

Thank you, sir. There are no further questions at this time. I will now turn the call back to Mr. Michael Kehoe, for closing remarks, sir.

Michael Patrick Kehoe
President, CEO & Director

Okay. Thank you, operator, and thank you, everybody, for joining us, and we look forward to another positive call here in a few months. Have a good day.

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