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Kinsale Capital Group, Inc.

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Earnings Call

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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

Andrew E. Andersen
Jefferies LLC, Research Division

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Unknown Analyst

Presentation

Operator

Good morning, and welcome to the Q2 2023 Kinsale Capital Group Inc., Earnings Conference Call. Before we get started, let me remind everyone that through the course of this 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 2022 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'll 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. Bryan Petrucelli, our CFO; and Brian Haney, our COO, both on the call this morning as well. Each of us will make a few comments, and then we'll move on to any questions you may have.

In the second quarter, 2023 Kinsale's operating earnings per share increased by 50% and gross written premium grew by 58.2% over the second quarter of 2022.

For the quarter, the company posted a combined ratio of 76.7% and an operating ROE return on equity of 30.6% for the 6 months. These results follow from the company's strategy of both disciplined E&S underwriting and technology-enabled low costs, which allows us to generate attractive returns and to take market share from competitors at the same time. The favorable market conditions in the overall E&S market further boosted the Kinsale numbers especially as respect to the quarterly growth of 58%. 2023 may be the sixth calendar year in a row with double-digit industry-wide E&S premium growth.

The commercial property market continues to be an area of opportunity for Kinsale with both rapid growth in premium and strong rate increases. As we've discussed previously, we are balancing the market opportunity and the goal of limiting volatility in our quarterly earnings.

Even with the recent growth in property premium, our expected losses relative to operating income have not materially changed. We have stressed the importance of establishing reserves for future claims in a conservative fashion. And in fact, on an inception-to-date basis for the last 10 years, all of our prior accident years have developed favorably. Given the rate increases we have achieved over the last several years, we believe our total reserves are more conservatively positioned now than at any time in the history of our company, even with the impact of elevated inflation in the last several years.

That being said, however, inflation has reduced the level of conservatism in our 2016 through 2018 accident years. And if inflation is hitting select Kinsale reserves, we suspect it is hitting our competitors as well. And to the extent that inflation is impacting casualty reserve adequacy for the industry, it may be bullish for continued strong rate increases and growth for the near term perhaps through 2024 or beyond.

As we've noted many times, longer term, we see levels of competition normalizing and our growth rate dropping into the teens, while our business model of disciplined underwriting and low cost allows us to continue to deliver best-in-class returns.

A final comment from me on the real estate investment we made in December of 2022. As you recall, we purchased 2 office buildings and vacant land adjacent to our existing headquarters for $77.5 million. One of those buildings is under a long-term lease and is now under our contract to be sold for $63 million and we expect that sale to close in the third quarter.

We also expect to begin renovations on the remaining building that is largely vacant later this year or early next year and to occupy it beginning in 2025. And with that, I'll turn the call over to Bryan Petrucelli.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Thanks, Mike. Again, just another really strong quarter with 58% growth in written premium and net income and operating income increasing by 169% and 51%, respectively. The 76.7% combined ratio for the quarter included 3.9 points from net favorable prior year loss reserve development compared to 4.9 points last year with less than 1 point coming from cat losses in either period.

In the second quarter of this year, we made an immaterial accounting policy change and reclassified policy fees from an offset to underwriting expense to fee income. This change was driven by the increase in policy fees relative to operating expenses. In connection with this reclass, we've modified the expense and loss ratio calculations to add the fees to premium and the denominator of each one of those ratios. For comparison purposes, we've reclassified prior periods to conform with the current period's presentation. We believe the current presentation provides better clarity and transparency to the users of our financial statements.

This change had a slight impact on the previously recorded ratios. However, no impact on the company's operating results. Most of the improvement in the modified quarterly expense ratio of 21% compared to 22.5% in the second quarter of last year related to ceding commissions from the company's casualty and commercial property proportional reinsurance agreements as a result of growth in both of those lines of business.

With respect to reinsurance, we successfully renewed our commercial property quota share, property cat and casualty variable quota share treaties on June 1. Pricing was consistent with previous years on the 2 quota share treaties. However, we did increase the ceding percentage on our commercial property quota share from 42.5% to 50%. We saw an approximately 20% increase in our cat treaty pricing on a risk-adjusted basis. As a result, we increased our retention to $47.5 million and at the same time, bought more limit on the top layer to account for increased exposure.

Lastly, we did not renew our personal insurance quota share treaty due to the dramatic decrease in concentration from actions we took after Hurricane Ian last year.

On the investment side, net investment income increased by 128% over the second quarter of last year as a result of continued growth in the investment portfolio and higher interest rates with gross returns of 3.8% for the year compared to 2.6% last year. We're continuing to invest new money in shorter duration securities with new money yields averaging a little higher than 5% during the quarter and duration decreasing slightly to 3.1 years, down from 3.5 years at the end of last year.

And lastly, diluted operating earnings per share continues to improve and was $2.88 per share for the quarter compared to $1.92 per share last year.

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

Brian Donald Haney
Executive VP & COO

Thanks, Bryan. As mentioned earlier, premium grew 58% in the second quarter, which was significantly higher than the past several quarters. The E&S market remains favorable with strong growth across most of our products. The products -- the property market continues to be hard. In addition to the property market, we are seeing continued strong growth in our entertainment and general casualty divisions. Management liability still continues to lag. Much of this is due to a lot of competition in this space, particularly from MGAs. Submission growth continues to be strong, again, in the low 20% range and slightly higher than the first quarter.

We view submissions as a leading indicator of growth, so the submission growth is a positive signal for our market opportunity. We sell a wide array of products and the rates on those products don't move in lockstep. But if we boil it all down to 1 number, we see real rates being up around 6% in the aggregate during the second quarter, a little less than the first quarter. Some of this change from the first quarter is natural volatility and some is from changes in the mix of business. The property market is still boosting our overall number. The rate changes for property would be well higher than the average. The rate changes for casualty divisions would vary greatly, but overall, it would be less than the average. It's important to stress that rate change and rate adequacy are 2 different things.

As our results demonstrate, our rates are more than adequate. We are continually reviewing our rates and adjusting them based on a number of considerations, such as our target combined ratio and return on equity, the market opportunity and shifts in the competition. I should also note that when we're talking about rate changes, we were talking about real rate changes. So any positive number would suggest improving margins.

With our return on equity running well ahead of our targets, we don't have a need to raise our rates at all in order to feel confident about hitting our profitability guidance. We could lower our rates and grow faster, as opposed, but we are growing fast enough as it is. We have twin objectives of profit and growth. And in this environment, we're achieving both without needing to cut rate. In any event, we feel the business we are putting on the books today is the most accurately priced business we've seen in our history.

As Mike mentioned, we are seeing effects of inflation in some of our longer tail business. We're in a good spot to keep pace with that with the strong pricing and the conservative reserving, but you may well see this play out across the industry. And if that happens, it could take a long while for the industry to catch up. I think that inflation will likely serve to prolong the hard market.

The market conditions are good again. For the most part, we see competitors either retrenching or behaving in a stable and rational manner. There are exceptions to this, but those exceptions tend to be concentrated among MGAs and fronting deals. I suspect that some of the recent adverse news in that space will highlight the pitfalls of that model and dampen investor enthusiasm, but that remains to be seen. Overall, clearly, a good quarter, and we are very happy with the results. And with that, I'll hand it back over to Mike.

Michael Patrick Kehoe
President, CEO & Director
Okay. Thanks, Brian. Operator, we're now ready for any calls in the queue.

Question and Answer

Operator

[Operator Instructions]

The first question is from Jack Madden with BMO Capital Markets.

Unknown Analyst

Just the first one on the E&S marketplace and pricing. We've seen some brokers and carriers report premium growth well in excess of expectations similar to your results. I guess can you talk about the momentum you're seeing either on the pricing front and can flow into the E&S space and maybe differentiating between casualty lines and property lines.

Brian Donald Haney
Executive VP & COO

Sorry, I lost half of that. Can you repeat the last half of your question?

Unknown Analyst

Can you just talk about the momentum you're seeing either on the pricing front and/or flow into the E&S marketplace? And then are casualty lines seeing pricing momentum? Or is it mostly just property lines?

Brian Donald Haney
Executive VP & COO

I would say that the property is obviously seeing more momentum. I would say casualty depending on what line you're talking about. Some of them are seeing pretty strong rate momentum. The submission growth, I think, tends to be fairly good across most of the lines. And to the extent that it is anything it has to do with some sort of ebbs and flows in the economy. But I would say for the most part, we are seeing continued momentum across both casualty and property.

Unknown Analyst

Got it. And then A follow-up on lawsuit and social inflation. So we've been seeing carriers report lower year-over-year levels of reserve and leases from longer tail lines with general liability. I guess can you talk about the casualty loss cost trends you're seeing in your portfolio, are they entering higher at all?

Michael Patrick Kehoe
President, CEO & Director

Yes. I mean we're seeing the effect of inflation on the longer tail lines and to the extent that older claims are inflated in value, it stretches out your development patterns. That's consistent with the comments I made about the 2016, '17 and '18 years. We think we're in good shape for those years in terms of reserve adequacy. It's just that we don't see the same kind of dramatic conservatism in the more recent years.

We've been raising rates ahead of loss cost trend since 2019. So it's year upon year upon year upon year. And that's what's driving our confidence in the strength of our balance sheet, the profitability of our business, the conservative position as respects reserves. But yes, the older longer-tail casualty lines are seeing the impact of inflation whether it's social or regular, I don't know that we distinguish between the two, but loss cost trend is real, and it's accelerated by inflation.

Operator

The next question is from Mark Hughes with Truist Securities.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Bryan Petrucelli, the fee revenue, is it -- it looks like there are about 2 points of written for the few data points we've got here. Is that a good way to look at it? How should we model that?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Yes. I think -- Mark, I think the best way to do it is if you take a look at the policy fees as a percentage of your direct written. And I think it is a little less than 2%. But I think if you're modeling it out, I think model it along with your direct premium growth projections.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. And then, Mike, the property mix, I think you've talked in the past how you've had maybe 20% property, maybe half of that cat exposed. How is that shaping up now? How can either of those numbers go?

Michael Patrick Kehoe
President, CEO & Director

Yes. It's steady quarter-over-quarter, Mark. There's a lot of opportunity in the property space. We're definitely leaning into that. As we've talked about in the past, we've got fairly rigorous controls around the concentration of property in any given geographic area. We buy a lot of reinsurance. We model the portfolio continuously. So that's where we have the confidence that our expected losses in the event of a major storm relative to operating income hasn't really shifted at all.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

You think about this quarter, the lot of cats, presumably some competitors really taking a hit. You had hardly any losses. Anything you could say about your book of business, why this was not relevant for you this quarter?

Michael Patrick Kehoe
President, CEO & Director

Well, I mean some of that can be random. Some of it is where those tornadoes, thunderstorms, hail events, et cetera, took place. And it seems like it was disproportionately a personal lines event, and we're not a huge personal lines writer. Our strategy on the commercial property, we definitely skew towards writing excess policies versus primary. So that gives you a little bit of insulation from a more minor event. That's all I can think of at the moment.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. No, that's helpful. I appreciate that. The cost basis in your -- the building that you're selling, the sale price was $63 million. What's the cost basis for what you're selling?

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

So if you look at the available for sale line item in our balance sheet, Mark, it's about $57.5 million.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And is that for the entire property, aren't you -- do I hear that you're selling just part of it? Or...

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Yes, the asset for sale amount is just the property that we're selling. The real estate investment line item underneath that is what we'll have left.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Right. So modest gain, fair enough.

Bryan Paul Petrucelli
Executive VP, CFO & Treasurer

Correct.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then Brian Haney, you mentioned the recent news in the MGA space may herald some kind of turn in that sector. What are you referring to generally speaking or if there are specifics you can share?

Brian Donald Haney
Executive VP & COO

Yes, I'm not going to name names, but there was some issues with the collateral of some MGA fronting deals, which is -- I mean, if you search the financial press, you'll find some examples of it. But I will say this, that particular instance, I would say, of our most aggressive competitors, the people we run into frequently and are frequently dramatically undercutting our rates. I would say they tend to be heavily concentrated in the people associated with this recent follow-up.

Operator

The next question is from Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Mike, I appreciate the commentary you provided on your property book and noted on where you are on the [indiscernible] I was wondering if there's something to think about your geographic exposure there. I suppose if you think of sort of about classic E&S property, that tends to be more exposed to the coast, right, and a little less in the middle of the country. Is that the same for your book?

Michael Patrick Kehoe
President, CEO & Director

No. I think ours is more balanced. We certainly write a lot of Southeastern coastal commercial property, but we write tough E&S occupancy is all over the place. Industrial type businesses, recyclers, manufacturers, warehouses, et cetera. So our book is a nice balance between kind of fire-driven business versus the wind.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Got it. Okay. And then just switching to premium growth here. And I'm trying to think about in terms of product mix. So when I look at your 1Q as a base, right, because that's where there's disclosure here by line. I think if you look at the stats statements, property more than doubled, right, favorable premium growth is about 45%. Casualty was higher, but not anywhere in your property. Was that a similar sort of growth pattern for this quarter as well, right, where a property is just much, much stronger than casualty in terms of growth?

Michael Patrick Kehoe
President, CEO & Director

Yes, I think it would be directionally similar.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Okay. And then sort of a similar question, but along the lines of geographic spread here and hear anything about data that you can get from the surplus lines offices. So I think for the second quarter, Florida and Texas were up close to 60%. California, maybe 20-ish percent, right, so altogether, those 3 states may be about 50% growth. Clearly, you grew above that. Does it imply that the rest of the country, which is about 50% of the E&S market, I guess -- was that sleeve growing 50-ish percent as well?

Michael Patrick Kehoe
President, CEO & Director

I don't have the data in front of us here on a state by state. But I would say, generally speaking, yes, the broad E&S market is quite attractive today. Candidly, just as it has been in the last 4 or 5 years. It's really a -- it's a very attractive market. And as we've said, we've got some a good level of confidence going forward as well based on submission growth and some of the headlines around some of these things in the fronting market and inflation's impact on reserves, there's a lot of rationale for kind of a continued level of confidence.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

Okay. And then just last for me, I'd be curious to hear your views on the property insurance market here. Clearly, it's a pretty good environment. Do you think this sticks around until '24, I suppose, if what the reinsurers are saying come to pass, right? If they think '24 will be a hard year for them, then that would have implications for other primary companies. But I'd be curious to hear your thoughts on where you see the property market going? And if you see any knock on effects for casualty lines?

Michael Patrick Kehoe
President, CEO & Director

I'll start, and then I'll hand it to Brian. I would just say, yes, I would be pretty optimistic this year and next. Eventually capitalism is such that if people are getting attractive returns, it's going to attract new entrants and new capital into the space. And you'd see uptick in competition and probably an abatement in some of the rate increases. But I feel pretty positive for the near term.

Brian Donald Haney
Executive VP & COO

I would say we've read the same things from some of the larger primary companies and/or brokers. And I would say the stuff I've read those people saying that, and it's going to last until 2024 are in a good spot to know like they're going to have the best view of that because they're going to see a lot of the data and a lot of the accounts. So the people I've read, I would trust that their guess is probably better than most people's.

Operator

[Operator Instructions]

The next question is from Andrew Andersen with Jefferies.

Andrew E. Andersen
Jefferies LLC, Research Division

Some really strong growth year-to-date. And if we look at it on a premium to surplus basis, it looks like it might be ticking up towards 1.1x, 1.2x. Just given the mix shift and growth in property, how should we kind of be thinking about the, I guess, ideal premium to surplus ratio here?

Michael Patrick Kehoe
President, CEO & Director

I would say there's no explicit ratio in the A.M. Best, BCAR model. But directionally, we're stretching our capital close to the max, we expect to borrow some more money here shortly to inject a little bit more capital into the insurance company 1.2-ish, 1.3 somewhere in there is probably the max. It varies too by mix of business, it depends on how much reinsurance we have on a given line and that type of thing. But I think 1.2 to 1.3 makes sense.

Andrew E. Andersen
Jefferies LLC, Research Division

And you mentioned conservatism in just the back book of reserves here. Is there an equal level of conservatism in how we're thinking about the underlying loss ratios in current year picks, which looked like it improved 60 bps, 70 bps year-over-year. I don't know if there's anything one-off in this quarter's number, but how should we think about that?

Michael Patrick Kehoe
President, CEO & Director

Yes. I mean I think the reserves that we set up for future claims are a big component of those loss ratios. So I think there's some conservatism in those picks. There's also some variability quarter-to-quarter just based on the flow of claims being reported and settled, that type of thing. But in general, I think investors should be confident that Kinsale's reserves are conservatively stated, and just as they have for years, they're likely to develop favorably over time as we settle out those claims.

Andrew E. Andersen
Jefferies LLC, Research Division

And maybe one last one for me. Just on the expense ratio, a lot of year-over-year improvement in the net commission ratio. I think the other underwriting expense ratio was roughly flat, perhaps just reflecting some employee comp and benefits here, but are there still some scale opportunities on the other underwriting expense ratio?

Michael Patrick Kehoe
President, CEO & Director

Yes, definitely. As I look back, when we IPO-ed, we were about 16 -- a little bit over 16% other underwriting expenses. And year-to-date, we're between 10% and 11% and so the big driver of that progress has been constantly looking for ways to drive more automation or technology into our business process. And I think we've achieved a lot over the years. But I think it's -- we've got ways to go. We've got a lot of opportunity to improve there in the years ahead.

I think it's one reason why the decision we made 14 years ago when we founded the company to make technology a core competency of our business alongside of underwriting and claim handling was the right decision. It's a decision that continues to yield benefits, especially around efficiency in our business, but not just there. It also positively impacts customer service, the amount of data we're able to collect, et cetera.

Operator

The next question is from Pablo Singzon with JPMorgan.

Pablo Augusto Serrano Singzon
JPMorgan Chase & Co, Research Division

So just one for me. Another specialty carrier that writes construction liability mentioned in its earnings call that it sees the market that is highly competitive and that contractors have begun to slight -- up to project slightly lower revenues. I was curious if you're seeing any revenue in your own book of business.

Brian Donald Haney
Executive VP & COO

Yes. I would say we are seeing that is probably, I would say, on the construction side, it's one of the areas where you're starting to see some effect from the economy, the higher interest rates and the flow-through into the construction business itself.

Operator

We have no further questions at this time. We'll turn it back to the presenters for any closing remarks.

Michael Patrick Kehoe
President, CEO & Director

Okay. Well, thank you, everybody, for joining us, and we look forward to speaking with you again in a few months. And with that, we'll go ahead and adjourn today.

Operator
This concludes today's conference call. You may now disconnect. Thank you.