S&P Global
Market Intelligence

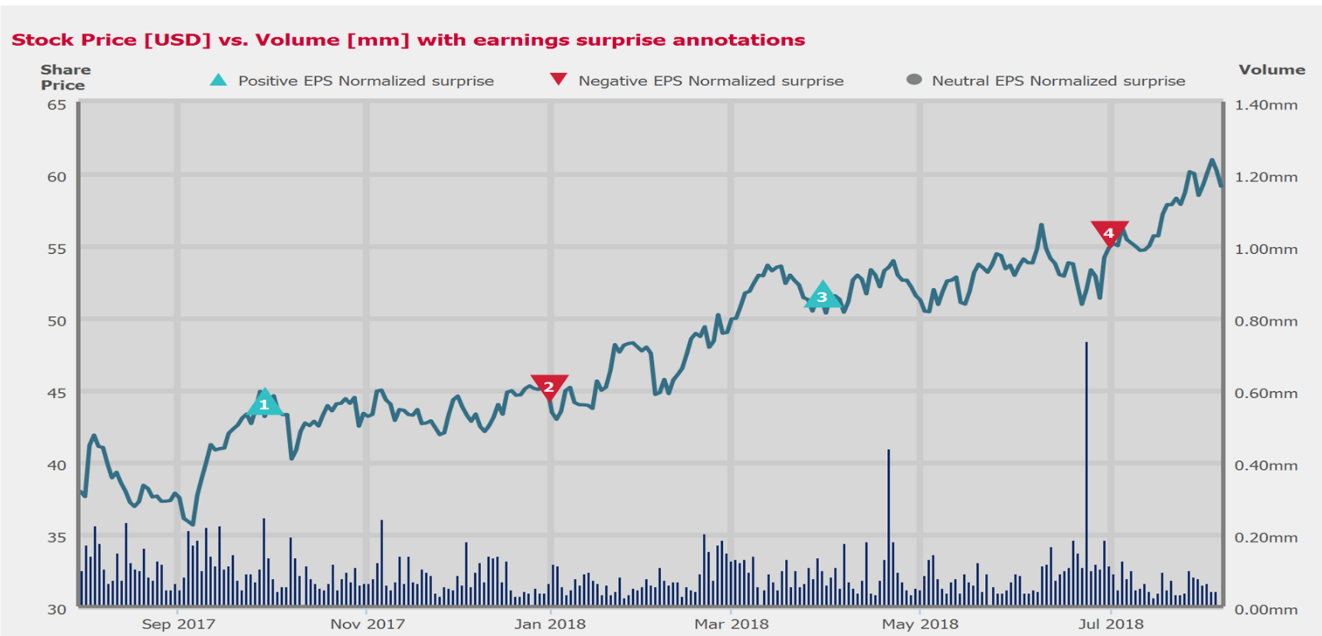
Kinsale Capital Group, Inc.
NasdaqGS:KNSL
FQ3 2018 Earnings Call Transcripts

Friday, November 02, 2018 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2018-			-FQ4 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.49	0.49	0.00	0.53	1.89	2.24
Revenue (mm)	57.78	60.14	4.08	59.94	222.77	260.50

Currency: USD
Consensus as of Nov-02-2018 12:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2017	0.36	0.44	18.92 %
FQ4 2017	0.39	0.36	(7.69 %)
FQ1 2018	0.37	0.38	2.70 %
FQ2 2018	0.49	0.46	(6.12 %)

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Call Participants

EXECUTIVES

Brian Donald Haney
Senior VP & COO

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Michael Patrick Kehoe
President & CEO

ANALYSTS

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

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

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

Presentation

Operator

[Audio Gap]

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 2017 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 third 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 also 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

Thank you, operator, and good morning, everyone.

With me today are Bryan Petrucelli, Kinsale's Chief Financial Officer; and Brian Haney, Chief Operating Officer. After some introductory comments, I'll pass the call to Bryan Petrucelli, who will review Kinsale's financial highlights for the quarter; and then over to Brian Haney, who will provide some commentary on our quarter and discuss our market outlook.

We usually like to begin these calls with a quick recap of the Kinsale strategy, which combines disciplined underwriting and claim handling with technology-enabled low costs to deliver attractive returns and growth to our stockholders even in competitive markets like we have today. At Kinsale, we focus on smaller accounts within the E&S market, the excess and surplus lines market. We target hard-to-place accounts. We carefully manage the coverage we provide, in part, to minimize inaccuracies in the underwriting process. And unlike competitors, we maintain absolute control over the underwriting and the claim management process, and we do not outsource those functions to external parties. All of these strategies drive Kinsale's attractive loss ratios. In addition, because of our proprietary technology and automation, combined with a healthy owner/operator business culture, Kinsale operates with an enormous expense advantage over many larger competitors. The combination of disciplined underwriting and claim handling combined with low costs is an endgame winner every time.

A couple comments on the recent storm activity. As you recall, Kinsale writes catastrophe-exposed property. We think the margins in that business are compelling, but we do so with a measure of conservatism in order to limit the volatility of the line. And specifically, I'm talking about a disciplined underwriting approach, strict limits on the concentration of business in any one geographic area. We regularly model the book of business, and of course, we buy a fairly robust reinsurance program. As a consequence of this approach, Kinsale's recent catastrophe experience has been consistent with both our risk appetite and our expectations. Our current estimates for the Florence losses are about $300,000, and Hurricane Michael current loss estimates are about $4 million pretax.

And with that, I'm going to pass the call over to Bryan Petrucelli.

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

Thanks, Mike.

The results for the third quarter were in line with our expectations. We believe the 84.6% combined ratio for the quarter is a market leader and continue to demonstrate the strength of our low-cost model, particularly in periods of intense price competition.

We reported net income of $11.9 million for the third quarter of 2018, a 184% increase over the $4.2 million reported in the third quarter of 2017. Net operating earnings increased by 153% to $10.6 million compared to $4.2 million last year. Increases in net income and operating earnings were largely driven by the cat losses in 2017, an increase in net investment income and a reduction in the company's effective income tax rate.

Our effective income tax rate was 17.1% for the first 9 months of 2018 compared to 30.5% last year and lower primarily due to the impact of the tax reform act.

The company generated underwriting income of $8.4 million and a combined ratio of 84.6% compared to $2.5 million and 94.5% last year. The combined ratio for the third quarter of 2018 included 4 points from net favorable prior year loss reserve development compared to 6.4 points last year. There was no meaningful cat activity for the quarter. However, cat losses contributed 17.9 points to the combined ratio in the third quarter of 2017.

Annualized operating return on equity increased to 15.4% for the first 9 months of 2018 and in line with our mid-teens guidance compared to 11.4% last year.

Gross written premiums were $69.5 million, representing a 25% increase over the third quarter of 2017, and continued to be generated from an overall increase in underwriting activity across most lines of business. And Brian Haney will get into a little more detail on that here in a bit. On the investment side, net investment income increased by 47.7% over the third quarter of last year to $4.1 million from $2.8 million as a result of the continued growth in the investment portfolio and rising interest rates. Annualized gross investment returns increased to 2.9% from 2.4% last year.

Basic and diluted EPS were $0.55 and $0.49 per share, respectively, for the quarter compared to $0.20 per share for both 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 25% in the third quarter, which is higher than the rate for the first 2 quarters of the year. All but 1 of our 17 divisions grew. The allied health care, commercial property and management liability divisions all grew robustly. Our Aspera business was up 39% for the quarter.

Overall, submissions continue to increase at a strong pace. Submissions in the third quarter were up 24% over the third quarter of 2017. We look at this as a good leading indicator for where the business is going. And the vast majority of our 17 divisions had positive growth in submissions.

Given that growth has been easier to come by, we have looked to push rates up where appropriate. We have a very heterogenous mix of business, so it's difficult to boil all the various rate movements down to a single number, but if we had to do that, we'd say the number was somewhere in the 2% to 4% range.

The market continues to be in a transitional state. Some areas like allied health and commercial auto are definitely experiencing some firming, other areas not so much. As we've noted in the past few years, there's some stress in the program space, which tends [to narrow] to our benefit. While we ourselves aren't in the program space and we don't give out underwriting authority to third parties, we do tend to see more opportunities when competitors' programs are experiencing poor results and having to shed business or shut down. I suspect the industry will continue to see more poor results coming out of some programs in the next few years. We continue to feel good about the state of the market and about our competitive position. Submission growth is good and accelerating. We are taking rate where appropriate, and we expect to continue to do that and perhaps press even more in that regard. Results are good. We continue to make incremental improvements in our internal processes to get out more quotes and get them out faster, which should allow us to capitalize better on the opportunities that come our way.

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

Michael Patrick Kehoe
President & CEO

Thanks, Brian.
Operator, we're now ready for any questions in the queue.

Question and Answer

Operator

[Operator Instructions] And our first question comes from the line of Mark Hughes from SunTrust.

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

The 24% growth in submissions, I wonder if you could -- any way to break that out in terms of kind of the bucket that's coming from, new relationships with wholesalers, just deeper penetration? You made a...

Brian Donald Haney
Senior VP & COO

I would say it's very widespread. So it's tough to break it out into one class or segment. Some of it is certainly coming from new producers, but most of it is just coming from just getting more traction with the producers and products we already have.

Michael Patrick Kehoe
President & CEO

I was just going to say the E&S market, I think, is growing at a pretty good clip now as well. So that's probably part of it as well.

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

The expense ratio in the quarter was still quite good but at the higher end of the recent range. Is anything unusual this quarter? Would -- I think you've been in the 24% area, low 24s. How would you see that going forward? Is this a good level? Or should it go back to the lower end of the range?

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

I would say, Mark, there's always some natural variability from quarter to quarter in expansions. I think that 25% to 25.5% or 26% loss ratio is probably in line with our expectations. I think what you're seeing in some of those quarters that were a little lower, particularly the third quarter of 2017, if you remember, we did have some cat activity. And those losses would have sort of a negative impact on the variable comp that we booked for the quarter. So I think that's what you're seeing there.

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

And then the pretax impact from Michael, as opposed to Florence, $4 million on Michael, could you talk about the -- what the exposures you had there that made that more meaningful?

Michael Patrick Kehoe
President & CEO

It's all personal insurance business. Our personal insurance targets manufactured homes in the -- from -- it's basically the southeastern coastal communities. So it was exclusively a personal insurance event for us, but again, the size of the loss was consistent with our business plan and our risk appetite.

Operator

And our next question comes from the line of Jeff Schmitt from William Blair.

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

Aspera, obviously, growing at a higher rate here and has been growing at sort of pretty high rate for some time. How big is that book now? And is there -- how many states are you in there now?

Michael Patrick Kehoe
President & CEO

The book is growing at a good clip, in part, because we're expanding geographically. A couple years ago, I think we're in 2 states, Florida and South Carolina. Now we have business from Texas up to the Mid-Atlantic. And we expect the geographic footprint to continue to grow. I don't have it off the top of my head, the number of states, but you can -- about a dozen or so. We'll probably write, I think, somewhere in the low to mid teens this year in terms of premium volume.

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

Okay. And then just looking at the underlying loss ratio up close to 400 basis points, similar to last quarter, can you maybe discuss what's driving that? How much is business mix shift versus -- are you seeing any changes in the underlying trends?

Michael Patrick Kehoe
President & CEO

Yes. I think you're referring to our current accident year loss ratio. When you exclude the changes from prior periods, it's slightly higher. I think, in general, we feel very good about the profitability of the business, so there's no pernicious trends that we're concerned about. Of course, there is steady loss cost inflation that we always take into account in our pricing, but I would say, in general, we try to be very conservative in how we reserve. The goal is to set the reserves high enough that we're -- that they're very likely to develop favorably over the years ahead. And so in general, I would attribute it to we're executing that strategy, always looking to put up conservative numbers, but in general, I think we feel very good about the book.

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

Okay. And just one quick one on the tax rate, 15% for the quarter, 17% year-to-date. I think you had guided to more like 19%. Is there a change in guidance at all there or...

Bryan Paul Petrucelli
Senior VP, Treasurer & CFO

I wouldn't say a change in guidance. I think one thing that's difficult to predict in -- whenever there is any stock options that are exercised, you do get a tax benefit. And that's going to vary from quarter to quarter. I think the 19% is a good guide. If there is heightened level of stock option exercises, obviously, it's going to be a little lower.

Operator

And our next question comes from the line of Mark Dwelle from RBC Capital Markets.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

A couple of mine have already been covered but just a quick numbers kind of question. On the net-to-gross premium retention, a little bit lower this quarter than some. Is that just timing or mix? Or is there some more fundamental change?

Michael Patrick Kehoe
President & CEO

Mark, it's Mike Kehoe. That's a purely mix of business. We cede off a high percentage of the premium on our excess casualty business, where we've put up larger limits. We cede off kind of a medium level, if you look at our -- some of our property lines where we have a risk cover and a cat cover. And then on our primary casualty, we keep that business net. So as the mix shifts a little bit, you're going to see a little bit of movement quarter-to-quarter, but there's no change in strategy.

Mark Alan Dwelle
RBC Capital Markets, LLC, Research Division

Okay. That makes sense. And you commented a couple times in the course of various remarks just about the E&S market growing. Is it -- would you view that growth as a migration of risk from the standard markets to the E&S? Or is this just primarily a function of kind of a strong economy and lots of new business in construction and whatnot?

Michael Patrick Kehoe
President & CEO

I think it's both, right? So in a period of strong economic growth, a lot of business formations, new businesses typically start in the nonstandard market. And then they can migrate away down the road, but I think there's a long-term trend where the nonstandard or the excess and surplus lines market is taking market share, if you will, from the standard market. Thinking of the A.M. Best report that came out about a month ago where they looked back, I think, over a 20-year period and the E&S market went from about 7% from the commercial P&C market 20 years ago to about 14% or 14.5% today. So it's a long, steady growth at one -- of one market at the expense of the other, although not every year. It does ebb and flow.

Operator

And our next question comes from the line of Mark Hughes from SunTrust.

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

You talked about hardening pricing perhaps in allied health and commercial auto. Just curious for an update on how close the pricing might be in the commercial auto category. When could it possibly get a little more interesting for you?

Brian Donald Haney
Senior VP & COO

Tough question to answer. I mean it's definitely getting there and that we are definitely looking at new products all the time. And some of those products are related to commercial auto, but we're not there yet.

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

How -- roughly speaking, how far away are you, 50%, 20%?

Brian Donald Haney
Senior VP & COO

That's tough to answer. I would say it's probably not 50%.

Michael Patrick Kehoe
President & CEO

Yes. I mean commercial auto rates have moved up dramatically over the last couple of years in reaction to just an abysmal amount of losses for the industry. Typically, when a market's in shambles, hey, there's opportunity. I think we're a lot closer than we were 3 years ago, but again, I mean, we don't have a specific number to throw out today. It is something we monitor all the time.

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

And then could you mention again? You said 1 -- or 16 out of 17 divisions grew, and I think you very quickly touched on a few of those. Where were you seeing more growth in your different areas?

Brian Donald Haney
Senior VP & COO

So allied health is growing pretty well. Commercial property, management liability is growing pretty well. I mean it is pretty widespread. We got a lot of divisions that are up pretty significantly. Our excess casualty book is growing pretty well. Obviously, Aspera is growing pretty well.

Operator

And I'm showing no further questions at this time. I'd like to turn the call back to the speakers for closing remarks.

Michael Patrick Kehoe
President & CEO

Okay. Well, I just want to thank everybody for joining us on the call today. And we look forward to talking to you again down the road in a few months.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a great day.