Root (ROOT) / 30 Oct 24 / 2024 Q3 Earnings call transcript

Company Profile

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Matthew LaMalva	executive
Alexander Timm	executive
Megan Binkley	executive
Thomas Mcjoynt-Griffith	analyst
Yaron Kinar	analyst

Operator

Ladies and gentlemen, greetings, and welcome to the Root Inc. 3Q '24 Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Matt LaMalva. Please go ahead.

Matthew LaMalva

Thank you for joining us today. Root is hosting this call to discuss its third quarter 2024 earnings results. Participating on today's call are Alex Timm, Co-Founder and Chief Executive Officer; and Megan Binkley, Chief Financial Officer.

Earlier today, Root issued a shareholder letter announcing its financial results.

While this call will reflect items discussed within that document, for more complete information about our financial performance, we also encourage you to read our third quarter 2024 Form 10-Q, which was filed with the Securities and Exchange Commission earlier today.

Before we begin, I want to remind you that matters discussed on today's call will include forward-looking statements related to our operating performance, financial goals and business outlook, which are based on management's current beliefs and assumptions. Please note that these forward-looking statements reflect our opinions as of the date of this call, and we undertake no obligation to revise this information as a result of new developments that may occur.

Forward-looking statements are subject to various risks, uncertainties and other factors that could cause our actual results to differ materially from those expected and described today.

In addition, we are subject to a number of risks that may significantly impact our business and financial results.

For a more detailed description of our risk factors, please review our most recent 10-K, 10-Q and shareholder letter. A replay of this conference call will be available on our website under the Investor Relations section. I would also like to remind you that during the call, we will discuss some non-GAAP measures while talking about Root's performance.

You can find reconciliations of those historical measures to the nearest comparable GAAP measures in our financial disclosures, all of which are posted on our website at ir.joinroot.com.

I will now turn the call over to Alex Timm, Root's Co-Founder and CEO.

Alexander Timm

Thanks, Matt.

Our third quarter performance was a landmark quarter for Root.

We have consistently said that our top priority has been to reach profitability. And in the third quarter, we delivered it. This is a pivotal moment for Root and a firm validation of our business model, technology and delightful customer experience.

Our success is a direct result of the steadfast hard work of our entire team, and I could not be prouder.

To build upon this success and to support future growth, we amended our term loan with our long-standing partner, BlackRock, and significantly improved our cost of capital moving forward. Megan will provide more details shortly. With profitability now achieved, we have the opportunity to reinvest our profits into the business in the quarters ahead, particularly investing in our growth engines in both the direct and partnerships channel. With indirect, during the quarter, we continued to expand and test into new areas of the marketing funnel, and we expect that to continue in the quarters ahead. And this includes investing more in R&D marketing, which typically takes more time to produce results.

With these investments, we expect to accelerate our policies in force growth over the long term.

As a reminder, we came out of a hypergrowth period in the first quarter of this year, which weighted our book toward newer policyholders. This dynamic typically results in lower retention in the near term following rapid growth.

We are now 2 quarters past the hypergrowth period. And as a result, we expect to see more contributions from renewals and therefore, a gradual return to policies in force growth.

Looking ahead, we believe there are material opportunities to expand our competitive advantage to additional data-rich channels.

As always, we will explore these channels in a disciplined, rigorous manner and quickly grow or jettison these experiments based on results.

We also made fantastic progress in our partnerships channel in the quarter, where we meet customers at contextually relevant times.

New writings in the channel more than doubled from the prior year, and we launched several exciting new partnerships. Notably, we launched a partnership with Goosehead Insurance, where our technology has enabled agents to quote faster and more efficiently, thereby providing their clients with a great experience at a great price. The partnership channel is a key to our continued long-term success given the differentiated access to customers it provides.

Our pipeline of partnership opportunities remains robust, and we believe we are well poised to drive strong growth in this channel in 2025 and beyond.

Our laser-focused mindset on disciplined underwriting, driven by our proprietary technology platform and data science algorithms led to what we believe is an industry best 57% gross loss ratio. Thanks to our consistently strong underwriting, we have the opportunity to reduce rates in select states while not compromising our target returns.

While we certainly believe lower rates for the best drivers can further improve growth, we do not set prices with a primary goal to gain market share.

Our goal is to set prices accurately and our data science acumen and high telematics adoption rates allow us to effectively price and realize our target returns.

As our data sets grow and we continue to retrain our models, we build an even stronger moat around our business.

As we look to 2025, we are excited by the growth opportunities in front of us.

We expect to add new partners, drive additional profitable growth, expand our geographic footprint and deliver even better products at better prices to customers.

Our team's determination to become the largest and most profitable personal lines insurance carrier in the United States is stronger than ever and achieving net income profitability is an important milestone on that journey, yet our momentum does not stop here. We maintain a culture of discipline and innovation, which we believe translates to long-term value for all of our stakeholders.

I'll now turn the call over to Megan to discuss our operating results in more detail.

Megan Binkley

Thanks, Alex, and good evening, everyone. We could not be happier with our operating results.

For the third quarter and on a year-to-date basis, we achieved net income profitability. This is a testament to our data advantages, disciplined underwriting and unwavering focus on expense management.

For the third quarter, we delivered net income of $23 million, a $69 million improvement year-over-year. Along with this milestone achievement, we generated operating income of $34 million and adjusted EBITDA of $42 million, year-over-year improvements of $68 million and $61 million, respectively.

Our outstanding results continue to be driven primarily by growth in our net earned premium, loss ratio performance, closely managed expense base and the responsible deployment of marketing investment.

As we've consistently noted, we do not defer the majority of customer acquisition costs over the life of our customer, which leads to accelerated expense recognition relative to earned premium. We saw significant increases in new writings, policies in force, gross written premium and gross earned premium compared to the third quarter of 2023. We achieved this growth while delivering a gross combined ratio of 89%, a nearly 30-point improvement year-over-year. The gross accident period loss ratio was 58%, a 4-point improvement year-over-year, driven by our continued investment in data science and technology.

In the third quarter of 2024, we ceded approximately 12% of our gross earned premium. We reduced the difference between our gross and net loss and LAE ratios to just 1 point, reflecting a reduction of 10 points year-over-year.

Our improvements in reinsurance costs were made possible through our continued improvement in underwriting results. Operating cash flow was nearly $50 million in the quarter, primarily driven by net income, continued growth and strong loss ratio performance.

In the fourth quarter, we successfully refinanced our term loan with BlackRock. We reduced the size of the facility from $300 million to $200 million, while maintaining $150 million of available growth capital. We improved our cost of capital from the original facility by at least 300 basis points. And as a result, we expect to see an approximate 50% run rate reduction in our interest expense moving forward. This will enhance our operating performance and enable further investment in our growth.

Overall, we are thrilled at reaching net income profitability in the quarter.

Our progress is far from over. We remain focused on prioritizing long-term profitable growth, expanding our geographic footprint and distribution channels and investing in opportunities for the business that present high return potential. These investments will modestly increase operating expenses from our third quarter print.

However, we believe it's the right decision to drive long-term success and shareholder value.

We are excited for our future, and we appreciate your continued support. With that, Alex and I look forward to your questions.

Operator

[Operator Instructions] The first question is from Tommy McJoynt with KBW.

Thomas Mcjoynt-Griffith

It sounded like you are expecting your appetite for growth spend to increase, I think, you said modestly going forward. Could you talk about sort of where you're looking to spend that? Is that consistent with geographic expansion? And then any way you could help us think about the magnitude of where that sales and marketing spend could go from 3Q levels?

Alexander Timm

Yes. Thanks, Tommy.

We continue -- when we look at our current marketing footprint and our partnerships, there's still a lot of opportunity for us to continue to reinvest the profit that we've generated into growth in the business. Obviously, we're very proud of the milestone we hit of becoming profitable, but it is a milestone. It is not the finish line. And we think that we can still build a much larger, more meaningful company, and we're going to continue to do that.

And so what we're planning to do is to continue to expand our growth investments. That's going to be in our partnerships channel, and you will see some of that come through in acquisition expense.

So bringing on new partnerships in the automotive and financial services and independent agency spaces. And then as well as mid- to upper funnel marketing channels.

We are still in a minority of marketing channels that most in the industry use.

And so we think that there's a lot of opportunity there.

In terms of geography, we're actively working in state expansion. We're only in 75% of the population, and there's no reason we shouldn't be in 100%.

So I think that when we expand geographies, you're also going to see us deploy more growth capital into those new geographies to drive profitable growth over the long term. Megan can comment a bit more on the magnitude and what we're expecting near term.

Megan Binkley

Yes. Thanks, Alex. And just to reiterate what Alex said, I mean, we're just getting started. We're really proud of the results this quarter, and we are looking to continue reinvesting in key areas of the business. We believe that this quarter is really proof that our model is working.

So we're going to continue our disciplined and opportunistic approach to performance marketing, and we're going to continue investing in the partnership channels.

As it relates to sales and marketing expectations, what I'll say is our focus remains on driving new business at our target return levels.

So we expect to invest as we continue to identify and source profitable growth opportunities. And what we spend in sales and marketing in a given quarter is heavily dependent on the competitive environment, and we expect that our direct marketing machine will react as it always does to ensure that we're continuing to hit our target unit economics.

So we're going to continue monitoring the efficiency of the spend. Overall, I would say we're not really in a position where we're going to give a specific target on marketing investment for Q4 or really into 2025, but we're going to continue the same approach that we've had in the past on driving profitable new business.

Thomas Mcjoynt-Griffith

And you may have touched on it a little bit there, but can you give us an update on how you guys are seeing the retention rates of your book of business go, especially the, perhaps policies that you put on over the last 12 months? And then when you think about the potential to reduce rates in certain markets, do you anticipate that will help your retention rates further?

Alexander Timm

Yes. Thanks for that question, Tommy. Yes, I think the first thing to notice and to note is, and as I said in my prepared remarks, we have doubled -- we've nearly doubled the size of the business on a year-over-year basis. And when we've done that in that real hypergrowth period, what that's resulted in is a lot of brand-new PIF.

And so we had a very young PIF and that young PIF tends to churn a little faster than older PIF. And what we've seen as our PIF has continued to age is we've seen churn come down. And we've seen that continue to abate through this quarter. We don't think we're at normalized levels yet.

So we think that's going to continue. And part of that has created a nice tailwind in the business where it's allowed us to grow PIF a little bit more gradually in this quarter-to-date.

So we are seeing those favorable trends on PIF churn.

In terms of rate reductions, we absolutely expect that will help retention. The lower your rates are, and with those rate reductions, you will see better retention rates. And we should also experience higher conversion rates.

And so we think both of -- those 2 things will be good news for the business.

Thomas Mcjoynt-Griffith

And actually, just one quick one on the retention side that I forgot to ask, one element of that. The partnership channel versus the direct-to-consumer, the retention rates of those businesses, do they differ materially?

Alexander Timm

Yes. The partnerships channel has much higher retaining business.

And so we see that really across most of our partnerships.

So you do see, particularly when you're building sort of that differentiated access to customers where a lot of your customers are buying for the customer experience and the ease of the technology is providing, that allows -- or what that does is it creates a much stickier customer.

And so we have seen that. We've also seen that those policies are just fatter policies, higher average premium, more vehicles per policy.

And so that's also really been helpful as well.

Operator

[Operator Instructions] The next question is from the line of Yaron Kinar with Jefferies.

Yaron Kinar

Maybe to follow up on some of the churn and retention questions. If we were to look at cohorts, are you seeing churn improving, namely if we have a first year cohort from the most recent year, is the churn there better than the first year cohort a year ago and 2 years ago and the like? And the same, I guess, will be true for other cohorts. I just use first year as an example.

Alexander Timm

Yes, that's a good question, Yaron. Yes, we have seen the -- when we look at churn and you've got to control for what channel it's coming from because, again, if you look at it on a blended basis, you do see those partnership new writings in those cohorts. Because they're retaining longer that those new cohorts are going to have higher retention, all else equal because of that. I'd say definitely, as the -- over the last couple of years, as we've seen the rate environment stabilize, you've definitely seen improved retention rates.

So I think that it's modest, but we are seeing improvement in cohort-based retention.

Yaron Kinar

Got it. And would you expect that to accelerate or just remain kind of a modest improvement cohort by cohort?

Alexander Timm

I think there's a couple of things that might -- that will accelerate it. One is certainly the continued expansion of the partnership channel as a percent of our new writings. That distribution channel has grown 130% for us year-over-year, which is tremendous, and we don't see that slowing down.

So I think that's definitely going to continue to improve that.

The second is as we continue to expand our more preferred customers into some other marketing channels that aren't necessarily just lower funnel marketing channels, you tend to see a more preferred mix of business and a bit more stickier business when you do that.

And so we do anticipate there to be some improvements. We're also making some changes to the product that we think makes it easier for customers to stay with Root for the long term.

And so we certainly have a lot of actions that we want to take to continue to improve retention.

Yaron Kinar

Okay. And then just a question on pricing. I appreciate you saying that you're looking to maybe lower rates a little bit here just given where the loss ratio is.

I think if we look at recent data, we haven't seen much of that yet, maybe a little bit in the last few weeks. I guess with the loss ratio running well below target for the last 4 quarters, why is this something that is only now coming about? And how -- well, I'm not sure you'd be willing to talk about this, but how aggressive would you be willing to be given where the loss ratio is?

Alexander Timm

What we're always doing is we're always looking at each market, and we're making sure that we are, to the best of our ability, hitting our target loss ratios. That we're not too high on those targets and that we're not too low. And we set those target loss ratios really where we think is the most efficient place to be operating the business. There have been a handful of states that we have reduced rates in, but we're not going to necessarily reduce rates just to gain market share. We don't really operate that way. We're always looking to hit our targets. And when we observe credible enough data to tell us that we should be lowering rates, we'll do that.

I think the other important thing to notice is we're not just lowering rates, and it's not just base rates, we're also improving segmentation. And as we improve segmentation through our new loss models and our new telematics models that we're constantly iterating on and innovating on what we believe to be one of the fastest pace in the industry, that then also allows you to see real benefit in the loss ratio. And as that comes through, you should anticipate us to then respond as well with base rate decreases. But we're actively looking at that, and we're constantly -- we think we're very fast to react.

Operator

[Operator Instructions] Ladies and gentlemen, as there are no further questions, this concludes today's teleconference.

You may disconnect your lines at this time. Thank you for your participation.