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Donegal Group, Inc. (DGICA)

Q4 2021 Earnings Call

CORPORATE PARTICIPANTS

Karin Daly
Vice President, The Equity Group Inc.

Kevin G. Burke
Chairman, President & Chief Executive Officer, Donegal Group, Inc.

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

OTHER PARTICIPANTS

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to the Donegal Group Inc. Fourth Quarter 2021 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operating Instructions] Please be advised that today's call is being recorded.

I would now like to hand the conference over to Karin Daly, Vice President at The Equity Group. Please go ahead.

Karin Daly
Vice President, The Equity Group Inc.

Good morning, and thank you for joining us today. Yesterday afternoon, Donegal Group issued its fourth quarter 2021 earnings release, outlining its quarterly and full year results. The release and a supplemental investor presentation are available in the Investor Relations section of Donegal's website at donegalgroup.com.

Speaking today will be President and Chief Executive Officer, Kevin Burke; and Chief Financial Officer, Jeffrey Miller.

Please be aware that statements made during this call that are not historical facts are forward-looking statements and necessarily involve risks and uncertainties that could cause actual results to vary materially. These factors can be found in Donegal Group's filings with the Securities and Exchange Commission, including its annual report on Form 10-K and quarterly reports on Form 10-Q. The company disclaims any obligation to update or publicly announce the results of any revisions that they may make to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

With that, I turn it over to Kevin Burke. Kevin?

Kevin G. Burke

Chairman, President & Chief Executive Officer, Donegal Group, Inc.

Thanks, Karin. And welcome everyone. I will focus my remarks on our strong top line growth and discuss the progress we've made on several strategic initiatives. Jeff will then provide details on our financial results for the fourth quarter and full year, and I'll return for closing remarks before we open the lines for questions.

Net premiums written increased 7.3% for the fourth quarter and 8.4% for the full year 2021, compared to prior year periods. We are pleased with the strong growth in our commercial lines, which was driven by strong retention and solid rate increases across most of our lines.

Commercial lines net premiums written increased 14.6% for the fourth quarter of 2021, compared to the prior year quarter. Similar to the first three quarters of 2021, the growth reflected premiums from our Mountain States region. As a reminder, Mountain States premiums were excluded from our results in 2020 and prior. The Donegal Mutual began placing policies into our underwriting pool effective in the calendar year of 2021. As a result, all of our commercial lines of business achieved growth for the full year led by Commercial Multiple Peril with a growth of 27%.

We continue to view commercial market conditions as favorable for growth across our regions, and we have targeted several well-performing regions for our new business growth. However, given the recent inflationary trends we've seen across multiple industries, we are focused on pricing increases and retention of premium, while continuing to grow profitably.

Personal lines net premiums written declined 2.8% and 4.3% for the fourth quarter and full year of 2021, primarily as a result of strategic underwriting measures we took over the past several years to improve the profitability of our personal lines business as we awaited the development of new products. We are pleased to announce the successful launch of new personal auto, homeowners and personal umbrella liability products in three initial states in the fourth quarter of 2021.

The new products include coverage enhancements, modernized rating methodology, enhanced pricing segmentation, application of new predictive analytical models and expanded utilization of third-party data. As a result of the new product rollout, we implemented a new personal lines agency portal, as well as the rating and underwriting policy issuance capabilities that will ultimately support our personal lines business in 10 states on our new technology platform.

Currently, the portal and systems are fully live in the states of Indiana, Ohio and Pennsylvania, and the initial agency feedback in these states has been very positive. Technical and business teams will continue to support the phased rollout of our new personal lines products in seven additional states throughout 2022. We are excited to effectively compete for new quality personal lines accounts and expect to generate modest levels of premium growth that will contribute to sustained profitability and stability in our personal line segment over the next few years. Jeff will provide more details in a moment.

But in summary, our underwriting results for the fourth quarter of 2021 were hindered by several headwinds that prevented us from achieving our profit target. While weather-related losses were in line with our five year average, we saw an increase in large fire losses and experienced higher commercial auto severity compared to the prior year quarter. Commercial multi-peril results reflect the large fire activity, as well as the impact of inflation of the cost to repair properties.

While we are pleased with the overall profitability of our personal lines segment in 2021, those results benefited greatly from favorable development of prior reserves that masked the underlying inflationary increases in core loss trends.

As we enter 2022, we continue to experience higher personal auto claims frequency and severity as driving activity has largely returned to pre-pandemic levels, and the impact of supply chain and labor market disruption is contributing to substantial increases in auto repair and replacement costs. We are quickly responding by increasing personal auto rates across our regional footprint, and it will take some time before our 2022 rate increases will begin to offset loss cost trends we are experiencing.

At this point, I'll turn the call over to Jeff for a review of our financial results. And then I'll return with a few closing comments.

Jeffrey D. Miller

Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

Thank you, Kevin. As Kevin mentioned, our fourth quarter underwriting results were impacted by several headwinds that I will describe in greater detail. The combined ratio was 101.6% for the fourth quarter, compared to 96.2% in the prior year quarter. For the full year of 2021, the combined ratio was 101% versus 96% in 2020.

While 2021 underwriting results reflected weather-related losses that were below our historical average and continued debt favorable development of reserves for losses incurred in prior accident years, our fourth quarter and full year 2021 results reflected the combined impacts of an increase in large fire losses and a return to pre-pandemic driving activity and inflationary pressures on loss costs. These impacts increased the non-weather loss ratio by 7.5 percentage points over the prior year quarter to 65.4%.

Commercial and personal auto losses increased substantially due to more active driving patterns and higher average claim severity. Additionally, large fire losses, which we define as losses in excess of $50,000 were $10.9 million or 5.5 points on the loss ratio for the fourth quarter of 2021. That is more than double the impact in the prior year quarter, with higher activity in both commercial and home property fires. We continue to closely review the details of all large fire losses, but have not identified any commonality among the causes.

Donegal Group is also not immune to the ongoing inflationary pressures that continue to make headlines, and we are seeing significantly higher costs related to property and automotive repairs and replacements. We're implementing premium rate increases across most lines of business to offset the loss trends and improve the performance of our book of business.

Fourth quarter of 2021 weather-related losses were in line with historical averages for the fourth quarter at $8.7 million or 4.3 percentage points of the loss ratio. Net favorable development of reserves for losses incurred in prior accident years was $5.3 million, reducing our fourth quarter of 2021 loss ratio by 2.7 percentage points, compared to $2.6 million, which reduced the loss ratio by 1.4 percentage points for the prior year quarter.

We had favorable development in the reserves for personal, auto, commercial auto and commercial umbrella liability losses during the quarter. We expect continued favorable development as we progress into 2022, albeit to a lesser extent than 2021 when the significant favorable development reflected pandemic-related disruption to historical claim emergence patterns that contributed to lower than anticipated incurred loss development.

On a statutory basis, the commercial, auto and commercial multi-peril combined ratios were 120.6% and 115.4% respectively for the fourth quarter of 2021. The deterioration in profitability from the prior year quarter for these lines was attributable primarily to higher claims severity, including the large fire loss activity and inflationary increases I mentioned earlier. Workers compensation and other commercial, which represents primarily commercial umbrella liability, remain profitable with combined ratios of 82.5% and 94.5%, respectively.

In personal lines, the auto loss ratio deteriorated 9.1 percentage points compared to the prior year quarter as a result of higher claims frequency due to increased driving activity and higher claims severity due to macroeconomic inflation trends that accelerated during the fourth quarter 2021. Our expense ratio for the fourth quarter decreased to 31.4%, compared to 32.4% in the prior year quarter. The decrease reflects lower commercial growth incentive payments to our agents, lower underwriting based incentive costs for our agents and employees, and a release of COVID-related bad debt reserves that we determined were no longer required. Our ongoing systems modernization project resulted in an increased allocation of costs that partially offset the other expense reductions. For the full year, our expense ratio was relatively in line with 2020 due to similar offsetting factors.

Within our investment operations, net investment income increased 8.6% to $8.2 million for the fourth quarter of 2021 compared to the prior year. We generated higher investment income due to growth in average invested assets with 94% of our consolidated investment portfolio held in fixed maturity securities as of December 31, 2021.

Total investments increased $55.6 million during 2021 to $1.3 billion. The average investment yield was 2.6%, and the average fixed maturity duration was 4.7 years. The portfolio yield remained relatively consistent throughout 2021, and we expect it will generally hold steady in 2022 as recent reinvestment rates are now closer to those of maturing investments than they were a year ago. Net after tax investment gains were $1.1 million for the fourth quarter, contributing to net income of $5.3 million. On a diluted Class A per share basis, net income was $0.17 per share compared to 49% – $0.49 per share in the prior year quarter.

With that, let me turn it back to Kevin for closing comments. Kevin?

Kevin G. Burke

Chairman, President & Chief Executive Officer, Donegal Group, Inc.

Thanks, Jeff. In 2021, we made significant progress on our ongoing systems modernization progress – project. In August, we successfully implemented the second major release, including a primarily the delivery of a new agency portal in the rating, underwriting and policy issuance capabilities necessary to support the launch of new personal lines products, with the full rollout to 10 states to be completed in 2022.

As we close out 2021 and have begun a new year, our focus remains on several primary strategies; achieving sustained excellent financial performance, strategically modernizing our operations and processes to transform our business, capitalizing on opportunities to grow profitably and delivering superior experience to our agents and customers.

Given the current macroeconomic environment, we expect to see continuation of headwinds for the insurance industry as a whole. We will focus on measuring the emphasis on profitability over growth in the near-term and take deliberate and strategic steps in response to the increase in loss activity. While we remain conservative in our underwriting approach, we will continue to be selectively pursue new business accounts across segments of our business where we see the best potential for profitable growth.

With a compounded annual growth rate of 6.5% since 2018, our book value per share was at $16.95 at December 31, 2021 with the cumulative dividend payout of $2.35 over the past four years. Our Board of Directors declared a regular quarterly cash dividend of $0.16 per share of our Class A common stock and $0.1425 per share of our Class B common stock that were paid on February 15, 2022.

In conclusion, the world has forever changed in the past two years but we remain optimistic for the future. We've made significant progress in recent years and believe we have a long term strategy that will enable us to improve financial performance and increase shareholder value over time.

At this time, we'll ask the operator to open the lines for any questions that you may have.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question will come from the line of Meyer Shields with KBW. Please go ahead.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Great. Thanks. Good morning. I apologize if I missed this. I don't think I did. I was hoping you could clarify your comfort with the personalized rate levels in the first state where the product – the new product is being rolled out.

Kevin G. Burke
Chairman, President & Chief Executive Officer, Donegal Group, Inc.

A

Good morning, Meyer. This is Kevin. Yeah. I'll respond to that. We feel very comfortable and confident with the new product that we've rolled out from a rate perspective in Indiana, Ohio and Pennsylvania. Unlike our legacy book of business where we really didn't have the opportunity to have an analytics department in place, this new product, the pricing is very, very refined. We're getting external data as well to make sure that when we look at where we're priced at, we're looking in and doing a comparative analysis.

And so, we've got that data available to us and as we roll this product out, I feel very, very comfortable that the pricing is dialed in and it's something that we are constantly monitoring. And more importantly, we now have the tools and the ability to monitor that at a time that we've never had before. So I feel very confident with where we're going with that.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Thanks. That's good news, that's very helpful. On a related note, how should we think about agency account growth, maybe focused on personal lines as the product is rolled out as a complement to the product itself?

Kevin G. Burke
Chairman, President & Chief Executive Officer, Donegal Group, Inc.

A

Well, first off, in terms of the agency plans that we currently have, I mean when we went through and decided how we were going to phase in the new product, we did it in three different phases. And by design it was Indiana, Ohio, and Pennsylvania; Pennsylvania, obviously being our home state, a key state for us that has many agents with long-standing relationships that have substantial personal lines books with us. Indiana and Ohio, particularly Indiana, is more of what I'll categorize a new state.

And we started there, the agency response has been very good. We have not had to appoint new agents in those three particular states as it relates to the personal lines rollout. We think that we've got a very solid agency plan in place. Right now it's really about gaining market share. The only place where we've really added agents to any level this year has been in a state like Texas, Utah, where we're continuing to grow our presence in those new states.

The existing states, we already have a good agency plan in place, and it's really about making sure that we keep that franchise value in place. And so we think that we've got the right agency plan to continue to grow this new personal lines product. And it's also about reengagement. As you're well aware, a couple of years ago when we started to take a fairly aggressive rate action to bring the book of business back into profitability, we did not have the analytical tools that we have today. And so, it's also part of the reengagement with those agents. And so far, the results have been very positive. So, I'm optimistic as the rest of these states come online for personal lines in 2022.

Meyer Shields
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Okay. That's helpful. Thank you very much.

Operator: [Operator Instructions] Your next question comes from the line of Bob Farnam with Boenning & Scattergood. Please go ahead.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.
Q

Yep. Thanks, and good morning. I have a question on personal lines and a question on commercial lines, and they're both related to pricing versus the loss trends. So it sounds like from your commentary that the loss trends are exceeding your pricing ability right now and it's going to have to – you're going to have to catch up over time. Are we taking that to assume that in 2022, you might have some deterioration in the core loss ratio just because pricing is falling short of where the loss trends are?

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.
A

Sure. Bob, this is Jeff. Thank you for that question. It is a bit of a different story between commercial lines and personal lines.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.
Q

Yeah.

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.
A

Let's talk about personal lines first, since that's where the situation is I think most impacted by inflation. Personal auto, our indications – rate indications jumped significantly from the second half to the latter half of 2021. So we were in a position around the first half of the year, we felt really good about our ability to stay ahead of the loss trends in our rate increases for what we were planning from that point forward. That changed dramatically in the second half of the year.

So we do find ourselves now with indications that are in excess of what we believe we can address with rate increases in the near-term. So we believe we can achieve rate increases that are keeping pace with loss trend, but it's not going to be a situation where we're able to make significant progress in reducing those indications for some period of time. It'll probably be into sometime 2023 before our rate increases are catching up and making significant progress in reducing those overall indications.

So the direct answer to your question is, I do believe in personal auto. It's going to be a challenge to maintain the core loss ratio that we would have seen in the early part of 2021. Our hope would be that we'd start to make progress towards the second half of the year in terms of rate increases, but the earned premium impact of that will take some time into 2023 and beyond.

On the commercial line side, the commercial auto indications, we were in really good shape with the exception of the State of Georgia which we've talked about in previous calls. We were actually at the point where we expected to actually see some profitability in that line in by the end of 2022, and we were planning to scale back on rate increases.

With the recent inflationary changes, we expect to continue to achieve double – low digit-rate increases in commercial auto, which is well ahead of the loss trend and we believe we'll be able to sustain our plan to have that – have that line of rate adequacy by the end of 2022. So we're feeling better about commercial auto with the exception of the State of Georgia, where we're just increasing rates significantly and working to reduce exposures.

Commercial multi-peril is the line that's most impacted, especially on the property side. We are seeing higher severity on property claims. Again we're going to be going out to the market in 2022 with low double-digit rate increases, which again is well in excess of loss trend. So we believe that we can – we can address the inflationary pressures in commercial auto with discretionary pricing adjustments and we're not expecting a significant deterioration in the loss – core losses of CMP.

But again, it takes time for those rate increases to be earned. So we could see some of that in the near-term. The other lines like worker's comp, that's fairly steady. We aren't seeing a significant impact there. Homeowners we have an automatic inflation guard, which helps to increase coverages and premiums. We're taking some additional rate in homeowners. There we think we can easily keep up with the loss trends. So hopefully that gives you an overall picture.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.

Q

Yeah. No. That's a good summary. I think so for the personal lines, personal auto rate increases, are you coming across any pressure from the regulators to kind of limit how much you're asking for?

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

A

That's a great question. We, at this point, are going to the regulators with rate increases that are not significantly above what we believe we can achieve. It'll take probably several rounds of rate increases to get to the rate level we need to be. So we understand there are certain limitations in terms of what we can achieve and what will get approved. And so, we're going to file rate increases in the first half of the year that we believe are basically as high as will be allowed to be enacted and then come back with another round of rate increases later in the year.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.

Q

Okay. All right. And second question, Jeff, while you're here is that, so the expense ratio it sounded like in the press release, you had a few moving parts in the expense ratio for the quarter. Just curious if you back that stuff, I'm looking for more for like a run rate. What should we use going forward because it sounds like the [ph] 30%, 31% (00:25:04) is kind of low?

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

A

It is low, and it's really the impact of the reduction in some of the incentives in the fourth quarter. As the loss ratio ticked up, the expenses come down and that's typically what you see. When we have a very profitable quarter in terms of loss ratio, you'll see a higher expense ratio. For the full year, we came in around at [ph] 33% (00:25:30) and with some additional technology expenses next year and assuming that we have a higher level of profitability, I think a run rate that we would be landing on is somewhere at [ph] 34% to 34.5% (00:25:45) for 2022.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.

Q

Okay. And that's not including the policyholder dividends?

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

A

Correct. That's just the expense ratio.

Bob Farnam
Analyst, Boenning & Scattergood, Inc.

Q

Right. Right. Okay. Thank you.

Operator: And we have no further questions at this time. I'll turn the conference back over to management.

Kevin G. Burke
Chairman, President & Chief Executive Officer, Donegal Group, Inc.

All right. Well, we thank everyone for your participation. And have a good day.

Jeffrey D. Miller
Executive Vice President & Chief Financial Officer, Donegal Group, Inc.

Thank you.

Operator: Ladies and gentlemen, that will conclude today's call. Thank you all for joining, and you may now disconnect.