Donegal Group, Inc. (DGICA; DGICB)

Q2 2022 Earnings Call - FINAL

July 28, 2022

Karin Daly – Vice President, The Equity Group Inc.

Good morning and thank you for joining us today. This morning, Donegal Group issued its Second Quarter 2022 Earnings Release outlining its results. The release and a supplemental investor presentation are available in the Investor Relations section of Donegal's website at www.donegalgroup.com. Please be advised that today's conference was pre-recorded and all participants are in listen-only mode. After management remarks, there will be a question-and-answer session for questions submitted ahead of the call.

Speaking today will be President and Chief Executive Officer, Kevin Burke; Chief Financial Officer, Jeffrey Miller; Chief Underwriting Officer, Jeffery Hay; and Chief Investment Officer, Tony Viozzi.

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, it is my pleasure to turn it over to Mr. Kevin Burke. Kevin?

Kevin Burke – President and Chief Executive Officer

Thank you Karin, and welcome everyone.

I will start the call with an update on our strategic initiatives and then ask Jeff Miller to provide details on our financial results for the second quarter of 2022. Jeff Hay will then highlight our commercial and personal lines segment results; followed by Tony Viozzi with an update on activities and results within our investment portfolio. I will then provide a few closing remarks before we address questions that were submitted to us.

As we have now passed the midpoint of 2022, I am pleased to report that we continue to make solid progress in our ongoing business transformation. We have now launched our new personal lines products in 8 of the 10 states in which we offer personal lines and expect to have the new product suite available in all 10 of those states for

policies effective in 2023. While our new business expectations remain modest as we closely monitor the competitiveness and performance of these products relative to our expectations, we are pleased with the initial agency engagement and early results. New business volumes are growing each month, and we are working diligently to encourage our agents to re-engage with us in the quoting of our new products, whether through our state-of-the-art online portal or comparative rating systems.

The focus of our new system development efforts has now shifted to commercial lines, as we work toward a 2023 release of a new BOP product, as well as migrating our commercial auto and commercial umbrella business lines to our new operating platform. The new platform will enable greatly enhanced straight-through-processing capabilities to streamline our agents' experience and improve the efficiency of our internal operations. This release of new systems is a heavy lift, as we offer commercial lines products in 24 states, and we very much appreciate the efforts of our technical and business teams who have been working tirelessly for several years to modernize our systems that will continue to drive the business transformation we need to effectively compete for quality insurance accounts in the years ahead.

We announced the hiring of a new Senior Vice President of Commercial Lines Underwriting to our team in April. We were also pleased to add a Vice President of Commercial Lines Operations and a Vice President of Personal Lines Product Management and Data during the second quarter. All three of these individuals have extensive industry expertise and experience and have already begun to make meaningful contributions within our underwriting departments. We are positioning our company to successfully execute our strategic plan by making critical investments in infrastructure, personnel and capabilities as we look forward to the return on these investments.

As we think about what we can accomplish in the remaining months in 2022 and are already beginning to plan for 2023, we are emphasizing to the entire Donegal team the importance of remaining focused on our core strategic pillars: achieving sustained excellent financial performance, strategically modernizing operations and processes to transform our business, capitalizing on opportunities to grow profitably, and delivering a superior experience to our agents and policyholders. Like our peers, we face many headwinds in the current challenging economic environment, but we are committed to the execution of our business strategy that we believe will yield successful results in the future and ultimately increase shareholder value.

At this point, I'll turn the call over to Jeff Miller for a review of our financial results for the second quarter.

Jeff Miller – Chief Financial Officer

Thank you, Kevin. I'll provide a brief overview of the quarterly results and then turn the call over to Jeff Hay for more information specific to our commercial and personal lines segments.

We are pleased with the continued modest premium growth in the second quarter, which was mostly related to strong retention results and premium rate increases that averaged 8.5% for all lines excluding workers' compensation. While underwriting results were heavily impacted by weather-related and large fire losses in the quarter, they also reflected inflationary pressures on loss costs in certain lines of business. For the second quarter, net premiums earned grew by 6.0% to $204 million, with 10% growth in commercial lines, which was primarily related to the additional premiums from our Mountain States region that were included in the pooling agreement beginning in 2021. The overall combined ratio was 105.0% for the second quarter of 2022, compared to 96.1% for the prior-year quarter. The deterioration of the combined ratio was primarily driven by higher weather-related losses, and a lower level of net favorable development of reserves for losses incurred in prior accident years compared to the prior-year quarter.

Similar to the broader insurance industry, our results were significantly impacted by numerous severe weather events that occurred in our operating regions during the second quarter, with weather-related losses totaling $19.6 million, or 9.6 percentage points on the loss ratio. While we did not incur significant losses from any single catastrophe event, the accumulation of losses from smaller events led to a weather claim impact that was higher than our previous five-year average for the second quarter.

Our non-weather loss ratio increased 6.7 percentage points from the prior-year quarter. The differential included 3 points from lower favorable reserve development, 50 basis points from large fire losses and a 3-point increase in core losses, which was due in large part to the inflationary impact on repair and replacement costs in our property and auto lines of business. While large fire losses had a relatively low impact to the loss ratio for the first quarter of 2022, we experienced an elevated volume of fire losses in the second quarter, totaling 13.4 million or 6.6 points on the loss ratio. That impact was relatively comparable to the 6.1-point impact on the loss ratio for the prior-year quarter when we also experienced higher-than-average fire losses.

We continued to experience favorable net development of reserves for losses incurred in prior accident years, albeit at a lower amount than in the first quarter of 2022 and prior-year second quarter. Favorable development totaled $7.9 million, or a 3.9-point reduction in the loss ratio for the second quarter of 2022, compared to $13.4 million, or a 6.9-point reduction in the loss ratio for the same period last year. Our insurance subsidiaries experienced favorable development primarily related to reserves for accident years 2021 and 2020.

The expense ratio improved to 35.0% for the second quarter of 2022, compared to 36.0% for the second quarter of 2021. We primarily attribute the expense ratio decrease to lower underwriting-based incentive costs for our agents and employees for the second quarter of 2022 compared to the prior-year quarter.

The combination of all of the factors I discussed, along with pre-tax net investment losses of $8.4 million, resulted in a net loss of $8.2 million for the quarter. Excluding the net investment losses, we had an operating loss of $1.6 million for the second quarter. While those results were disappointing, we believe the rate increases we have implemented, and will continue to implement, as well as strategic shifts in our geographic business mix that Jeff Hay will discuss in more detail, will lead to improved profitability in future periods.

From a capital perspective, on July 21, 2022, we declared regular quarterly cash dividends of 16.5 cents per share for our Class A common stock and 14.75 cents per share for our Class B common stock, which are payable on August 15, 2022 to stockholders of record as of the close of business on August 1, 2022.

With that, let me turn it to Jeff Hay, to provide more details about our commercial and personal lines results.

Jeff Hay – Chief Underwriting Officer

Thank you, Jeff. I will start with our commercial lines segment where we continue to execute on a number of strategies to achieve profitable growth. Net premium written growth increased 4.3% in the segment, continuing our momentum in several states we have targeted for growth, offset by reductions in several states where we have intentionally reduced exposures in today's challenging environment. We strategically decreased our emphasis on new business premiums in the quarter to appropriately allow our premium rates to catch up with the inflationary loss cost increases. As renewal rates increase and returns to adequacy, our market analysis suggests that producers are spending less time on new business opportunities which is evident in our submission volume quarter over quarter. Offsetting the strategic decline in new business, however, our retention remained strong – holding in the low to mid 90's range across most lines of business and regions. So, from a margin perspective, retaining a better class of accounts proves to be a better trade off than accepting potentially underpriced new business in our current macroeconomic environment.

Speaking of rate, we have successfully achieved nearly twice the rate increases achieved in the second quarter of 2021, at high single digits to low double digits across all major lines of business and policy size bands, with the exception of workers compensation where we continue to feel downward pressure from filed bureau loss cost decreases that we are working hard to mitigate where possible based on our own experience. It is important to

note that we continue to execute our strategic initiative to provide more refined rate guidance to our underwriters that consider price adequacy, loss experience, as well as rate characteristics correlated to loss experience. We began this approach in Commercial Auto and have been pleased with the preliminary results indicating stronger rate achievement in our lowest margin business and higher retention levels in our highest margin business.

In total, commercial lines statutory combined ratio for the second quarter of 2022 was 101.6%, compared to 94.3% for the prior-year quarter. The deterioration in our profitability is primarily attributable to heavy storm activity, significant fire losses and the impact of inflation that Jeff mentioned earlier. We endured storms from many angles, as did most of the industry, from widely publicized tornadoes in Michigan and Wisconsin, a Derecho event in Ohio, wind & hail in New Mexico, and wind & hail in the Northeast, with events occurring in across April, May and June all across our footprint. Large fire losses were elevated in the quarter, but it is important to note that the percent of losses attributable to large fires on a year-to-date basis was comparable to the first half of 2021 and in-line with our expectations, largely due to the lower incidence of fire losses for the first quarter of 2022. However, inflationary pressures were evident, with core severity increasing in the quarter compared to the prior-year period in nearly every major line of business, particularly in our property & auto physical damage coverages. Additionally, we continue to see increases in the costs and duration of repairs due to supply and labor shortages, increasing our overall costs through price increases in labor, parts & materials. Claim frequency remained generally consistent, with the exception of Commercial Auto, where frequency continues to increase gradually as we return to normalcy from the COVID-19 pandemic. We do continue to execute our pricing strategy to return to rate adequacy, and we continue to believe our commercial auto performance will benefit from earned premium rate increases and various strategic actions we implemented over the past several years to improve the profitability of that line of business.

As mentioned last quarter, we continue to evaluate and take action as part of state-specific strategies for each line of business. The execution of these strategies has continued to make an impact in the second quarter of 2022, with premiums written in the states to which we assigned a growth posture growing at more than twice the rate of our overall commercial segment with lower-than-average loss ratios, and premiums written in our profit improvement states shrinking in the double digits. The resulting shift in the mix of our overall commercial portfolio will help enhance our profitability as we continue to promote growth in the targeted markets.

Moving on to personal lines, we are pleased with the return to modest premium growth in the quarter. Net premiums written for the quarter increased 4.0%, reflecting increased momentum from the introduction of our new personal lines product suite. We successfully launched, as scheduled, new products in the states of Maryland, Tennessee, and Virginia during the second quarter, after seeing a continuing increase in relevance within the marketplace in the states of Indiana, Ohio and our flagship state of Pennsylvania, where we previously introduced

the new products. In the second quarter, we more than doubled our new business production compared to the same period last year in these states. We continue to closely monitor the success of these products to ensure overall rate adequacy and segmentation. As such, we have already implemented various rate adjustments in reaction to their initial competitive position and performance and to keep up with the ongoing inflationary pressures on loss costs. As we head into the back half of 2022, we remain on track to release the new products in WI, DE and GA. However, due to regulatory approval delays, we have delayed our implementation date for the state of Michigan to early 2023.

And as we continue the rollout of the new personal lines' product suite, we are also diligently working to maintain the profitability of our legacy renewal book of business. Policy retention averaged near 90 percent across both personal auto and home, and we have at least two planned rate change revisions during 2022 in each line of these lines business in every state where we are offering legacy personal lines products. Cumulative rate filings are currently in the high single digit range, and we continue to adjust our automated coverage renewal increase amounts to account for property exposure changes.

Our overall personal lines combined ratio was 107.5% for the second quarter, compared to 96.9% in the same period last year, again, driven by weather, fire and inflationary impacts. Weather-related losses impacted the homeowners' line of business from the same storms mentioned in my commercial lines commentary. We are also seeing pressure on claim frequency and severity in our auto line of business, as miles driven continues to near pre-pandemic levels. And again, both material costs and time to repair are increasing overall costs, with key items such as vehicle replacements parts, appliances, electrical wiring and copper continuing to be the most difficult resources to obtain. Additionally, talent shortages in repair shops are resulting in delays and increasing costs. We will continue to closely monitor the market success and results of our new personal lines products, and we are effectively gaining traction to get to overall rate adequacy for our legacy personal lines book of business.

Before I hand the call to Tony, I'd like to take a moment to highlight a change in our Personal Lines leadership team. Effective 7/1/2022, David Sponic was named our Senior Vice President & Head of Personal Lines. Dave succeeds Jeff Jacobsen, who will transition into an advisory role leading up to his retirement in early 2023. Dave is a long time Donegal leader, having first joined the organization as an underwriter back in 1990 and has played a critical leadership role in the development of our recent new personal lines market offering. Dave's robust industry knowledge, leadership and strategic perspective will help navigate the highly competitive and ever-changing Personal Insurance marketplace.

I will now turn the call to Tony Viozzi, Chief Investment Officer, for an investment update. Tony?

Tony Viozzi – Chief Investment Officer

Thank you, Jeff. Over the course of the last twelve months, we have been able to take advantage of widening spreads in certain fixed income sectors, which resulted in a few, modest asset allocation adjustments. It is important to note, that last quarter we announced that our average reinvestment rate exceeded the rate we were receiving on bond cash flow, which consists of maturities, calls, and Mortgage-Backed Security pre-payments. We are happy to note, that this positive development continued in Q2 and appears to be trending positively again in the third quarter.

Total investments increased by $22.4 million from December 31, 2021, as new funds invested were partially offset by $41.5 million of unrealized losses within our available-for-sale fixed-income portfolio, due to rising market interest rates.

Net investment income of $8.2 million is an increase of 7.2% from the second quarter of 2021. Investing new money from premium growth and profitable operating results had allowed us to consistently maintain and increase our investment income. If market rates remain stable, we expect to experience a lift on new investments and see the end of market value declines. Our short-term investment yields have improved from one basis point a year ago to approximately 1.25%, and we expect short-term rates will continue to move higher in 2022 as the Fed continues its tightening plan to fight inflation.

Net investment losses of $8.4 million for the second quarter of 2022 were primarily related to unrealized losses in the fair value of equity securities held as of June 30, 2022. Equity values have begun to rebound somewhat in the last few weeks.

In the second quarter, an increase in interest rates resulted in a decrease in the market value of our available-for-sale bonds, with the tax-adjusted unrealized loss impacting our stockholders' equity by $32.8 million and impacting our book value by $1.02 per share. That decrease, coupled with the loss events impacting our quarterly results, contributed to a 6% decline in book value per share from year-end 2021, to $15.87 as of June 30, 2022.

I will now turn it back to Kevin for closing remarks.

Kevin Burke – President and Chief Executive Officer

Thanks, Tony. We are excited about Donegal's future as our strategic commercial lines focus, new personal lines product suite and ongoing underwriting and rate actions combine to yield favorable results over time. While a single

quarter's results may be tempered by significant weather and ongoing economic volatility, we remain encouraged by the path we are on. We know our work is not complete and as each day brings on new challenges, Donegal's hardworking staff remains determined in continuing the transformation to a better future at Donegal. Thank you to our employees and shareholders for your continuing support of those efforts.

At this time, I'll ask Karin, our Investor Relations consultant and Vice President at The Equity Group, to moderate our question-and-answer session.

Question & Answer

Karin Daly – Vice President, The Equity Group Inc.

Thank you, Kevin. I'd like to take a moment to discuss the format for the question-and-answer section. Along with the announcement of Donegal's second quarter 2022 earnings and webcast schedule, we requested and received questions from interested parties in advance. While we have worked answers to some of these questions into our prepared remarks, where appropriate, there were a few questions that we will address directly:

Karin Daly – Vice President, The Equity Group Inc.

The first question relates to the losses in the quarter: Can you please provide additional detail of the fire losses and weather-related losses, in terms of geographical location or segment impact?

Jeff Hay – Chief Underwriting Officer

I can take that one, this is Jeff Hay and thank you for the question. On the weather side of the equation, we were hit across our footprint from the widely publicized tornadoes in Michigan and the Wisconsin, a Derecho event in Ohio, hail & wildfires in NM, and Hail & wind in the Northeast, and those events occurred across April, May and June. On the fire side of the equation, as I mentioned in my commentary, there is really nothing out of trend from a year-to-date perspective and the experience was random across our geographic footprint with a notable exception of a large personal lines fire in Northern Virginia and a wildfire related loss in New Mexico.

Karin Daly – Vice President, The Equity Group Inc.

Great, thank you. Following up on those comments, we have several related questions about the loss ratio impact of weather and fire losses by segment.

Jeff Miller – Chief Financial Officer

Sure, Karin, I can provide some more granular details as to the loss ratio impact, starting with the weather and fire losses. The weather impact was weighted more heavily to our personal lines segment, representing 14.5 percentage points of our personal lines loss ratio, versus 6.6 percentage points of our commercial lines loss ratio. For fire losses, there was a $1.5 million increase in commercial property fires compared to the prior-year quarter, with fire losses representing 5.9 percentage points of our commercial lines loss ratio. While the overall dollar impact of homeowners fires was comparable to the prior-year quarter, we had two large home fires that exceeded $1.5 million in damages and contributed to a total 7.6 percentage point large fire impact on our personal lines loss ratio.

Karin Daly – Vice President, The Equity Group Inc.

Thanks for those details. The next question is on the commercial lines state-specific strategy to exit or growth in targeted areas – can you give us an idea of the progress that has been made and when we should expect to see targeted areas be fully assembled/disassembled?

Jeff Hay – Chief Underwriting Officer

Jeff Hay here again and thank you that question. The state-specific strategies developed last year are being successfully utilized to support growth in our most profitable states. In this quarter, we grew our states with a growth posture at more than twice the rate of the overall growth in the commercial segment, and those states had lower-than-average loss ratios, as well. And our profit improvement states shrinking in the double digits, and we are seeing improved loss ratios as a result of the underwriting actions are doing there. This reshaping of our book is more of a journey than a destination as we will continually look to steer our portfolio growth in the most opportune geographies & industries, even actively seeking out ways to play offense in the right classes and lines of business in even our less profitable states.

Karin Daly – Vice President, The Equity Group Inc.

The next question is on personal lines: what percentage of total personal lines premium is currently coming from your new personal lines product and where do you expect this number to be by 2024?

Jeff Hay – Chief Underwriting Officer

Thanks for that question, Jeff Hay here again. As we roll out our new states, we are only allowing new business writings in the new product, so from a new business perspective, we are already writing 2/3 plus of our new business in the new product with the states we have live now and that will increase to 100% with our final rollout of states late this year and early into 2023. In total, that is less than 5% of our total book today which may grow to as much

as a quarter of our total book over the next 2 years. However, we are being very deliberate about our growth of the new product, especially in today's dynamic environment. While our new business production is up significantly over recent prior years, it is now only at a level to allow us to stave the shrinking of the book we have experienced over the past several years and will allow us moderate single digit growth in the personal lines business segment overall as a complement to our commercial lines of business.

Karin Daly – Vice President, The Equity Group Inc.

Thank you. The next question relates to favorable reserve development – can you provide the impact of reserve development on loss ratios for individual lines of business, and then a related question – are significant reserve releases in personal and commercial auto related to lower-than-expected frequency due to the pandemic, largely behind you?

Jeff Miller – Chief Financial Officer

I can address those questions. Favorable reserve development for the quarter was split among major lines of business, with workers' compensation at $3.6 million, commercial automobile at $3.5 million, and personal automobile at $2.7 million, offset partially by commercial multi-peril and other commercial that had combined adverse development of $2.8 million related to a handful of specific case reserves

As to the reserve releases related to the pandemic period, we did experience a slowdown in the favorable development for our automobile lines in the second quarter compared to the first quarter, which we fully expected. My expectation is that I do think the favorable development related to the lower frequency in the accident years influenced by the pandemic is largely behind us, as that impact was primarily in the 2020 accident year for which we now have substantial reported claim data that underlies the actuarial estimates. For the relatively immature 2021 accident year, we continue to carry a fairly substantial amount of actuarially determined reserves for the auto lines. Considering that the assumptions that go into the selection of actuarial estimates are largely based on recent loss experience and trends, and the fact that the effect of many of the underwriting actions we have taken is not yet fully reflected in recent loss history, particularly in commercial auto, I believe it is reasonable to expect our auto reserves will continue to develop favorably, within a reasonable range, in future periods.

Karin Daly – Vice President, The Equity Group Inc.

The final question is regarding the investment portfolio – how have you changed your portfolio thus far in 2022 to create a better performing portfolio in today's market?

Tony Viozzi – Chief Investment Officer

Thank you Karin. We have gradually moved excess cash this year, into higher performing, yet cash flowing MBS product. This allows us to pick up income today yet provides cash flow for reinvesting at higher rates in the future. In addition to MBS purchases, we have been able to take advantage of spread product in both Agency debt and Taxable Municipal bonds. We continue to ladder the portfolio and use a barbell approach, when appropriate. With these slight changes and the fact that the market is moving off of historical lows, we feel positive about our current and projected investment income.

Karin Daly – Vice President, The Equity Group Inc.

Thank you, and that wraps up the questions received in advance of the call. If there are any further questions, please feel free to reach out to us. Thank you to all interested parties for submitting questions and listening in today. I will now turn it back to Kevin for any final remarks.

Kevin Burke – President and Chief Executive Officer

Thanks Karin. We will continue to executive our strategic and tactical initiatives to generate and sustain positive financial results in our go-forward results. We appreciate the ongoing support and thank you for joining us today.

Karin Daly – Vice President, The Equity Group Inc.

This now concludes the second quarter of 2022 earnings webcast. You may now disconnect.