Donegal Group Inc. (DGICA; DGICB)

Q1'24 Earnings Call Transcript – FINAL

Karin Daly – Vice President, The Equity Group Inc.

Good morning and thank you for joining us today. This morning, Donegal Group issued its First Quarter 2024 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.

Speaking today will be President and Chief Executive Officer, Kevin Burke; Chief Financial Officer, Jeff Miller; Chief Underwriting Officer, Jeff Hay; Chief Operating Officer, Dan DeLamater; 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. We will provide some details on our quarterly financial results and an update on the progress of a number of initiatives that we expect will generate incremental improvement in our results as the year progresses.

We saw significant improvement in our results for the first quarter of 2024 relative to the fourth quarter of 2023, but we will discuss a few factors that prevented us from achieving our targeted level of underwriting profit, and overall earnings, as the call progresses.

From a top-line growth perspective, our commercial lines premiums earned and written continue to reflect the impact of the strategic non-renewals of all commercial policies in the states of Georgia and Alabama. That initiative will be largely completed in the second quarter of 2024, and we are pleased that we were successful in achieving higher levels of commercial lines new business relative to prior-year quarter in states and classes of business we have targeted for growth. Our dedicated small business underwriting team is also making great progress, working with our marketing team to communicate our value proposition to specific agency partners, and executing a strategy designed to accelerate small business growth in targeted geographic areas and classes of business in the years to come. We expect to see more meaningful increases in small business premium as we continue to refine and expand our operating capabilities throughout the remainder this year to enable us to effectively capitalize our profitable growth opportunities in 2025.

In personal lines, we are continuing to implement significant rate increases that account for virtually all of the premium increases in that segment, as we actively control new business growth levels to essentially maintain overall exposures within that segment. Earned premiums will reflect even higher levels of rate increases in future quarters, which we expect will continue to drive performance improvement as loss trends continue to stabilize and we get closer to rate adequacy.

We are making solid progress on our last two major software releases within our systems modernization project. We have begun the development phase of the major commercial systems release that will include a new commercial package policy and modernize the other commercial products remaining on our legacy systems. We have submitted all of the regulatory filings to convert all remaining homeowners and dwelling fire policies included in the first phase of the last major personal lines software release. Both of these efforts will continue to run in parallel over the next two years with the phased rollout of implementations beginning in 2025.

Jeff Hay and Dan DeLamater will provide further details on our strategic initiatives that give us optimism that we will see further margin expansion, and Tony Viozzi will provide an update on our investment portfolio that is providing increased levels of investment income.

Before we get to those operational updates, I'm going to turn the call over to Jeff Miller for a review of our quarterly financial results.

Jeff Miller – Chief Financial Officer

Thanks Kevin. For the first quarter of 2024, net premiums earned increased 5.8% to $227.7 million. Net premiums written increased by 6.0%, with similar drivers to those we experienced in the second half of 2023, as strong premium rate increases and retention were offset partially by planned attrition in states and classes of business we are exiting or have targeted for profit improvement. Rate increases achieved during the first quarter of 2024 were consistent with those we reported for the fourth quarter of 2023, averaging 12% in total and 14%, when excluding workers' comp.

The combined ratio was 102.4% for the first quarter of 2024, compared to 101.2% for the prior-year quarter, with a higher impact of large fire losses primarily accounting for the increase. The core loss ratio increased modestly from the prior-year quarter, primarily due to a higher personal lines core loss ratio compared to that quarter despite a 16.6% increase in net premiums earned for that segment.

Weather-related losses of $10.8 million, or 4.7 percentage points of the loss ratio for the first quarter of 2024, were down from $14.1 million, or 6.5 percentage points for the first quarter of 2023. The lower impact was primarily due to lower commercial property losses, with $2.1 million of losses contributing 4.3 percentage points to the quarterly commercial multi-peril loss ratio, comparing favorably to 10.5 percentage points of the loss ratio for that line of business in the first quarter of 2023. The weather impact to the homeowners line was $7.3 million, or 21.3 percentage points of the homeowners loss ratio, which improved modestly compared to 23.9 points in the prior-year quarter. In total, the quarterly weather claim impact was in-line with the previous five-year average for the first quarter of 4.7 percentage points. Our insurance subsidiaries did not incur losses from any single event during the first quarter of 2024 that exceeded their individual $3 million catastrophe reinsurance retention with Donegal Mutual.

Large fire losses (which we define as over $50,000 in damages) contributed 6.6 percentage points to the loss ratio for the first quarter of 2024, which was higher than 5.1 percentage points for the prior-year quarter. An increase in the frequency and severity of both commercial and homeowners fire losses contributed to the increase.

Our insurance subsidiaries experienced $8.4 million of net favorable development of reserves for losses incurred in prior accident years, representing a 3.7-point reduction in the loss ratio, for the first quarter of 2024, which was comparable to $8.3 million, or a 3.9-point reduction in the loss ratio, for the prior-year quarter. Specific line of business detail for the first quarter of 2024 included favorable development of $5.0 million for commercial multi-peril, $2.7 million for commercial auto, $1.1 million for homeowners and $2.5 million spread across other lines. That favorable development was partially offset by unfavorable development of $2.9 million for workers' compensation. We attribute the unfavorable development in workers' compensation to higher-than-expected severity for a relatively small number of previously reported losses in accident years 2022 and 2023.

The expense ratio of 35.7% for the first quarter of 2024 decreased modestly compared to 36.4% for the prior-year quarter. The decrease primarily reflected early impacts of expense reduction initiatives, offset partially by higher technology costs related to our ongoing systems modernization initiatives.

In summary, the underwriting loss we incurred for the first quarter of 2024 was more than offset by $11.0 million of investment income and $2.1 million of net investment gains, resulting in after-tax net income of $6.0 million, which was modestly higher compared to $5.2 million for the first quarter of 2023.

To provide more details about our commercial and personal lines segment results and related initiatives, I will turn the call over to our Chief Underwriting Officer, Jeff Hay.

Jeff Hay – Chief Underwriting Officer

Thank you, Jeff. I will first dive deeper into commercial lines before providing additional insight into our personal lines performance.

Overall, growth across the commercial lines of business was slightly negative at -1%, due to our ongoing strategic initiatives that include non-renewing and exiting commercial lines in Georgia and Alabama, and other targeted non-renewals in select classes in other states that are improving the risk profile of our book of business at a steady pace. Other specific actions driving positive impacts include ITV improvements, enhanced roof underwriting through the use of an aerial imagery, with embedded artificial intelligence, and point of sale integrations with catastrophe models that lead to improved terms and conditions on properties with higher potential exposure to severe weather.

For the first quarter, intentional attrition accounted for a nearly -5% decrease in our commercial lines premium and led to a 78% overall retention rate. Excluding this impact, we achieved our plan for commercial lines premium growth in our active footprint with retention at a strong 82%. We continue to emphasize renewal rate increases in the areas where the intersections of class, line of businesses, and geography are most challenged. We achieved 11.9% renewal rate increases across our commercial book excluding workers comp, with commercial multi-peril at 13.3% and commercial automobile at 11.4%.

Turning to profitability metrics, the first quarter was marked by some elevated loss trends in several lines of business, and we are continuing to tighten our underwriting guidelines and procedures to improve the underlying portfolio performance. Large fire losses increased from the prior-year quarter, driven by both frequency and severity of those losses. To reduce the frequency of large fire losses going forward, we recently introduced several new underwriting resources to our front line teams to alert them to specific factors that collectively increase the risk of fire. Weather-related losses were close to our historical average for the first quarter, despite an unusually active storm quarter. Of note, we did not incur material impact from the Smokehouse Creed wildfires in Texas.

Our first quarter workers’ comp loss ratio included 11 points of prior-year reserve development that we attribute primarily to reserve increases arising out of routine periodic case reviews for a small number of prior-year claims. The reserve increases primarily reflected updated projections of future medical costs we expect to pay on claims for accident years 2022 and 2023 in our flagship state of Pennsylvania. Claim frequency within the workers’ compensation line of business continued to trend downward, and indemnity severity appears to be showing early signs of abating. We maintain a conservative stance in our reserves and risk/appetite strategy, as evidenced by our historical trends. While we believe the workers’ comp development in the quarter represented a timing anomaly, we will appropriately monitor reserving activity in the state to ensure there are no broader trends behind that activity. And as Jeff mentioned earlier, commercial auto and commercial multi-peril experienced net favorable prior-year reserve development, more than offsetting the adverse impact from workers’ comp.

On a core loss basis, excluding large fire and weather-related losses and prior year reserve development, the underlying commercial multi-peril loss ratio improved modestly compared to the prior year period while commercial auto and workers’ compensation increased slightly. On an overall basis, the commercial lines core loss ratio increased by 1 percentage point over the first quarter of 2023.

We maintain our offensive strategy in Commercial Lines and will continue to spread our geographic footprint of the property book of business to optimize the diversification benefit and improve the loss ratio performance for the year, and well beyond.

Echoing Kevin’s comments about our personal lines business, we are controlling our new business volume to accelerate our return to profitability by limiting our exposure growth. We successfully reduced our new business writings by 19% compared to the first quarter of 2023 and still achieved 18.5% premium growth in the quarter, primarily driven by aggressive renewal rate increases coupled with strong retention. Policies-in-force decreased 2.5% from March 31st of last year, and were down 0.6% from year-end 2023, indicative that our growth in the quarter was fully attributable to renewal rate achievement, with rate increases averaging 15.2% for Personal Auto and 19.0% for Homeowners. As a reminder, we have been aggressively taking rate since late 2022, and we are now seeing earned rate levels in excess of loss costs, which is driving margin expansion. We expect to see an acceleration of earned rate, particularly from our personal auto line of business as an increasing percentage of our auto policies are written on 6-month terms. Premium retention continues to be very strong at 107.2%, indicating that policyholders are accepting higher renewal premiums across the personal lines book.

The homeowners lines of business experienced elevated large fire losses in the quarter compared to the prior year period and our historical average. Weather-related losses included the impact of severe Midwest convective storm activity in the first three months of the year but remained close to our historical average quarterly weather impact. Similar to our commercial lines business, we are managing our geographic footprint of the homeowners book to diversify our portfolio or risks in relation to regional weather patterns. During the first quarter, we made great progress on reducing our policies in force in counties where we have higher concentrations of risk and modestly grew in other counties that reflect a positive combination of underwriting and agency management.

The personal automobile line of business loss ratio improved by 3 percentage points compared to the first quarter of 2023, primarily driven by an improvement in the core loss ratio that we can attribute to rate-driven increases in earned premiums. Similar to commercial automobile trends, liability severity trends continue to move higher, but post-pandemic frequency increases have leveled off and are now showing signs of a downward trend. Furthermore, we are seeing a continuation of moderation in auto physical damage severity that is primarily due to gradual declines in used car prices.

Our teams are working tirelessly to improve our underwriting results, and we remain confident that our strategic actions will create positive momentum in the results over time. With that, I will turn the call over to Dan DeLamater. Dan?

Dan DeLamater – Chief Operating Officer

Thank you, Jeff. To follow those comments, I will add a bit more context around several important operational initiatives that support the underwriting efforts Jeff just described.

As we discussed last quarter, we launched our newly re-aligned regional structure effective January 1, 2024, after solidifying the regional leadership in each operation. We had previously managed our business in six distinct regions, but with these changes have reduced our regional footprint to four regional operations. We expect to achieve improved operating efficiencies, increased effectiveness, and greater economies of scale in this structure. Leaders in these four regions are working collaboratively with marketing, underwriting, product development, and claims resources to drive a consistent strategy and working environment. We expect this concentrated structure will drive improvement now and well into the future.

And it's within these four regions that we are executing our state strategy action plans that Jeff Hay has elaborated on just before, and in previous calls. These state strategies not only guide our growth, line, and class of business objectives, but they also include sub-state initiatives to effectively manage the weather exposure of our property book of business.

I'd like to take a moment to highlight a developing success story that originated through our state strategy sessions. We entered the state of Arizona last summer and began building relationships with independent agents across the state. We are extremely pleased with the engagement of these agency partners and thank our local team for their energy and their efforts. The team is aligned in our strategic plan for the state of Arizona, and while our 2024 premium growth goals are modest in relation to our overall book, early results are promising. In the first three months of 2024, we have nearly surpassed the amount of new quote activity seen in the final five months of 2023. Even more impressive, we have already surpassed the amount of new premium written in this same time period. All the while, our team remains engaged on the quality of submissions, quality of new business written, and continued engagement with our independent agency partners for book management and profitable growth. We expect Arizona will contribute to the growth and success of our Southwest region over time.

The execution by our team is tangible as we are recognizing disproportionate growth in our thirteen "grow" states, modest growth in our six states labeled "maintain", and significant premium reduction in the five states identified for "profit improvement" or "exit". And, likewise, our loss ratios continue to track in those states confirming our desire to grow in our "grow" states and de-emphasize our "profit improvement" states.

Our national account team supports our regional teams and these state strategies. We have built an engaging small national accounts marketing team to work alongside our regional marketing, underwriting, and product teams to accomplish our unified state and regional objectives. This team is a dedicated contact and valuable resource for the various local, state, regional, and national leaders in our twelve strategically identified national relationships. Agencies from these groups accounted for over 37% of our new business in the first quarter and nearly 35% of our overall in-force book of business. We are thankful for the support and commitment from all of our independent agency partners, and these national account groups certainly provide a significant opportunity for future profitable growth as we strive to become the regional carrier of choice in their organizations.

Before I turn it to Tony, I would like to provide an update on our targeted expense reduction initiative. As we expect to reach the peak expense impact related to our multi-year systems modernization project in 2024, with approximately 1.3 points of expense ratio impact from that project this year, we expect to achieve meaningful offsetting cost reductions throughout this year, and beyond, through intentional and targeted expense management efforts. Our senior leadership team has worked together to identify tangible expense savings in several areas of our organization. We have created an accountability framework so that each of our senior leaders can track and report their progress toward their committed expense reductions. The planning process for this initiative has been significant, and we view the execution as paramount to the achievement of our long-term goal to achieve sustained excellent financial performance.

In the end, I am pleased with the many ways our team continues to refine our focus on operational efficiencies and excellence. And with that, I'll turn it over to Tony for an investment update. Tony?

Tony Viozzi – Chief Investment Officer

Thank you, Dan. Our current investment strategy is to minimize credit risk by purchasing high-quality securities and taking advantage of the higher reinvestment interest rates that have continued to provide strength in our investment portfolio. During the first quarter of 2024, net investment income of $11 million increased 16.1% from the prior-year quarter.

The average tax-equivalent yield was 3.40%, up from 3.00% for the first quarter of 2023. This is the highest average portfolio yield we have seen in over a decade due to increased market rates as well as our ongoing shift out of US Treasuries, municipal bonds, and equities into higher-yielding cash equivalents, mortgage-backed securities, and agency debt. Portfolio reinvestments in the first quarter resulted in an incremental boost in the average yield on those funds of approximately 85 basis points compared to maturing investments. We are currently investing new funds at rates close to 5.50%, representing a spread of more than 100 basis points from the yield on the second quarter maturities. We are projecting approximately $115 million of bond reinvestment cash flow for the next twelve months that is currently invested at an average yield of 3.85%.

Net investment gains of $2.1 million for the first quarter of 2024 compared to net losses of $331,000 for the first quarter of 2023, with both amounts reflecting the change in the market value of modest equity investment holdings at the end of the respective quarters. As a reminder, we reduced our equity holdings in 2023 to capitalize on strong fixed-income rates. We remain opportunistic in our investment allocation decisions, and depending on market dynamics, we may consider increasing our investment allocation in equities in the future.

At March 31, 2024, our book value per share was $14.53, compared to $14.39 at December 31, 2023, for a $0.14 increase from year-end. The increase in book value was driven by our quarterly net income that was slightly offset by unrealized losses in our available-for-sale fixed income portfolio during the quarter that decreased in our book value by $0.05 per share from December 31, 2023.

We expect to maintain our historically conservative investment approach, emphasizing preservation and expansion of capital, while seeking to limit volatility and ensure the investment portfolio's resiliency to support our insurance operations.

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

Kevin Burke – President and Chief Executive Officer

Thanks Tony. As you heard throughout the call today, our entire team is focused on execution. We have developed clear strategic goals, and there are many tactical initiatives in various stages of completion, all of which we expect will help us achieve growth and performance objectives as they are fully implemented. This is a critical time for Donegal, as we are working diligently to complete the final releases of our systems modernization project that began over five years ago. The significant efforts our team has put forth over the past few years to reinvent our company and provide a stable, modern platform are beginning to support our future growth. We truly believe we are at an inflection point where those efforts will translate into improved operating performance. We look forward to providing further updates on the progress in our next quarterly call.

Thank you for joining us today. I'll turn the call back over to Karin.

Karin Daly – Vice President, The Equity Group Inc.

Thank you, Kevin. While we requested and received questions in advance of today's call, we have worked answers to these questions into our prepared remarks. If there are any additional questions, please feel free to reach out to us. This now concludes the Donegal Group first quarter 2024 earnings webcast. You may now disconnect.