Donegal Group Inc. (DGICA; DGICB)

Q2'24 Earnings Call Transcript

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 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. In today's call, we will provide commentary on our quarterly financial results and an update on a number of strategic initiatives that we expect will continue to drive improved results in future periods.

Above-average severe convective storm activity continued into the second quarter of 2024, with hail, tornado and wind events reported across the country. There were more than 1,200 tornadoes reported for the first half of 2024, which is the highest number on record since 2011. Experts predict that these events have resulted in damages exceeding $20 billion. While we are working to restore properties for a number of policyholders who incurred tornado losses, we are pleased that decisions that we made as part of our state and regional strategies in recent years, as well as our ongoing management of geographic risk concentrations, served us well in mitigating the weather loss impact to our second quarter results. We will discuss more details about weather-related losses and other key earnings drivers as the call progresses.

Our top-line growth storyline is similar to the one we have been sharing over the past year. Commercial lines premiums earned and written in the second quarter continued to reflect the impact of the strategic non-renewals of all commercial policies in the states of Georgia and Alabama, which is now essentially completed. We continued to achieve higher levels of commercial lines new business relative to prior-year quarter in targeted states and classes of business. We are making solid progress in refining our small commercial business underwriting strategies and the capabilities to accelerate small business growth. We are looking forward to our annual state strategy sessions that will occur in early August, when our sales, underwriting and claims leaders across our organization will collaborate to refine our strategies and action plans in each of the 23 states in which

we conduct business. We expect that small commercial growth will be a significant emphasis within our 2025 business plan, as we prioritize opportunities for profitable growth within updated state-specific action plans in the next few months.

For personal lines, our strategy remains to implement renewal premium rate increases to further improve margins and actively control new business growth. Earned premiums now reflect significant rate increases we implemented over the past several years, and we expect further margin expansion within this segment in future periods.

As we reported in our first quarter call, we are working on the final two major software releases within our systems modernization project. Development efforts are on track for a major commercial lines system release that will include a new commercial package policy and modernize the other commercial products remaining on our legacy systems. Other members of our project team are working diligently on a major release to convert all remaining personal lines policies on our legacy systems. The first phase of this release includes homeowners and dwelling and fire policies, and the second phase will include all remaining personal auto policies. We are continuing to progress well toward implementation dates beginning in 2025 for both of these major releases.

I will now turn the call over to Jeff Miller to review our second quarter financial results.

Jeff Miller – Chief Financial Officer

Thanks Kevin. For the second quarter of 2024, net premiums earned increased 8.3% to $234.3 million. Net premiums written increased by 9.1%, 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 second quarter of 2024 remained in double-digit percentages, averaging 11% in total, and 13% when excluding workers' comp.

The combined ratio was 103% for the second quarter of 2024, compared to 104.7% for the prior-year quarter, with a decline in the expense ratio primarily accounting for the decrease. The core loss ratio was unchanged from the prior-year quarter.

Weather-related losses of $24.7 million, or 10.6 percentage points of the loss ratio for the second quarter of 2024, compared to $19.7 million, or 9.1 percentage points for the second quarter of 2023. The higher impact was primarily due to severity of commercial property losses, with $8.2 million of losses contributing 15.9 percentage points to the quarterly commercial multi-peril loss ratio, compared to 9.2 percentage points of the loss ratio for that line of business in the second quarter of 2023. The weather impact to the homeowners line was $11.2 million, or 31.7 percentage points of the homeowners loss ratio, which compared to 30 points in the prior-year quarter. In total, the quarterly weather claim impact was higher the previous five-year average for the second quarter of 8.8 percentage points. Our insurance subsidiaries incurred $6 million in losses from a May tornado event that caused significant commercial property losses in Indiana and Michigan and exceeded their aggregate catastrophe reinsurance retention with Donegal Mutual.

Large fire losses (which we define as over $50,000 in damages) contributed 5.3 percentage points to the loss ratio for the second quarter of 2024, which was slightly lower than 5.9 percentage points for the prior-year quarter. Despite a handful of

New Mexico wildfire claims for commercial properties, we experienced modest decreases in the frequency of both commercial and homeowners fire losses compared to the prior-year quarter.

Our insurance subsidiaries experienced minimal development of reserves for losses incurred in prior accident years, with virtually no impact on the loss ratio, for the second quarters of 2024 and 2023.

The expense ratio of 31.9% for the second quarter of 2024 represented a meaningful decrease compared to 34.2% for the prior-year quarter. The decrease primarily reflected ongoing impacts of expense reduction initiatives that Dan will highlight in a few minutes, offset partially by higher technology costs related to our ongoing systems modernization initiatives.

In summary, the underwriting loss we incurred for the second quarter of 2024 was more than offset by $11.1 million of investment income and modest net investment gains, resulting in after-tax net income of $4.2 million, compared to $2.0 million for the second quarter of 2023.

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

Jeff Hay – Chief Underwriting Officer

Thank you, Jeff. Starting with commercial lines, net premiums written increased 7.1% during the quarter, with the execution of our go-forward strategy producing positive momentum in new business and strong renewal rate achievement that exceeded intentional attrition related to our non-renewal of less profitable business as we discussed in prior quarters. At June 30th, we had essentially completed our exit of commercial lines business in Georgia and Alabama. We are very excited to achieve this significant milestone in the execution of our profit improvement initiatives. Excluding these two states, our commercial lines net premium written growth was 10.4% for the second quarter. Our success in writing new business is highly aligned with the targeted geographic and class of business strategies that I have outlined previously. In fact, 66% of the new business we wrote during the quarter was within highly targeted classes where we expect higher profitability, which exceeded our target of 60% and improved over 59% for the prior-year quarter.

We have continued to execute several other profit improvement initiatives within our commercial lines book of business, including:

- the introduction of a Probable Maximum Loss underwriting tools that now provide, to our underwriters, a comprehensive analysis of fire risk factors as they review and price commercial properties;
- revised underwriting guidelines for certain profit-challenged classes of business; and
- the introduction of mandatory wind/hail deductibles across our footprint, whether or not a state has been historically identified as a CAT-prone.

We are also taking further actions to increase the precision of our risk selection and pricing, such as using third-party data to ensure appropriate property valuations, utilizing aerial imagery for roof evaluations, and integrating advanced catastrophe modeling to drive appropriate changes to terms and conditions on more exposed properties.

We are continuing to emphasize renewal rate increases in areas that are most challenged when considering the intersections of class, line of business, and geography. Excluding workers' compensation, we achieved an average of 11.8% renewal rate and exposure increase across our commercial book, led by commercial multi-peril at 13.8% and commercial automobile at 10.2%.

Turning from top-line growth to results, the commercial lines statutory combined ratio for the second quarter was 104.9%, a slight deterioration from 103.6% for the prior-year quarter due primarily to the impact of very active weather pattern during the quarter – as Kevin and Jeff mentioned earlier. There was a tornado or hail event reported somewhere in the United States in every day during the month of May. So, we are not surprised that weather-related losses were elevated during the quarter, with commercial property losses from weather increasing 90% over the prior-year quarter, primarily due to a handful of severe claims from tornadoes and large hail in the state of Michigan, Indiana, Ohio and South Carolina. Despite this increase, we believe our ongoing geographic diversification strategy served us well, as the weather impact on our loss ratio was significantly lower than other companies across the industry have reported. It also bears mentioning that we received no claims to date related to Hurricane Beryl.

Large commercial fire losses incurred were relatively flat for the quarter, and we expect a reduction in the likelihood of large fires going forward as we continue to execute on specific actions to mitigate fire peril risk.

Within our workers' compensation line of business, we added to our loss reserves for prior accident years, primarily related to higher medical loss estimates on previously reported claims in our flagship state of Pennsylvania. These adjustments relate in large part to medical developments requiring longer treatments within individual cases, as we continue to see relatively stable medical inflation trends. Both commercial auto and commercial multi-peril lines experienced favorable reserve development that essentially offset the workers' compensation development. We are closely monitoring our reserving activity across all lines of business and are continuing to analyze the underlying factors that drove the unusual increase in workers' comp reserves.

Drilling down into loss trends for commercial auto, we believe the post-pandemic increases in claims frequency have abated and have noted moderation in auto physical damage severity increases as well. Liability severity remained generally in-line with historical levels. For commercial multi-peril, overall severity appears to be moderating, and favorable frequency trends continue. We are continuing to see upward pressure on liability severity trends, but that increase has been partially offset by favorable frequency trends for this line.

We are continuing to execute our offensive strategy in Commercial Lines, and we are pleased that our small business initiatives continue to gain traction. We expect to see further improvements in our straight through processing and hit rates on our new and improved small commercial products and service offerings going forward.

Shifting to our personal lines business segment – we achieved a 12.1% increase in net premiums written for the second quarter, primarily driven by a continuation of aggressive premium rate increases, coupled with strong policy retention. Personal auto and homeowners rate and exposure increases were 13.4% and 16.3%, respectively, for the current quarter.

We are now seeing earned rate increases related to responsive actions we took beginning as early as 2022. Earned rate increase levels are now exceeding loss cost trends, resulting in margin expansion for the personal lines segment. Our strategy remains to accelerate our return to profitability by actively controlling new business volume, which led to a 3.7% decline in policies in force compared to a year ago and a 2.3% decline from year-end 2023.

Policyholders are accepting higher renewal premiums, with our real retention remaining strong and consistent at 89.1% for the quarter. Premium retention also continued to be very strong at 104.7% for the quarter, again driven by rate increases in all states.

The personal auto loss ratio improved by 6.5 percentage points from the prior-year period, driven by core loss ratio improvement and a continuation of favorable prior year reserve development that contributed to a profitable 95.6% statutory combined ratio for the quarter. Similar to commercial auto, we are seeing moderating increases in auto physical damage severity, as used car prices and parts prices have begun to level off. Claim frequency trends have shifted from post-pandemic increases to moderate decreases. Furthermore, liability claim severity remained relatively stable during the current quarter.

The homeowners loss ratio deteriorated by nearly 4 percentage points, due to the unusually active tornado and hail season mentioned earlier, while non-weather trends continue to be largely in check. The statutory combined ratio for the quarter was 103.1%, with no impact from prior year reserve development. We are making solid progress in diversifying the geographic spread of risk in our property book, reducing exposures by 8.8% in geographies we have identified as more prone to severe weather and growing modestly in other areas we view as less weather prone.

We were pleased to see the improvement in our personal lines underwriting results due to many strategic actions we have taken across the portfolio, and we remain confident in our ability to maintain that positive momentum as we continue to execute on our strategies. With that, I will turn the call over to Dan DeLamater. Dan?

Dan Delamater – Chief Operating Officer

Thank you Jeff. As we assess our operational performance in the first half of the year, I will first and foremost provide an update on our expense reduction initiative discussed in previous calls. For the second quarter, we operated at an expense ratio of 31.9% which compares favorably to our quarterly expense ratio of 34.2% for the second quarter of 2023. We are pleased to recognize significant improvement, and we are now operating, mid-year, at an expense ratio of 33.8% through June 30th. This compares favorably to our expense ratio of 35.3% through the first half of 2023. These expense reductions are even more noteworthy considering we are realizing the peak expense impact of Project Nautilus, our systems modernization project, in 2024.

Through multiple targeted initiatives across every department in the organization, we are clearly on pace toward our expectation to reduce our expense ratio by one full point in 2024 and two points by the end of 2025. As stated before, these initiatives range from the reduction of our regional footprint from six operating regions to four, changes to our underwriting report strategy in Personal Lines comparative raters, use of analytics to improve underwriting report strategies in Commercial Lines, the implementation of a credit card surcharge to offset the increased costs of credit card payments by our policyholders, revisions to agency incentive programs to ensure they align with our own corporate profitability, reductions in commissions paid for mono-line homeowner policies to recognize the challenges of that line of business, targeted reductions in staff, hiring restrictions for many open positions across the company, and more.

I am proud of our leadership and colleagues across Donegal for the commitment and resilience they have shown. Several of these initiatives are difficult. But this is a serious effort and has full visibility across the company. And for every high profile initiative, there are dozens of smaller ones that all contribute to meaningful and sustainable expense improvement. We recognize the acute need for improvement in 2024 and 2025 to offset the peak expense years of our Nautilus infrastructure project. We also recognize the need for broader efficiencies and long-lasting expense improvement to contribute to our operating profitability.

Aside from our expense initiative, we also continue to work through our state strategy initiatives that define our product mix, rate strategy, marketing strategy, and growth objectives in every state and line of business where we write. These are especially important as we underwrite property books in weather-prone states, but they also help steer our regional marketing & underwriting teams, product teams, and national accounts team toward appropriate product mix and appropriate growth plans in all lines and classes. Our teams are aligned and highly engaged, and our monthly portfolio meetings provide transparency and accountability toward state-by-state objectives. As a matter of fact, we believe that these efforts helped us significantly mitigate exposure to Midwestern storms in May and New Mexico wildfires in June. While this work is not complete we are encouraged by the achievements already recognized.

While the first half of 2024 wasn't without challenge, we believe it sets a solid foundation and provides ample opportunity in the second half of the year. We will continue to obtain rate to offset inflation, large loss activity, social inflation, and claims costs generally; and we will continue in our expense reduction efforts. Executing on both of these are paramount to the achievement of sustained excellent financial performance.

For additional insight into our investment results, I'll now turn it over to Tony.

Tony Viozzi – Chief Investment Officer

Thanks, Dan. In our ongoing effort to preserve and expand our capital, our investment approach remains conservatively opportunistic. We are continuing to buy high-quality securities while taking advantage of historically high reinvestment rates that we expect will provide ongoing strength in our investment portfolio.

During the second quarter of 2024, net investment income increased 9.0% from the prior-year quarter to $11.1 million. The average tax-equivalent yield for the quarter was 3.40%, up from 3.21% for the second quarter of 2023. Market interest rates continue to be favorable, and we continue to invest portfolio cash flow into much higher-yielding bonds.

During the quarter, we continued our move out of tax-exempt municipal bonds and shifted into higher spread products, such as corporate debt and fixed-rate mortgage-backed securities. We expect to increase our position in equities at a conservative pace as market opportunities provide entry points. While still at a modestly conservative equity allocation, we have increased our equity position 25% year-to-date.

Net investment gains for the second quarter of 2024 were approximately $700,000, compared to $2.5 million in the prior year period. These gains were primarily unrealized gains within our equity portfolio for both periods. We will continue to selectively modify our portfolio allocations in response to market trends and conditions moving forward.

Overall, our average reinvestment rate of 5.76% during the second quarter represented a 142 basis point improvement over the bond cash flow during the quarter.

As of June 30, 2024, our book value per share was $14.48, a 9-cent increase compared to $14.39 as of December 31, 2023. The increase in book value was driven by investment income and gains that were partially offset by a net underwriting loss, declared cash dividends and modest net unrealized losses in our available-for-sale bond portfolio during the first half of 2024.

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 various initiatives are beginning to generate improvements in our underlying results, and our entire team remains focused on successful execution to achieve sustained excellent financial results. I am proud of our team's efforts and the progress we have made to date, and we look forward to providing further updates in our next quarterly call.

I'll now turn the call back to Karin to moderate our question and answer session.

Question and Answer Session:

Karin Daly – Vice President, The Equity Group Inc.

Thank you, Kevin. In advance of today's call, we requested and received questions from interested parties, and while we answered many of the questions within management's prepared remarks, we will address a few of the questions directly. The first question relates to premium growth:

Q: How should we be thinking about growth by line in commercial? More specifically, what sort of trajectory would you like to see for commercial auto and workers' compensation moving forward?

A: This is Jeff Hay – I can take that one. We are and expect to continue to be an all-lines account writer. And, when we write an account, we ask our agents for the opportunity to write all of the policies within that account that fit our underwriting appetite. So, from an exposure or policy count basis, we expect similar growth rates across lines of business in commercial lines. The premium growth variance between lines will largely be driven by market rate dynamics. For example, we expect to continue to see challenges in workers' comp rates due to bureau-mandated reductions, but we do expect positive rate trends for the commercial multi-peril and commercial auto lines. We are pushing for outsized growth in Small Commercial, as I mentioned in previous calls, and as a result, we expect to see outsized growth in BOP package policies relative to middle market CPP policies as our Small Commercial strategy gains momentum.

Q: The next question relates to personal lines - can you quantify the increasing percentage of auto policies written on a 6-month basis, compared to 12 months ago?

A: Jeff Hay here again - We now write 6-month policies only for all new business policies for personal auto, but we continue to renew our legacy book on the same terms as they were originally written, with most of those being 12-month policies, to limit disruption within that seasoned book of business. Over the past year, our mix of terms within our auto book has shifted from 28% being six-month policies to 40% being six-month policies now. We expect that mix will continue shifting naturally over the next several years, which is beneficial because a higher percentage of six-month policies allows us to increase the speed at which we can earn rate changes to more quickly improve margins. Having said that, we do not have any long-term targets for shifting the book, as we do desire to retain as much of our profitable legacy book as possible and will convert most of those policies on 12-month terms.

Q: Thank you, Jeff. The next question relates to reserving - can you provide additional color on the moving pieces on reserve development this quarter?

A: This is Jeff Miller - Specific line of business detail for the second quarter of 2024 included favorable development of $3 million for commercial auto, $1.6 million for personal auto, offset by unfavorable development of $4.7 million for workers' compensation. As Jeff Hay shared earlier, we attribute the unfavorable development in workers' compensation to higher-than-expected severity for a relatively small number of previously reported losses, primarily in accident years 2022 and 2023, but

also spread across older accident years. That development added 17.4 percentage points to the current quarter loss ratio for the workers' compensation line of business.

Q: Thank you, Jeff. The final question relates to our investments - can you provide more details on the make-up of your mortgage-backed securities portfolio? Can you split it between Commercial vs. Residential, or any details on geographical splits?

A: This is Tony - Our MBS portfolio consists almost exclusively of fixed rate agency residential mortgages. We typically buy large major pools with a diversified geographical exposure and avoid states such as NY, FL, and CA when possible.

Karin Daly – Vice President, The Equity Group Inc

Thank you, Tony. If there are any additional questions, please feel free to reach out to us. This now concludes the Donegal Group second quarter 2024 earnings webcast. Thank you and have a great day.