Donegal Group Inc. (DGICA; DGICB)

Q1 2023 Earnings Call Transcript - FINAL

April 27, 2023

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 2023 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; 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 begin the call with an update on several strategic initiatives before turning it over to Jeff Miller for a review of our quarterly financial results. Jeff Hay will then provide details about our segment performance and action plans for the remainder of 2023, followed by Tony Viozzi who will provide an investment update.

I reported in our year-end earnings call just a couple months ago that we successfully launched new personal lines products in 9 of the ten states where we offer personal lines during 2022, and we were awaiting approvals of our product filings from regulatory authorities in Michigan. I am pleased to report that we have now received those approvals and are preparing to implement the new products in Michigan, thus completing the ten-state rollout. We are actively monitoring our personal lines new business growth, which has exceeded our expectations. Jeff Hay will provide more commentary about the actions we are taking to control the pace of our growth and ensure rate adequacy in light of ongoing inflationary pressures on loss costs.

We successfully deployed our third major software release as planned at the end of March. This release included a new businessowners product and modernized commercial auto and umbrella products with new advanced pricing models and enhanced straight-through-processing capabilities. These products and systems will allow us to focus on the small commercial market as our primary source of profitable growth over the next few years. The products are currently available for new business in three states for policies effective beginning in June, and we are on track to implement them in our 19 remaining states in the third quarter. We also plan to begin converting our legacy policies on the new platform in the fourth quarter of 2023. That renewal conversion process will continue throughout 2024. Our commercial lines footprint will include 22 states after the completion of strategic actions that Jeff Hay will discuss further in a few moments.

Looking ahead to releases remaining in our systems modernization project, the next major commercial lines release will include development of a new commercial lines package policy and migration of our remaining commercial products to the new platform. Considering the significant business resources dedicated to the ongoing rollout and monitoring of the recent commercial lines release and the renewal conversion activities during the remainder of 2023, we expect to begin working on the next commercial lines release in early 2024.

In the meantime, the project team is now focused on migrating our dwelling fire product and beginning the process of preparing to migrate our remaining legacy personal lines products to the new platform as they renew. Due to the relatively short timeframe before kicking off the next major commercial lines release, we have limited the scope of this interim release to development of a dwelling fire product in a base state and converting legacy homeowners policies in Virginia, where required regulatory changes led us to prioritize that migration. We are currently planning to continue personal lines legacy conversion activities on a parallel track with the commercial lines release in 2024 as project resources allow.

I am very proud of the Donegal team that has shown remarkable resilience and perseverance over the past five years. They have been working to develop and implement new systems, products, reporting systems and advancements in data analytics. These initiatives have transformed our business processes and refined our underwriting and pricing sophistication and capabilities. While there is more to accomplish over the next few years, I'm looking forward to seeing favorable results from all of the team's efforts. We expect to begin realizing the return on our significant investments in talent and technology through improved operating results over time.

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

Jeff Miller – Chief Financial Officer

Thank you Kevin.

Net premiums earned increased 8% to $215.2 million for the first quarter of 2023. Net premiums written grew by 8.6%, with premium rate increases and continuing strong retention contributing to growth across our lines of business despite planned attrition in several regions where we are working to improve profitability.

The combined ratio of 101.2% for the first quarter of 2023 was higher than we targeted, due primarily to a 5 percentage-point increase in the loss ratio compared to the first quarter of 2022. The core loss ratio decreased by over 2 percentage points from the prior-year quarter, but that improvement was more than offset by the impact of higher weather-related and large fire losses as well as lower net favorable reserve development from prior-year losses.

Weather-related losses were $14.1 million, or 6.5 percentage points of the loss ratio for the first quarter of 2023, compared to $8 million, or 4 percentage points for the first quarter of 2022. Homeowners impact was $7.3 million, and commercial property impact was $5.3 million, with the remainder in the auto lines. We incurred close to $4 million in losses from severe wind and hail storm activity on March 31st. As a result, the total first quarter weather claim impact was higher than the previous five-year average for the first quarter of 4.8 percentage points.

Large fire losses (which we define as over $50,000 in damages) contributed 5.1 percentage points to our first quarter of 2023 loss ratio, slightly higher than 4.8 percentage points for the prior-year quarter, with an increase in commercial fire severity due in part to our higher per-risk reinsurance retention for 2023 as well as inflationary repair cost increases.

Our insurance subsidiaries experienced net favorable development of reserves for losses incurred in prior accident years of $8.3 million, or a 3.9 percentage point reduction in the loss ratio for the first quarter of 2023, compared to $16.5 million, or an 8.3 percentage point reduction in the loss ratio for the period-year quarter. Favorable development was primarily related to lower-than-expected claim emergence for accident years 2020 and 2021, with approximately $3.8 million in commercial automobile, $3.6 million in workers' compensation and $800,000 in commercial multi-peril.

The expense ratio was 36.4% for the first quarter of 2023, with an increase in technology systems-related expenses primarily driving the increase over the prior-year quarter. The quarterly expense ratio was slightly above our expected run rate for the full year. Premium writings are seasonably higher in the first quarter of the year, when many of our commercial policies renew. As a result, certain non-deferrable variable costs are incurred in the first quarter, while the premium writings will be earned throughout the remainder of the year.

In summary, the underwriting loss we incurred for the first quarter of 2023 was more than offset by $9.4 million of investment income, resulting in after-tax net income of $5.2 million, which declined from $13.1 million for the first quarter of 2022 when our results benefited from milder weather conditions and unusually favorable loss reserve development.

With that, I will turn the call over to Jeff Hay to provide more details about our commercial and personal lines segment results.

Jeff Hay – Chief Underwriting Officer

Thanks, Jeff. Overarching, we have remained focused on our long-term profit objectives by taking the actions to improve our underwriting performance and responding to macro-economic trends that have continued to have an impact on our results. As we continue to take aggressive pricing actions and implement go-forward strategic initiatives, we expect to generate more favorable underwriting performance in the future.

Starting with our commercial lines specifically, we are diligently pursuing profitable growth while also striving to improve profitability in certain identified geographies by implementing significant rate increases in areas and segments of our book that are most challenged. Rate increases across commercial lines of business averaged 11%, excluding workers' compensation, during the first quarter. Premium retention remained strong at just over 90 percent, despite our intentional pullback in areas targeted for profit improvement. Our claim severity trends reflect ongoing macroeconomic trends and the impact of higher costs of labor as well as parts and materials, especially in Commercial Property and Automobile Physical Damage.

Our commercial multi-peril line of business was impacted by several fire losses in the quarter, contributing 6.1 points to the first quarter commercial lines loss ratio. While it is the nature of our business to insure for fire losses, we have implemented a number of specific actions and underwriting guideline changes that are designed to reduce the likelihood and frequency of large fire occurrences.

Weather-related losses in the quarter contributed 4.8 percentage points to the commercial lines loss ratio, up 3.2% in the same period last year. These losses were primarily driven by three storms. In late February, ice and winter storms tore through Michigan, leaving our insureds without power for several days. In the first week of March, a wind event impacted Pennsylvania, Tennessee, Ohio and Indiana. Then, on the last day of March, a wind and hail event caused losses that we estimated to be approximately $4 million. While that storm event impacted our regions for the first two days of April, we expect minimal impact to our second quarter results as the March 31 impact was close to our intercompany catastrophe retention with Donegal Mutual.

Excluding the large fire and weather-related losses, however, and the favorable reserve development Jeff Miller discussed earlier, our core loss ratio in every commercial line of business has begun to reflect the positive impact of the rate and underwriting actions we have taken over the past 12 to 18 months, improving more than 200 basis points over the prior-year first quarter for the commercial segment as a whole. In addition to ongoing rate increases in commercial lines, we continued execution on several profit improvement initiatives that I will quickly summarize now:

- First, we announced our decision to exit the commercial lines business in the states of Georgia and Alabama due to the profitability challenges we've had in those states. We will continue to be a viable market in Georgia for Personal Lines, as this is a strategic commercial lines move only. We are no longer writing new commercial business in these two states and will begin non-renewing existing accounts beginning in July.
- Second, we are also exiting or re-underwriting several non-strategic or profit-challenged classes of business.
- Third, we're enhancing the data we provide to our underwriters to assist them in underwriting and pricing catastrophe-exposed properties.
- And finally, we are expanding the use of advance analytics in our new business and renewal decisions. For example, as I mentioned in prior quarters, we introduced a new pricing guidance model for commercial package policies earlier in the first quarter.

Kevin mentioned the planned rollout of a new agency-facing portal with enhanced small commercial products and straight-through-processing capabilities. This enhancement was two years in the making, and we believe that it will significantly improve our ability to compete for quality accounts in the small commercial market. We expect the rollout to be completed in the third quarter of this year, and we look forward to engaging with our agents to grow the small commercial segment of our business.

Turning to Personal lines, the double-digit premium growth during the first quarter reflected new premium growth that exceeded our expectations as well as rate increases that contributed to 100% premium retention. Our agents have re-engaged with us since we introduced new personal lines products in 9 of our 10 personal lines states. Having recently received regulatory approval for our new products in Michigan, our tenth and final state for the rollout, we expect to begin issuing policies in that state in June. While we are pleased with the successful launch of our new product suite, we are taking actions to control the pace of our growth as we continue to monitor our pricing relative to current loss trends.

While the personal lines loss ratio was elevated for the first quarter, it was generally in-line with our expectations due to our projected timeline for rate increases to be reflected in our net earned premium. Compared to the prior-

year quarter, large fire losses within the homeowners line of business moderated significantly from both a frequency perspective, declining more than 50% and contributing only 3.5 points to the personal lines loss ratio. On the other hand, weather-related losses contributed 9.2 percentage points to the loss ratio for the first quarter, compared to 5.3% in the prior year period. While elevated compared to the prior-year quarter, we fared relatively well considering the severity of weather events during the quarter. We are continuing to manage our geographic spread of risk and are implementing several tools to help our underwriters manage concentrations and ensure appropriate risk-adjusted pricing in weather-prone areas.

We have accelerated planned personal lines rate increases for 2023, both in our new and legacy personal lines products. Filed Homeowners rate increases averaged 9.5% for the first quarter, and we continue to automatically increase insured values north of 8% at renewal. Overall achieved rate and exposure impact for the first quarter surpassed 11%. Achieved Personal Automobile rate increases for the first quarter averaged 5%, but filed rate increases with future effective dates were higher, averaging 13%. In both lines of business, we plan to take additional rate throughout the remainder of the year. And similar to the comments I made earlier about our commercial lines business, we are beginning to see favorable impact of our rate and underwriting actions on our personal lines core loss ratio, with nearly a 200-basis point improvement compared to the prior-year quarter, although the improvement was primarily from our Homeowners line of business. As the year progresses, we will continue to fine-tune our state strategies. We are refining the granularity of our strategies to a sub-state level with the goal of achieving a more balanced book of business, greater spread of risk and, ultimately, improving our profitability.

At this time, I'd like to turn it over to Tony Viozzi for an update of our investments portfolio.

Tony Viozzi – Chief Investment Officer

Thank you, Jeff. We are pleased to report another quarter of higher investment income, driven by an increase in average investment yield. The first quarter of 2023 was our fifth consecutive quarter with increased portfolio rates, with the quarterly average tax equivalent yield of 3.00%, up 42 basis points from the prior-year quarter. Rising market rates and attractive spreads in certain fixed-income sectors have contributed to our investment performance. The average reinvestment yield of 4.91% was approximately 133 basis points higher than the yield of bonds that were called or matured in the quarter.

Net investment income increased 20% to $9.4 million during the first quarter. The increase was the result of higher cash equivalent yields and higher market reinvestment rates as we made strategic allocations into U.S. Treasuries and wider-spread agency debt and mortgage-backed securities. We continue to expect improvement in our investment income throughout 2023, with the assumption that short-term and fixed income rates remain elevated.

Net investment losses were $331 thousand in the quarter, compared to $76 thousand in the prior-year quarter. While we maintain a modest percentage of our portfolio in equity securities, our equity performance was in-line with the S&P Index. We consciously decreased our equity exposure in late 2022 and will continue to have a lower emphasis on equities through 2023 based on our expectation for volatility in the equity markets. We continue to maintain a conservative investment approach and given uncertainties in the macro-environment, we believe our portfolio is well positioned.

We had a $4 million increase in our after-tax available-for-sale bond market value, contributing a 13 cent improvement in book value per share. Coupled with our operating results in the first three months, book value per share increased 1.5% to $15.01 compared to $14.79 at December 31, 2022.

I will now turn it back to Kevin.

Kevin Burke – President and Chief Executive Officer

Thanks Tony. While the first quarter earnings did not meet our targeted profitability, we are pleased with the solid execution of various strategic initiatives and the favorable impacts we are beginning to recognize. We remain confident that the transformational improvements and enhancements we have implemented and are continuing to implement will lead to improved results and enhanced shareholder value in the years ahead. Thank you for your continued interest and support, and I'll now turn it 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, as appropriate. If there are any additional questions, please feel free to reach out to us. This now concludes our first quarter 2023 earnings webcast. You may now disconnect.