Donegal Group, Inc. (DGICA; DGICB)

Q1 2022 Earnings Call

April 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 First 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 Kevin Burke. Kevin?

Kevin Burke – President and Chief Executive Officer

Thank you Karin, and welcome everyone. I will focus my remarks on the progress we have made on several strategic initiatives. Jeff Miller will then provide details on our key financial results for the first quarter of 2022. Jeff Hay will then highlight our commercial and personal lines segment results; followed by Tony Viozzi with an update of our investment portfolio. I will then return for closing remarks before we address questions that were submitted to us in advance.

We continue to make solid progress in modernizing our systems and transforming our business. The new operating platform we have implemented for workers' compensation and our new personal lines products increases our ability to be nimble and pivot quickly to respond to changes in the marketplace. Leveraging the new technology will continue to provide opportunities for increased efficiencies and customer experience enhancements, and we look forward to bringing additional products on to the new platform over the next few years.

The successful launch of our new personal lines products in six states is a great example of how the new systems are enabling our ongoing business transformation. While we remain diligent in our strategic emphasis of commercial lines and emphasizing the growth, we are pleased to report modest growth in personal lines premiums for the first time since the onset of our strategic plan to restore personal lines profitability starting back in 2018.

In addition to the roll-out of new products with significant enhancements on our pricing segmentation and capabilities, we launched a new personal lines agency portal that integrates third-party data providers to pre-fill information and it gives us additional underwriting insights and further enhances the user experience of our agents. We view our strong relationships with independent agents as a key component to our continued success. Whether we are working directly with an independent agency or building relationships with large national agency groups, our mission remains the same – to deliver real value to our agents by being highly accessible and responsive to them. Protecting and building upon the Donegal franchise value for our agents is and will always be a focal point for us. Part of that mission is finding ways we can help our agents and agency groups grow their books of business with us for our mutual success. We have added dedicated team members to work with national agency group leaders and their affiliate agents to further enhance our opportunities for profitable growth in the years ahead.

Since implementing our Enterprise Analytics unit back in 2019, we have made excellent progress in enhancing our capabilities to capture and utilize data in order to improve our operating results and stay attuned to market developments. The exponential increase in our use of data has truly changed our operating routines and has greatly enhanced our ability to forecast the future impact of actions we have implemented to support our strategic and business plans. We will continue to add expertise and make capital expenditures as required to further leverage data to help us effectively navigate challenging economic conditions and drive further improvements in our overall operating results.

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

Jeff Miller – Chief Financial Officer

Thank you, Kevin. We are pleased with the solid premium growth and underwriting results we achieved in the first quarter of 2022. For the first quarter, net premiums earned grew by 6.4% to $199 million. I'd like to remind you that starting in January 2021, we began to include the commercial business from our Mountain States region in the underwriting pool, and those additional premium writings in 2021 will contribute to increases in net earned premiums throughout 2022. The overall combined ratio was 95.8% for the first quarter of 2022, compared to 98.5% in the prior-year quarter. The solid underwriting results reflected continued net favorable development of reserves for losses incurred in prior accident years, lower weather-related loss activity compared to our five-year historical average for the first quarter, and a lower quarterly impact of large fire losses than we experienced on average during 2021. These favorable trends were partially offset by inflationary pressures on loss costs in certain lines of business.

There were no unusually severe weather events or conditions in our operating regions during the first quarter of 2022, with weather-related losses totaling $8 million, or approximately $2 million lower than the previous 5-year first quarter run rate, and representing 4 percentage points of the loss ratio. The non-weather loss ratio improved 480 basis points, reflecting a lower incidence of large fire losses and favorable prior-year loss reserve development during the period. Fire losses over $50,000 totaled $9.6 million, or 4.8 points of the loss ratio, compared to $10.3 million, or 5.5 points of the loss ratio for the prior-year quarter. The decrease was largely due to a lower frequency of large commercial fires, as we had only two fire claims in excess of $500,000, compared to eight in the prior-year quarter. Conversely, there were six homeowners fire claims in excess of $500,000 in the first quarter of 2022, compared to only one in the prior-year quarter.

Net development of reserves for losses incurred in prior accident years of $16.5 million reduced the loss ratio for the first quarter of 2022 by 8.3 points, compared to $8.2 million, or 4.4 points of the loss ratio for the first quarter of 2021. Our insurance subsidiaries experienced favorable development in all lines of business in the first quarter of 2022, which has been a consistent trend over the past several years. We were especially pleased that we experienced $6.1 million of favorable development in our commercial auto line of business, a line of that we have been diligently working to build up reserves and restore rate adequacy for several years. That favorable development generally resulted from lower-than-expected emergence of claim severity than we projected for accident years 2021 and 2020. While the low incidence of severe losses and impact of favorable reserve development drove the quarterly commercial auto combined ratio to a lower level than we can reasonably expect to sustain, we believe our commercial auto performance will continue to reflect the benefit of earned premium rate increases and underwriting actions we have taken to improve the profitability of that line over the past several years. We also had $3.6 million of favorable development in personal auto, which was primarily in the 2020 accident year when the pandemic conditions disrupted our historical loss patterns. The majority of the remaining favorable development was spread across commercial multi-peril, workers compensation and other commercial lines. We increased our actuarially determined reserves during the quarter to reflect additional exposures, particularly those related to the additional Mountain States exposures included in the underwriting pool.

The expense ratio was 35.8% for the first quarter of 2022, compared to 34.1% for the first quarter of 2021. We primarily attribute the expense ratio increase to higher underwriting-based incentives for our agents and employees, and technology systems-related expenses associated with our ongoing systems modernization project.

From a capital perspective, we did not declare any dividends in the first quarter of 2022, which follows our historical practice. We announced during our annual stockholder meeting on April 21st that our board of directors approved a 3.1% increase in our quarterly Class A dividend rate to 16.5 cents per share and a 3.5% increase in our quarterly Class B dividend rate to 14.75 cents per share, and we declared quarterly dividends payable on May 16 to stockholders of record on May 2.

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

Thanks Jeff and it's a pleasure to be on the call today. So I will start with commercial lines where our net premiums written increased 1.7% overall. We experienced growth in all of our lines of business except for workers' compensation, where the ongoing mandated rate reductions that the industry is experiencing continued to reduce our premiums as well. And while the 1.7% growth rate is modest, we did achieve our written premium goals for the quarter, primarily as a result of both improved rate increases and strong retention rates. Our strategy was to deliberately slow the writing of new business compared to the first quarter of 2021 to give us time to increase premium rates to maintain pace with inflationary increases in loss costs that we are experiencing. However, our new business growth was even lower than we projected. We are receiving some agency market feedback that general shopping activity is down in the market, as well as talent shortages within the agency plants themselves being particularly impacting agents' abilities to pursue new business. We saw higher new business volume later in the quarter and we're optimistic about the improving trends.

More than offsetting the shortfall in new business, premium retention remained strong, holding within the low-to-mid 90's range with renewal rate increases averaging 8.2% excluding the workers' compensation line of business. The achieved increases were

fairly consistent across the lines of businesses and policy-size bands. Also, beginning in 2022, we are refining our rate strategies to deliver enhanced renewal pricing guidance to our underwriters, allowing us to pursue higher rate increases on the most underpriced accounts to further improve margins. We began this approach in our Commercial Auto line of business and expect to roll out this enhanced guidance for other commercial lines of business throughout the remainder of the year.

The all-in commercial lines statutory combined ratio for the first quarter of 2022 was 93.5%, that compares to 99.3% for the prior-year quarter. Despite the improved loss ratio in each major line of business within commercial lines, again due to relatively favorable weather and the lack of multi-million-dollar shock losses during the quarter, inflation does continue to impact our results. Claim severity increased compared to last year for nearly every major line of business, and we are seeing increases in the costs, as well as the duration of repairs, due to supply and labor shortages in the marketplace. Claim frequency was largely in-line with historical averages, with the exception of Commercial Auto, where frequency continued to revert closer to pre-pandemic levels. Because of these trends, we will continue to execute our pricing and rate strategies throughout the remainder of the year. I did want to call out the commercial auto combined ratio, which was unusually favorable at 89.1%, that's reflecting a low incidence of severe losses and the impact of favorable reserve development that reduced the loss ratio for that line of business by 15 points. While it would be unreasonable to expect to sustain that combined ratio going forward, we believe our commercial auto performance will continue to reflect the benefit of earned premium rate increases and various strategic actions we implemented over the past several years to improve the profitability of that line of business.

So digging somewhat deeper into commercial lines, we are taking a number of actions as part of state-specific strategies for each line of business. After a careful evaluation, we developed a commercial lines strategic posture for each state, ranging from a strong pursuit of growth to aggressive profit improvement, where needed. Tactical plans were then developed for 2022 based on the strategic posture we assigned to each state. Early execution of these strategies has been successful thus far in 2022, with states we identified as attractive markets growing at more than twice the overall segment growth rate and generating lower-than-average loss ratios, versus those states we identified for profit improvement shrinking as much as double-digit percentages and showing significant loss ratio improvement to date. While we believe these strategic geographic shifts within our overall commercial portfolio will help accelerate and sustain favorable loss results, we continue to promote growth in our targeted markets and reduce exposures in underperforming markets. To further support those strategic efforts, we recently implemented a new operating structure in commercial lines with two components that I would like to share with you:

- We formulated a new corporate underwriting function to focus more intently on the underwriting of larger accounts and specific industries. This group of specific industry and subject matter experts will support our underwriters in evaluating more complex risks; Secondly,
- We are in the process of centralizing of our underwriting operational support teams to drive efficiency & effectiveness in order to take full advantage of the automation opportunities provided by our new policy administration system.

And as we announced in mid-April, we have hired Matt Hudnall as our new Senior Vice President & Head of Commercial Lines to lead this new operating structure. Matt has a breadth of experience that will bring new perspectives to our already successful commercial lines operation; and he has a proven track record of driving transformative change with a focus on independent agency relationships and customer experience.

Moving on to personal lines, overall premium growth was slightly positive in the quarter for the first time in recent memory, and we were pleased with the 94.8% combined ratio for the segment. Thanks to the successful launch of our new product suite in Indiana, Ohio, and our flagship state, Pennsylvania, in late 2021 and early 2022, we significantly increased new business production for those states for the first quarter of 2022 compared to the same period last year. We have launched these new products in three additional states for policies effective in the second quarter and, barring any regulatory approval delays, will roll them out in the four remaining states later this year.

We continue the rollout of the new personal lines product suite, we are also diligently maintaining the profitability of our legacy renewal book of business. Policy retention averaged near 90 percent across both personal auto and home, and we achieved rate increases averaging nearly 6% to help offset the inflationary pressures on loss costs. We have at least two planned rate change revisions during 2022 in each of the ten states where we are offering personal lines and expect the rate to build throughout the year.

Our personal auto combined ratio of 93.5% was favorable but did benefit from 8.4 points of favorable development. Our homeowners combined ratio of 108% reflected a 12.6-point increase in the loss ratio from large fire losses compared to the first quarter of 2021. It is imperative that we continue to obtain rate increases to address the increases in inflation-driven claim severity we are experiencing as well as the increases in personal auto claim frequency that is returning to pre-pandemic levels. To sum up for Personal Lines, we are closely monitoring the market success and results of our new personal lines products, as well as working to ensure overall adequacy for our legacy personal lines book of business.

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

Tony Viozzi – Chief Investment Officer

Thanks Jeff. We continue to maintain a large percentage of high-quality fixed-income securities in our investment portfolio, representing approximately 95% of the $1.3 billion dollars of invested assets as of March 31, 2022. We have strategically increased allocations in corporate and municipal debt over the last two quarters to take advantage of rising market yields and widening credit spreads. More recently, we have also been adding assets to the mortgage-backed portfolio and reducing equity exposure in what we feel will be a more volatile market in the short term. We expect these strategic investment strategies, coupled with our laddered holdings, to enhance our cash flow for reinvestment opportunities as market bond rates stabilize or continue to rise.

Net investment income increased 4.6% from the first quarter of 2021 to $7.9 million. Investing new money from premium growth and profitable operating results has allowed us to consistently maintain and increase our investment income. While our average tax-equivalent yield held steady in the first quarter, our average reinvestment rate exceeded the rate we were receiving on maturing assets for the first time in several years.

Net investment losses of $76,000 were modest compared to net investment gains of $2.5 million for the prior-year quarter. Gains and losses in both periods were primarily related to unrealized gains or losses in the fair value of the relatively modest equity portfolio we held at the end of the respective periods.

Based on carrying values at year-end 2021, we classified 44% of the bond portfolio as available for sale. We adjust the carrying value of available-for-sale bonds to market value at the end of each quarter and record the unrealized gain or loss as an adjustment to our stockholders' equity. While the interest rate spike during the first quarter was beneficial to us in terms of reinvestment rates, it also resulted in a $20.6 million after-tax decline in the market value of the bond holdings, which equated to 65 cents per share. That decline more than offset the contribution of our favorable operating results, lowering book value per share from $16.95 at year-end 2021 to $16.72 at March 31, 2022.

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

Kevin Burke – President and Chief Executive Officer

Thanks, Tony. As a result of the investments we have made in technology, data analytics and the acquisition of new talent to further support our talented team of professionals, we are very encouraged by the path we are on. We are beginning to see the positive impact of many of the initiatives we have implemented, but we know our work is not complete. Our excitement about Donegal's prospects for the future fuels our drive and seeks further advancements and team engagement to successfully enhance profitability over time. We've never been in a better position to achieve our business goals, and we look forward to reporting on progress in future quarters. I want to thank our hardworking staff for the dedication they are demonstrating as we continue to make great strides in transforming our business. And thanks to you, our shareholders for your continued support throughout this time of transformation and great progress.

At this time, we'll ask Karin 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 Q1 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:

The first question we received relates to the inflationary impact on loss cost trends – how will Donegal's pricing strategy change in response to these trends? Jeff Hay, could you respond to this question?

Jeff Hay – Chief Underwriting Officer

Yes, Thank you for the question. We have changed our pricing strategy as a result of the record levels of inflation that we are experiencing. And we have close to doubled the rate achievement in the first quarter in our commercial lines of business and plan to continue with that strategy of balancing our rate achievement with our overall retention goals, and thus far, has been pretty successful in that endeavor. We are also providing guidance to our commercial underwriters on the accounts that we deem to be the most underpriced based on predictive analytics that we have done so we can push even harder for increased rates on those risks. Based on our analysis of rate indications, we believe we can achieve rate increases that will largely offset the inflation rate as those rate increases are earned overtime.

Separately, on the Personal Lines side, the timing of the implementation of our new product suite is actually allowing us manage our new business pricing separately from our renewal legacy book. While we are managing market dynamics through pricing segmentation adjustments within our new products, we can separately take larger rate increases across our renewal legacy book to combat these inflationary pressures while also maintaining high levels of retention for this segment overall. However, it will take some time for us to obtain the regulatory approvals and implement our rate plan during 2022, which will delay our achievement and overall earnings of rate adequacy in personal lines.

Karin Daly – Vice President, The Equity Group Inc.

Great, thank you. A follow-up to loss cost trends – this question relates to the shift in large fire losses from commercial to personal: were there any identifiers that suggest the uptick in homeowners large fire losses may become a longer-term issue within personal lines? Jeff Miller, any insights on that trend in the quarter?

Jeff Miller – Chief Financial Officer

Yes, I'll be glad to address that question. As we monitored the significant increase in large commercial fire losses during 2021, we commented in our calls that we were unable to identify any correlation or commonality in those fires. We were certainly pleased that the incidence of large commercial fires returned to a more normal range in the first quarter of 2022, as I mentioned in my prepared remarks, there were six homeowners fire claims in excess of $500,000 in the first quarter of 2022, compared to only one in the prior-year quarter. There really were no factors in those large homeowner losses that suggest there is a particular trend forming. We typically see a higher volume of homeowner fire losses in the first quarter when heating systems are in full use, but we have no reason to believe that trend will continue as the year progresses. The shift between lines was noteworthy, but in total, the number of large fires and the average severity were both generally in line with the first quarter of 2021.

Karin Daly – Vice President, The Equity Group Inc.

OK, Jeff Hay, I believe the next question is for you - premium growth plans: what are your specific plans to achieve profitable growth?

Jeff Hay – Chief Underwriting Officer

Sure, I can take that one. I will separate it our because he strategies vary between personal lines and commercial. For commercial lines, we are being very deliberate about our management of retention, new business, and rate in, hopefully, what is the short-term accelerated inflationary environment. Our lower levels of new business and moderate growth levels are very intentional while we manage rate levels in response to the inflationary dynamic.

In the longer term, we are building out the new corporate underwriting as a function to increase our underwriting specialization in specific industries, account sizes and lines of business, which will afford us take advantage of additional market opportunities down the road. The formation of our centralized underwriting operations team, that I previously mentioned in my prepared remarks, will also drive automation and efficiencies in our processes that will flow into the market through improved responsiveness to our agents and online bindability for our agents as well as improved pricing competitiveness in the market.

Now for our Personal Lines, our future growth is dependent on the success of the new product suite and the enabling technologies that support it on both the front and back ends, driving scalability in these lines of business. As I mentioned earlier, we are also managing the balance between the success of these new products with retention and rate adequacy levels of our renewal legacy book of business, and that will be a critical for the overall profitability for the personal lines division. Kevin talked earlier about our focus on building stronger relationships with the national agency groups, and many of the agents in these groups have large personal lines books of business. So we will see those growing relationships, we do see those as a source of profitable personal lines growth moving forward.

Karin Daly – Vice President, The Equity Group Inc.
The next question is regarding the expense ratio – it ticked up a bit quarter over quarter, what is the expected run-rate for expenses as technology improvements continue, and are you seeing other inflationary impacts such as wage inflation for the longer-term impacting expenses? Jeff Miller, I assume you'll take that one?

Jeff Miller – Chief Financial Officer
We have been providing updates on our major technology upgrade over the past few years. Expenses related to the technology systems-related expenses added about a full point to the first quarter of 2022 expense ratio, which is right where we projected it to be. That compared to half a point in the prior-year quarter. The other main driver of the increase was increased underwriting-based incentive accruals for agents and employees due to the more favorable loss ratio. As we have talked about in the past, there is a direct inverse relationship between our loss ratio and our expense ratio as a result of those underwriting-based incentive costs that vary depending on our profitability. The current quarter expense ratio was very consistent with past quarters when we had a similar loss ratio. A direct response to the question, we are not necessarily seeing a material impact of wage inflation on the expense ratio as of this point, but we continue to add talent and expertise to support our ongoing initiatives and increase our capabilities. As we look ahead to the next couple years, we are projecting an expense ratio between 34.5 and 35% as the run rate we expect over the next couple of years.

Karin Daly – Vice President, The Equity Group Inc.
Great, thank you for that insight. The final question related to the investment portfolio – how will you mitigate the market value impact from the bond portfolio moving forward if rates continue to rise? Tony, I will refer that one to you.

Tony Viozzi- Chief Investment Officer
Thank you Karin. At this point, we are not seeing projections for higher rates on the 10-year US Treasury. With that said, we continue to classify longer-term investments as held-to-maturity to mitigate the potential for market value adjustments should rates rise farther. At the same time, we are building a strong cash flowing portfolio on the shorter-end of the curve so that we have funds available to reinvest as we anticipate a rise in short-term rates.

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 hope our commentary has been informative today and that you now have a sense of the many strategic and tactical initiatives we are working on to generate and sustain positive financial results. Thank you for joining us and have a good day.

Karin Daly – Vice President, The Equity Group Inc.

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