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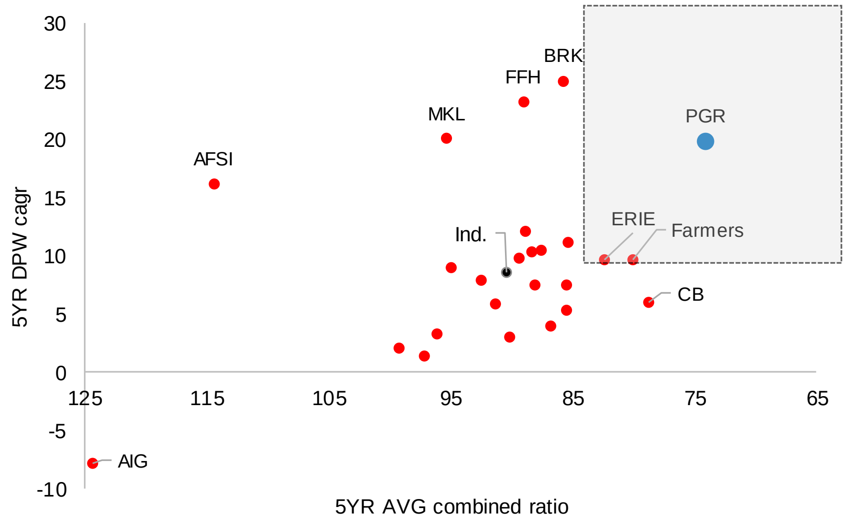
COMMERCIAL AUTO: THE PROGRESSIVE PROBLEM



Over the past few decades, **Progressive** has been at the heart of innovation and disruption in personal lines insurance. From the use of credit scoring in pricing models in the 1990s to being the first mover with telematics in the 2000s, the firm has used its competitive advantages in data analysis and pricing segmentation to capture massive market share in personal auto, which has grown from 4.2% in 1998 to 11% in 2018.

In turn, this growth has led to increasing advantages, from bigger and better data sets, a direct business with a large and growing moat in the form of its advertising budget and consumer brand, and a claims infrastructure that both better controls LAE and claim outcomes.

In short, the firm's competitive advantages have proved self-sustaining through increasing returns to scale as secular changes around big data have revolutionized the personal lines business.

In our view, similar secular forces are beginning to play out in **commercial auto**, and will likely lead to a similar disruption of the status quo over the next decade or so, with Progressive again at center stage.

Big data solutions naturally lend themselves better to high frequency, low severity insurance businesses with homogenous risks like auto. Commercial auto, with some similar characteristics in certain segments (away from large fleet trucking), is a natural extension of this. And as we note below, changes to federal laws on data logging appear to have accelerated this phenomenon by escalating the quantity and velocity of data and adaptation of telematics-style technology.

There are three factors we expect will drive both Progressive's growth and secular changes in commercial auto.

- The first is telematics and big data. As we note below, Progressive believes telematics data for commercial auto

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Progressive, Key Statistics

Market Cap ($mn)	**45,304**
Share price	**77.9**
MTD	**(3.8)%**
YTD	**29.1%**
1-YR	**17.5%**
Div Yield	**0.5%**
Price / Earnings	**14.1 x**
Price / Book	**3.5 x**
Price / Tangible Book	**3.7 x**

Source: S&P Global, Inside P&C

will be more predictive than its revolutionary Snapshot product in personal auto, with take-rates of ~50% in Direct and ahead of Personal in agency.

- The second is leveraging its extensive claims management infrastructure, giving it a competitive advantage on LAE costs, customer experience, and allowing it to bend the cost curve on pure loss costs.
- The third is leveraging its product distribution expertize to capture more small business on its direct platform, which is likely to become a bigger segment of the market due to demographic changes.

However, even outside of these secular factors, Progressive's monster growth is becoming harder to ignore as a contributing factor to market-wide dynamics.

Its premium growth in 2018 alone was comparable to the total premium of the eighth biggest writer of commercial auto premium in the US. Meanwhile its margins remain excellent, near the top of its peers. Details below.

We think there is a reasonable *prima facie* case to argue it may a factor driving an adverse selection cycle at peers.

Now this is likely an unprovable thesis as there are just too many macro-variables to be able to isolate it. But it fits the pattern of Progressive's substantial growth, the margins it has achieved, and the persistent trouble many rival companies have had catching up to loss costs despite consistent and sizeable price increases for many consecutive years.

Finally as we outline below, the firm is only just getting started. Though already #1 in the line, it is targeting more segments where it is underpenetrated, leveraging its scale advantage in claims handling, and using its substantial advantages in telematics and data processing to win share.

Over time, we expect similar technology transfer from the personal lines business to other areas of the commercial insurance value chain. And commercial auto remains the most interesting testing area for this thesis. Watch this space.

COMMERCIAL AUTO: PROGRESSIVE'S GROWTH PLAN

- ***Progressive aims to treble total addressable market in comm. auto***
- ***Captured 27% of 2018 increase in comm'l auto DWP***

During Progressive's Q2:19 earnings call, **Tricia Griffith, CEO**, highlighted the group's growth plans for its commercial lines segment. Progressive is expected to increase its commercial lines total addressable market by 3x, and will use its successful personal lines approach, using granular data-driven segmentation to achieve success in the business.

Progressive has a significant player in the commercial auto business for some time, consistently outgrowing the industry, and overtook Travelers to be the #1 market in 2015. On a GAAP basis, commercial lines account for just ~12% of the firm's net written premium, but over the last 4 years, it has increased its market share in commercial auto by 50%, all while maintaining attractive margins.

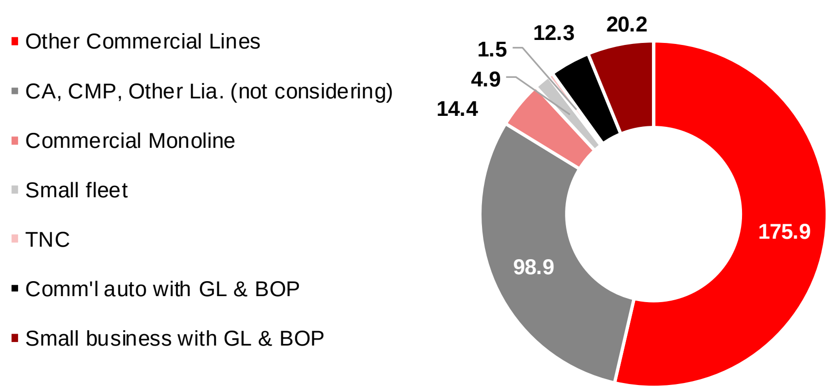
The commercial lines business is led by **John Barbagallo, Commercial Lines group president.** He has been with the firm since 1983, having started in claims, and over the past 10 years has worked with **Karen Bailo, Commercial Lines Senior Controller,** on the segment's agency distribution.

Background sub-segment:

- **Commercial Monoline**: Current share of 22%, believes it can take more.
- **Small fleet:** Does well in 6-9 vehicle segment, wants to expand to 10-30.
- **Transportation Network Companies (TNCs):** Continuing to grow, long relationship with Uber.
- **Comm'l auto with GL and BOP**: "Robinsons" (e.g. bundlers) of comm'l auto, started writing business this year, going to expand across country.
- **Small business with GL and BOP:** Think $30mn small businesses with sub-20 employees.
- **….But won't touch:** Hazardous materials, public transport, businesses with more than 20 employees – the company wants to be surgical, measured, and disciplined, but will consider expanding later.

EXHIBIT: COMMERCIAL LINES' MARKET OPPOURUNITIES ($BN)

Source: Company Reports, Inside P&C



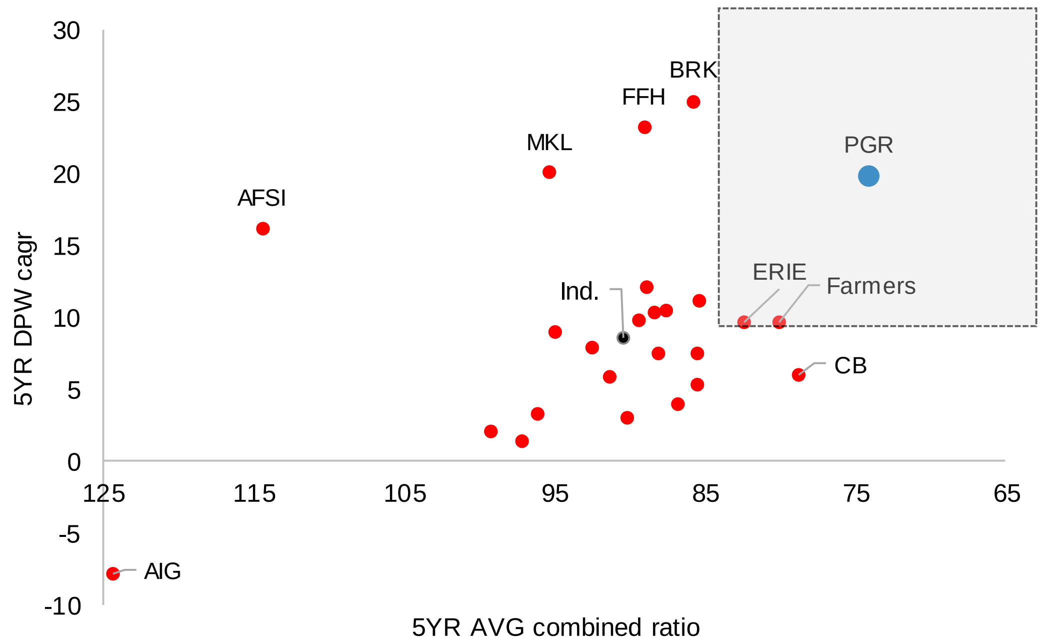
Maintaining attractive margins, even while taking share:

Progressive's excellent growth has been accompanied by impressive margins. The firm has grown its commercial auto direct premiums written at a 5YR CAGR of 20% while maintaining a 5YR average direct simple combined ratio of 74%.

The following figure shows how Progressive stacks amongst its peers in the business segment.

EXHIBIT: TOP 25 COMM'L AUTO 5YR DPW CAGR TO 5YR CR

Source: S&P Global, Inside P&C



Progressive has maintained its attractive margins by applying a granular focus to commercial auto.

This has allowing the firm to adapt quickly to changing market environments. For example, between May and November 2016, Progressive saw a rapid uptick in frequency trends along with positive severity trends, and in a little over three months, rates were raised more than 10% on the portfolio. Much of the market was slower to react.

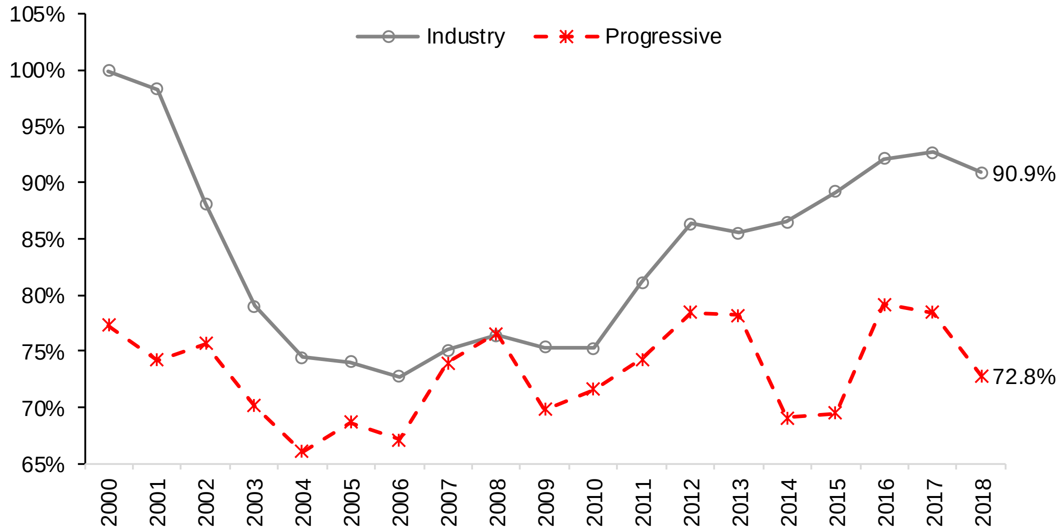
Progressive's strategy to maintain high margins:

- Leveraging personal auto infrastructure and quality control processes to handle high volume of commercial Auto claim features at a low cost.
- Targeted specialization within commercial lines on highest impact claims.
- Accurate Reserving with minimal variation.

Progressive's commercial auto strategy has a strong track record, with an average combined ratio spread with the industry of roughly 11%.

EXHIBIT: COMMERCIAL AUTO COMBINED RATIOS

Source: S&P Global, Inside P&C



Management highlighted Progressive's claims organization as a significant factor to maintaining attractive profitability. The firm has drawn from experienced and tenured employees, with its new specialty group primarily built from internal hires. Highlights include:

- Over 19k employees with a high degree of specialization handling the majority of Comm'l auto claim features.
- A specialty claims group including over 750 people, working exclusively on Commercial Lines, handling nearly 60% of the indemnity dollars spent as they deal with the highest impact and most complex claims.
- 115 tenured commercial casualty managers handling the highest exposure, and often most complicated commercial injury claims.
- 300 dedicated claims people on physical damage, majority of which are deployed in the field.
- 200 wholly dedicated claims managers supporting TNC business.

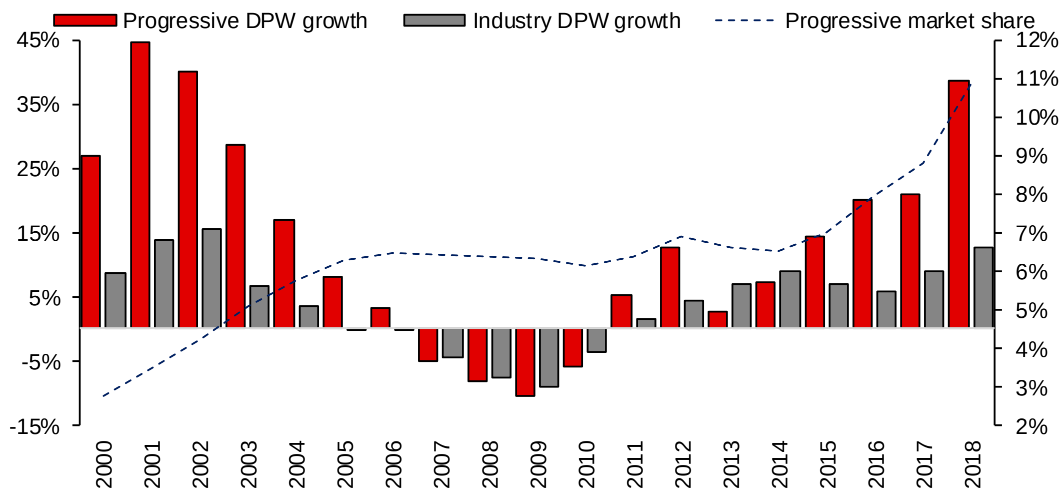
The firm also accredits strong margins to accurate reserving, maintaining a strong claims organization, and getting more of the high-impact and complex claims into hands of the specialized claims group. The segmented approach to loss reserving for Commercial Auto is same as done for other products, allowing the firm to see pattern changes sooner and react appropriately.

Maintaining growth and taking share from competitors

Historically, Progressive has maintained a high growth rate compared to the industry, and has steadily taken share in the comm'l auto market. In 2018 it grew DWP by 38.6%, well above the industry average of 12.6%. The firm has captured a market share of 10.8%, up from 2.8% in 2000, and has increased its market share for the past four years in a row.

EXHIBIT: PGR COMM'L AUTO DPW GROWTH & MARKET SHARE

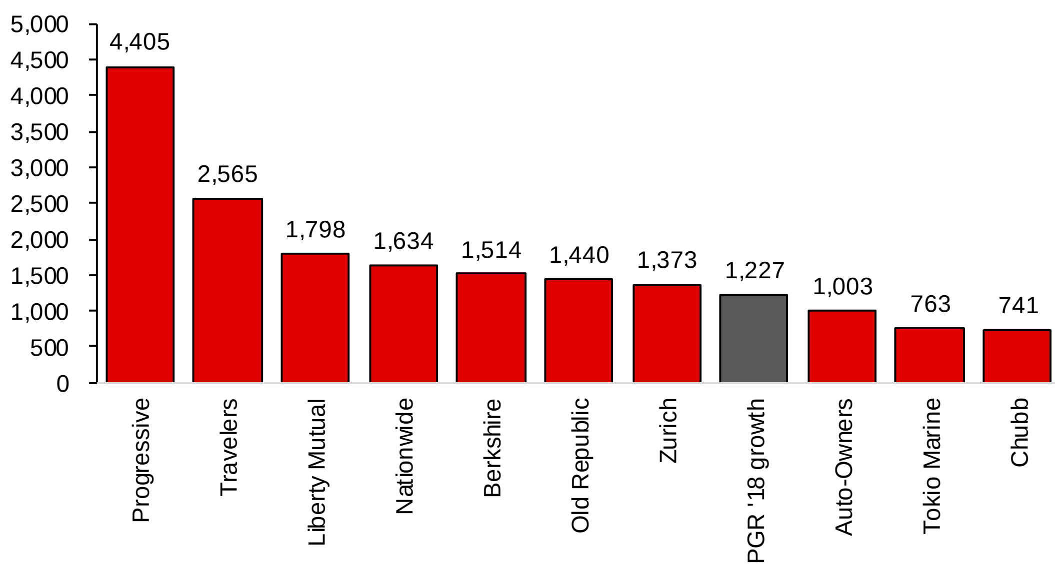
Source: S&P Global, Inside P&C



The firm's advance on the market is so large that its comm'l auto nominal DWP <u>growth</u> can be compared to the <u>total</u> DWP of its peers.

EXHIBIT: PGR '18 NOMINAL DWP GROWTH VS. PEER TOTALS

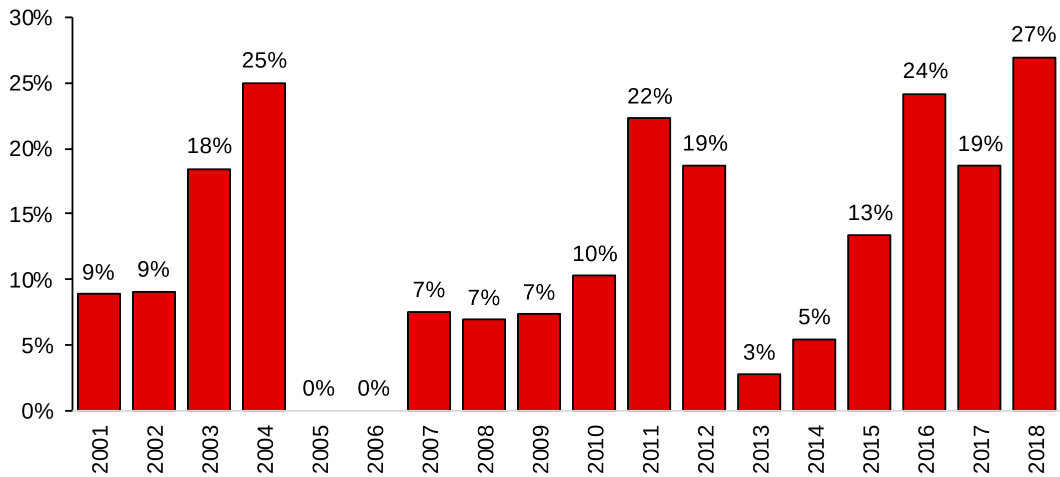
Source: S&P Global, Inside P&C



With this level of growth and size, it is no surprise that in 2018 Progressive captured 27% of the overall industry comm'l auto growth of $4.5bn. The next closest were Berkshire Hathaway and Travelers which captures 7.2% and 6.6% respectively.

EXHIBIT: PGR DWP GROWTH / TOTAL INDUSTRY DWP GROWTH

Source: S&P Global, Inside P&C



To maintain Progressive's growth in commercial lines, management outlined three key investment initiatives which included **pursuing untapped commercial auto potential, expanding distribution of products, and expanding its product portfolio.** The following sections break down each initiative.

Pursuing untapped commercial auto potential:

Progressive highlighted its use of data to pursue untapped commercial auto potential. The firm expects telematics to be a key driver of its success in its small fleet business. The added segmentation, resulting from increased data collection, is expected to be as important as it is in personal lines, with its telematics data expected to be even more predictive than Snapshot. The federal electronic logging mandate, which requires truckers to log hours that went into affect in 2017, also benefitted Progressive, as its Smart-Haul product is able to incorporate those data logs. Customers will benefit from better rates, and value-added services in the form of its SmartTrip program.

Highlights included:

- Telematics programs (smart-haul) allowing for discounts of up to 18%.
- Geolocation information allowing for potential rate improvements.
- Geolocation information eliminating less reliable methods (radius of operation)
- Smart Haul quotes are converting at double the rate of its normal trucking business with savings of around $1,400.
- A 50% take rate in its direct business
- Adoption rate in agency is stronger than in Personal Lines

- Targeting the 10-30 vehicle market, $4bn market, current low penetration.
- New small fleet enhancements (process and workflows around service levels and turnaround times) in Texas resulted in 28% improvement in quotes, and conversion rates up 3x.
- Countrywide rollout of enhancements expected represent over 80% of premium by end of 2019.
- SmartTrip countrywide rollout expected next year, currently piloting in 6 states.

Expanding product distribution:

On product distribution, Progressive highlighted the expansion of its small business direct channel. The firm stated that consumers across a wide range of industries are showing both acceptance and preference for shopping through direct channels, and that they don't expect small business owners to be any different. Quoting systems are important in generating new business, and progressive is focused on increasing engagement. Quoting flow steps include **accurately classifying the business, improving the overall quoting experience by increasing capacity and improving or accurately matching carriers to the risk, and adding online buy functionality.** Allowing for accurate business classifications is another thing they're working on

<u>Highlights included:</u>

- Novarica report – expects small business direct channel to capture as much as 15% market share in the next 5 years.
- Novarica report - younger small business owners are comfortable and prefer shopping and buying online.
- Expects changing demographics of small business owners to contribute to online preference and drive market demand.
- Broadened marketing for product offerings.
- Built an in-house agency to sell other carrier business owner policies, general liability, workers' comp, and professional liability products in addition to Comm'l auto product.
- BusinessQuote Explorer, or BQX, (online quoting platforms introduced in September 2018) now give customers a choice for how they shop for their small business insurance needs.
- Planning to incrementally improve quoting experience based on improvement feedback cycle (led to improved new business yield in personal lines).
- Applying supervised machine learning that guides a business owner through a series of questions that are designed to get to an accurate and common business classification – saw an immediate 7% increase in quoters moving forward in the quoting experience following release of tool.
- Expanding offering availability - can meet 70% of customers needs.
- Combination of improvements over past year increased quote yield 2x.
- Quotes that are offered an online buy option are quoting at a 15% higher rate than those not offered an online buy option - results indicate that online quoters are comfortable executing their purchase digitally.

Expanding the product portfolio:

BOP, a multiline policy providing liability and common property coverage, was emphasized for expanding the firm's commercial lines product portfolio.

A countrywide rollout of this solution is considered a primary step to opening up a new $20bn market, and $12bn addressable market for the commercial auto market currently tied up in BOP bundles.

Progressive will deploy its BOP product in the agency channel first, and is designing a product, system, and experience that will succeed with agents, all while keeping an eye on a path to a digital channel.

Progressive has limited its appetite to five categories which include contractors, offices, restaurants, retail & services, and wholesale distributors.

The target segments have sub-20 employees, and represent roughly 50% of the 31mn small businesses in the US. The categories are large enough to develop the pricing and segmentation aligned with Progressives straightforward and intuitive quoting methodology.

<u>Highlights included:</u>

- May 2019 introduced BOP, and now has 144 independent agents trained and authorized to sell it.
- Will offer industry-specific endorsement packages and unique embedded endorsements to cover things including: employment liability, cyber, equipment breakdown and E&O.
- BOP quote start to finish ratio is very high and in line with other established products – management believes design is right.
- Expecting aggressive rollout in 2020 and 2021 - will take a considered, measured approach, and will be disciplined around loss ratio targets and our business mix.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, and Dan Lukpanov.

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