

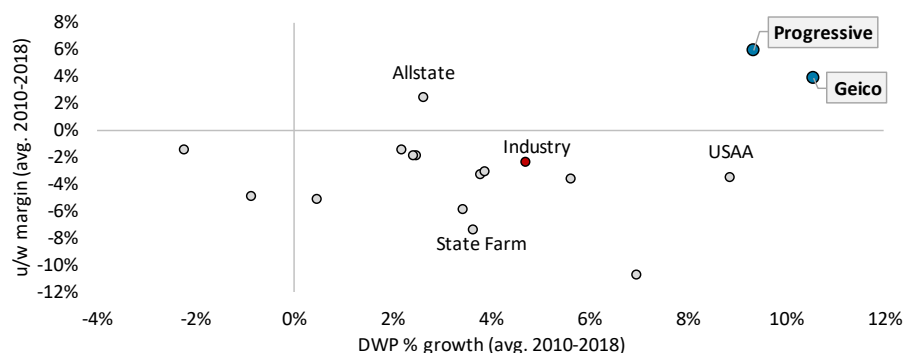
Progressive: Let the Omni-wars begin

In heavily intermediated markets, most insurance companies are price takers – to take share they lower prices thus sacrificing margin. Progressive is an outlier in that it's a distribution business. It's taken significant share in the personal auto market all while maintaining attractive margins. It's achieved this by focusing on the direct and independent agency distribution channels, and most importantly, facing limited cost-efficient competition in the direct channel for decades.

Compared to its peers utilizing captive agents, Progressive's channel choice played well with its "*simpler need*" auto customers. Its lower cost structure allows for cheaper policies, and its focus on direct (online/mobile) made it easier to shop. The group's long term DWP growth to underwriting margin in personal auto (~83% total NWP) highlights the group's success, and a similar picture is shown in commercial auto (~13% total NWP) where it has taken significant share in the monoline auto market.

Exhibit: Average DWP % growth & U/W margin (Pvt Auto '10-'18) (Statutory)

Source: SNL, Inside P&C



For the party to continue, Progressive must: **(1)** continue to compete against cost-inefficient carriers, **and/or (2)** find strategically smart areas to expand its total addressable market "TAM". Additionally, it must **(3)** adapt to new distribution channels that take hold - as a first mover or fast follower.

Our view is that following decades of market share growth, meaningful cost-efficient competition from large carriers like Allstate is on the horizon. Additionally, its new TAM, the preferred "Robinsons", places the firm in highly competitive agency channels where it will not benefit from its historic competitive advantages. More broadly, carriers are embracing an omnichannel strategy, which points to continued commoditization, even if in its early stages. With carriers crossing into competitor territory, let the omni-wars begin!

Valuation: As an innovative disrupter, Progressive deserves to trade at a premium to its peers. And it does, but at a 15x forward P/E (14.8x LTM) it may not look particularly expensive given its track record. We expect it to enjoy above average growth, particularly during periods of stress. However, cost-efficient competition will likely slow its long-term growth prospects and accelerate its reversion of its excess growth phase to industry mean, especially given that it will be more difficult to take share in its new runway. Additionally, the current auto cycle continues the risk of near-term downside volatility (See: [Auto: Expectations vs. Reality](#)). Note: Following the coronavirus selloff, prices / valuation multiples have fallen ~6% largely reflecting beta exposure.

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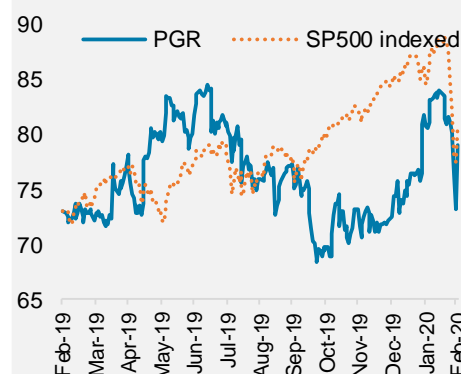
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Market cap (\$M)	46,115.6
Price	78.9
BVPS	22.53
Tang. BVPS	21.37
Price/Book	3.5 x
Price/Tang. Book	3.7 x
52-week High/Low	84.39 / 68.4
Dividend Yield	0.5%
ROE	30.9%

1 YR Price Performance



Data as of 03 / 02 / 2020

Source: SNL, Inside P&C

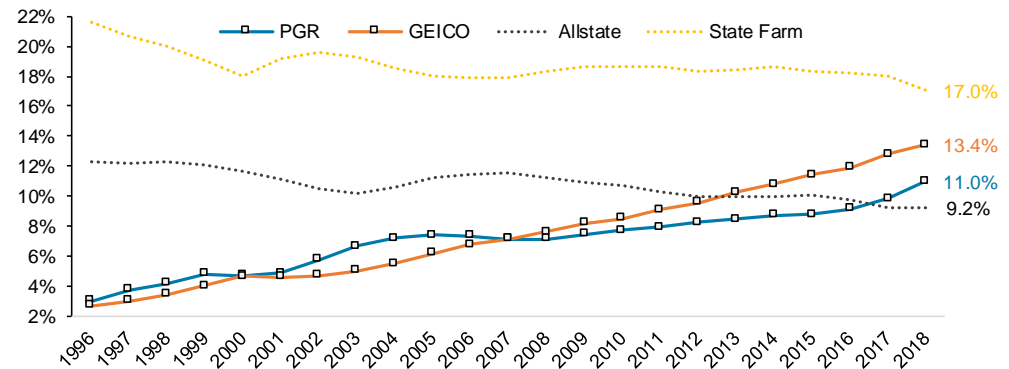
Competition is here, and it will slow Flo's market share heist

Jeff Bezos has claimed that the “*greatest piece of business luck in the history of business so far as I know*” was Amazon Web Services (AWS) facing no like-minded competition for seven years. To that we say check out Progressive and Geico - they have grown substantially, and profitably, with no like-minded competition for *decades*.

The dynamic changed in December 2019 when Allstate announced its “transformative growth plan”. This omnichannel strategy shift, which focuses on brand rather than channel, points to a changing industry attitude and poses a threat to the Gecko / Flo duopoly.

Exhibit: Progressive market share against peers (Statutory DWP)

Source: SNL, Inside P&C



Progressive's jump on direct, a lower-cost channel, played very well with its “*simpler needs*” customer targets in auto. This compares to more complicated homeowners / bundled policies where captive agents add more value, albeit at a higher cost given the added expertise.

Progressive

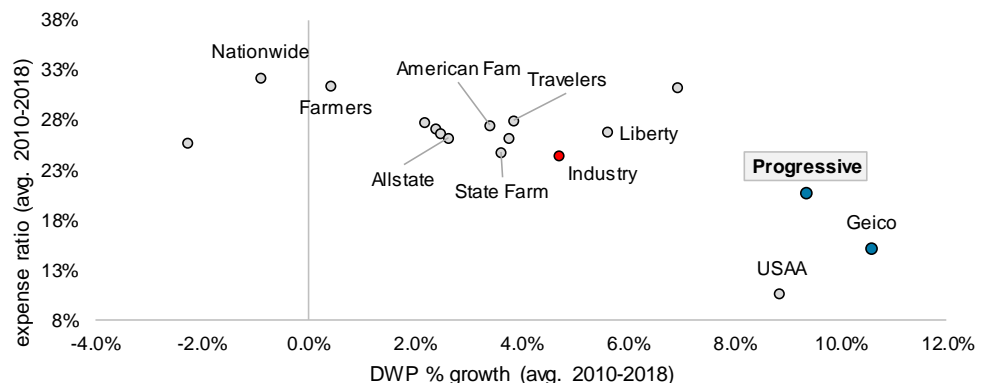
"For decades, we've been heavily focused on growing share within the simpler needs auto insurance marketplace."

- **President of Personal Lines Patrick Callahan (Q3:18 call)**

The benefits of direct are twofold: it plays well with shifting consumer shopping preferences, and it allows for a lower cost structure. This resulted in cheaper policies as excess margin is passed on to customers – a big value-add for shoppers who don't need the additional guidance.

Exhibit: 2010-2018 average private auto statutory expense ratio (Statutory)

Source: SNL, Inside P&C



Ultimately, this has allowed for decades of market share growth all while remaining profitable.

Allstate

"... we're growing, but GEICO and Progressive are growing auto insurance market share faster through massive advertising spending and low-cost structures."
- CEO Thomas Wilson (Q4:19 call)

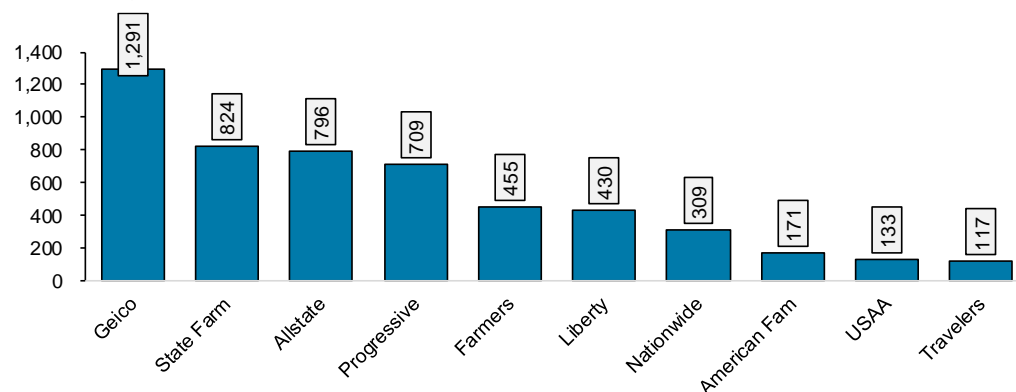
While Progressive's growth is largely rooted in direct, it's also outperformed peers in its agency business, particularly relative to captive agency businesses. The key here is that it uses independent agents, sheltering the firm from the headwinds of a shrinking captive channel (excluding homeowners / bundled products). Progressive has been a user of independent agents for decades, and the more-choice, lower-cost channel remained a stable channel for simpler need customers.

So, what happened to the growth stalling low barrier to entry competitive dynamics the insurance sector is known for?

As a first mover in direct (first via mail and phone, and then online / mobile) with now billions of premium, it is difficult for new entrants to grow without writing new business at a loss (think Esurance). This stems from the massive advertising spend needed to push the message of "name your price", and Geico's "15 minutes could save you 15% or more on car insurance". For reference, Geico and Progressive spent \$1.73B and \$1.29B on advertising in 2018. Note that both Allstate and State Farm already spend comparable amounts to be competitive and not face the same barrier to entry problem.

Exhibit: 2010-2018 average nominal ad spend 2010-2018

Source: SNL, Inside P&C



What about the other large carriers with recognizable brands and the necessary top line for competitive ad spend - think State Farm, Allstate, Liberty, Farmers, Nationwide etc.? While they added capabilities to shop direct, Allstate and Farmers maintained rules that pushed customers to agents, and they all continued to utilize agents for servicing, making it difficult to compete on price. And this made sense as the larger carriers were focusing on quality service, and that aligned with the market they held significant shares in - the bundled auto / homeowners' customers. Ultimately, a direct model relies on being top of mind for consumers at time of purchase, leaving a limited number of seats at the table in terms of optimum market structure. And nobody has been willing to risk the channel conflict issues for a full-frontal assault.

The dynamic changed when Allstate announced its "transformative growth plan"

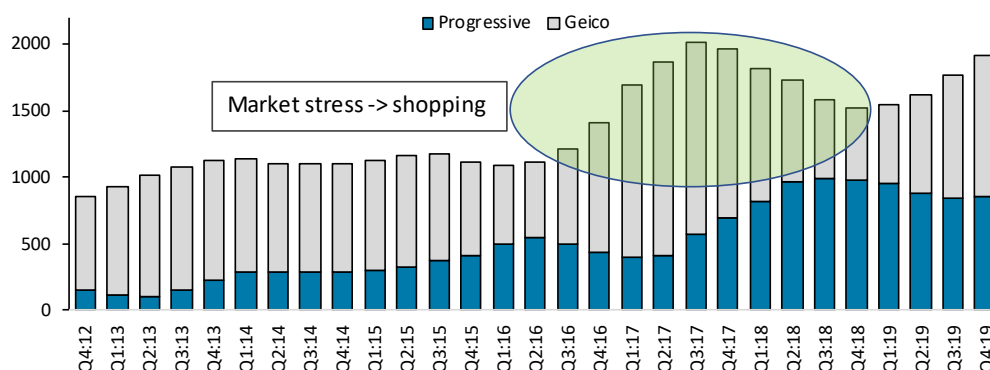
In December 2019, Allstate admitted that it wouldn't be able to keep up with Progressive and Geico without shifting gears, and it outlined its goal to lower expenses by shifting service costs to centralized locations to take work off its agencies. Agents will now pay Allstate to handle the servicing they were once responsible for, and rules

that forced new business to agents will be dropped. Commissions will be raised for new business, compensation will be adjusted down for renewals, and businesses including Esurance (its M&A driven attempt direct) will be rolled into the Allstate brand to consolidate its ad-spend.

Any added cost-efficient competition does not bode well for Progressive as its PIF growth appears to be somewhat of a zero-sum game with Geico.

Exhibit: TTM nominal direct PIF growth (k), Progressive vs. Geico

Source: company reports, Inside P&C



Spotting the forest for the trees, an omnichannel future is coming to auto

Allstate's strategy shift follows years of grappling with an "innovators dilemma" problem. Not wanting to upset the agents it depended on for its strong presence in the bundled auto / homeowners' market by introducing channel conflict with direct, it tried to "split the baby" of this strategy problem by purchasing a separate Direct business Esurance. This left it with a stretched marketing spend, unable to properly scale and compete in direct, and struggling to defend its home turf.

While Progressive and Geico were enjoying higher growth, they too stuck to their channels, and offered compelling products for those with simpler needs. With all the large carriers (largely) sticking to their channels, a somewhat peaceful coexistence ensued.

This likely changed in 2015 when Progressive, reaching maturity in its existing agency markets, acquired a controlling interest in ARX, determined to take on the bundled auto / homeowners' market. It has since pushed new advertising and expanded its capabilities with its Platinum agents who are focused on selling bundled auto / homeowners' policies. This likely marked the end of this peaceful coexistence, and Allstate's shift is likely the first sign of a massive assault by some very well-funded incumbents who are coming to terms with the fact that they're now all playing in the same sandbox.

All said and done, the changes won't come overnight, and Allstate made clear that its plans are a multiyear effort with expense ratio improvements to come in the nearer-term, and Esurance to be phased out by the end of 2020. Other tech improvements will take longer to implement. This bodes well for Progressive's short-term growth prospects, but it will be interesting to see how long it takes other carriers to shift their stances on cost structure / channel in order to keep up – particularly State Farm. In particular, these deep pocketed competitors may be willing to subsidize initial growth in direct out of profits from existing channels, which could "poison the well" for Progressive and Geico. Combine this with the growing push by low cost InsurTechs into the space (e.g. Root), and competitive dynamics could be set to change.

Even with longer-term competition on the horizon, Progressive's abnormal growth can continue if it can find strategically smart businesses where it can take share.

Unfortunately, as explained below, its largest target market is likely what set off Allstate's shift in strategy, the preferred "Robinsons" (auto bundled with home). It's agency driven and dominated by highly competitive incumbents.

Progressive's runway is agency driven and highly competitive

Management is focused on two avenues for growth: "The Robinson's" (preferred auto bundled with home) and commercial lines. At a glance, this gives Progressive plenty of room to grow assuming it can win a comparable market share to its current businesses. However, pre-existing competition and an agency bias will likely result in slower growth as customers will be harder to win over, and could even run the risk of adverse selection in this slow to turnover market.

"The Robinsons" are the preferred bunch who bundle with home and have an agency bias. The subgroup accounts for ~40% of personal auto DWP premium – a \$163B market opportunity in 2017 (incl. homeowners). The subsegment differs from its other customer targets including "Diane", "The Wrights" and "Sam" with its higher retention and lifetime value.

Exhibit: Progressive customer targets

Source: Company reports, Inside P&C

Feature:	Robinson family	Diane	Wright family	Sam
Characteristics*	- Preferred, bundled - Full coverage and umbrella - Agency customer	- 38 y/o single - Renter - Full coverage - Inc. direct bias	- Homeowner (self-packaged) - Full coverage - Inc. direct bias	- 25 y/o single - Inconsistently insured - Often a renter - Liability only - Agency bias
% of PPA*	43%	39%	12%	6%
Brand switchers*	6-8%	10-14%	11-15%	25-35%
Market share**	~1%	~11%	~14%	~19%

* 2013 Investor day slides (source)

** 2015 Investor day slides (source)

While the Robinsons exhibit strong qualities, as a preferred captive agency customer, Progressive will have trouble benefitting from its historic tailwinds driven by the direct channel. The channel also has intense pre-existing competition from the likes of Allstate and large mutuals with experienced agents who dominate the preferred / bundled market. Additional headwinds exist given that many homeowners' policies are bundled into mortgage costs, and more generally require time / energy to change policies.

In commercial, Progressive is currently the #1 writer in commercial auto at 10.8% market share in 2018 (Travelers #2 at 6.3%). Going forward, it aims to expand into lines ranging from small fleet to small business with GL & BOP. Management expects this to increase its addressable market in commercial lines by ~3x to \$50B from \$14B (Q3 Call). The firm's disinterest in hazardous materials, public transportation, and businesses with more than 20 employees (\$98.9B total market opp.) is refreshing given the trend of companies boasting large TAMs to inflate growth prospects.

The increase in TAM by 3x and its lead in the use of telematics in comparison to its largest peers bodes well for its ability to continue taking share and growing meaningfully, however as a smaller market opportunity when compared to bundled auto in personal lines, things would need to go exceptionally well to compensate for growth deceleration in its largest segment.

Offering products through new channels with limited competition is an additional opportunity for growth, and an area where InsurTechs have drawn the spotlight. In short, while they offer a clean UI and simple apps, it's still direct and will add to the

increasing competition Progressive will face as the new entrants aim to further reduce costs.

InsurTechs add competition, but are not an existential channel threat

InsurTechs including MetroMile and Root are trying to undercut Progressive and Geico on prices by being even more cost efficient. As startups, they're also unburdened by legacy systems, so their apps and websites are easy to use and function well. To meaningfully take share, the InsurTechs need to do at least one of the following: **(1)** have a substantially superior UI / product offerings, **(2)** be lower cost, and/or **(3)** spend significantly more in advertising or find niche marketing strategies.

- While the apps / websites / pay as you go offerings are nice, they can be copied easily, and Progressive has proven to be nimble and quick to act.
- While they offer competitive prices, they run above 100% combined ratios suggesting problems with its pricing model, and user reviews point to annoyance with having to speak with robots and difficulty dealing with claims. Additionally, Root is a copycat rate filer of Progressive, likely due to a lack of data assets, which speaks to the challenges facing start-ups versus incumbents.
- On ad spend, the startups have lower budgets, and cuts will likely be made as profitability becomes important as insurance companies need to fund capital to support growth. Ultimately, the startups will add further competition in the channel, and could even nibble away at Progressive's short-term prospects, but they should not be considered existential threats just yet.

Notably, both expense ratio and loss ratio problems could lead to problems if they are not able to keep obtaining new capital injections from the two markets these markets have depended on: VC and reinsurance capacity.

Tesla Insurance is interesting - it's like how Apple offers AppleCare+ for its products. Tesla claims that its coverage is less expensive given its unique understanding of its vehicles, tech, safety, and repair costs. The pricing also reflects the vehicles active safety and ADAS features. Online reviews point to below average policy costs but still show Geico and Progressive with lower cost offerings.

For now, this looks more-like something that increases the value proposition of buying a Tesla, but not a paradigm shift in how auto insurance is purchased. While for a different product, it'd be as if Square Trade (Allstate's tech protection plan) couldn't keep up with Apple's AppleCare+ for its products, but reviews show otherwise.

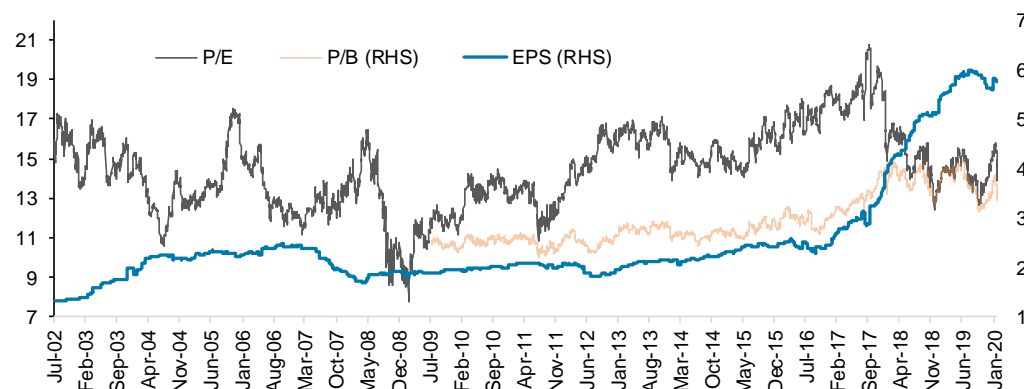
All in, more competition by means of any channel serves as a headwind to growth but added competition should be one's base expectation for any industry, let alone insurance.

Valuation – margin contraction to offset growth opportunity

Traditional NTM valuation metrics like P/B and P/E are giving mixed signals on the company's stock. The disconnect stems from strong earnings growth led by margin expansion over the past two years.

Exhibit: Progressive P/E, P/B, and normalized EPS (ntm estimates)

Source: FactSet, Inside P&C



As an innovative disrupter, Progressive deserves to trade at a premium to its peers, and it does, but at a 15x forward P/E (14.8x LTM) it may not look particularly expensive given its track record. While we expect it to enjoy above average growth with its high exposure to direct, particularly during market stress that drives shopping like in 2015-2018, the emergence of cost-efficient omnichannel competition will make it difficult for Progressive to continue taking share at its historic rate.

Additionally, short-term cycle pressures continue the risk of downside volatility as discussed in our [Auto: Expectations vs. Reality](#) note. To summarize, cyclically driven high margins are now trending back to targets, and the impact of TTM margins drifting back to averages around 93% would result in a 4pt drop in TTM operating ROE to 21% - it currently sits at 25%. The margin deterioration is also equivalent to a 16% hit to LTM operating EPS, or +3pts to the firms LTM P/E. To top things off, its 1.3% NII reinvestment rate does not bode well for earnings as the line currently amounts to roughly 22% of LTM pretax earnings, and interest rate risk remains high with its lower duration. This comes at a time where markets are signaling high expectations given the stock selling off following most monthly filings.

Note: Following the coronavirus selloff, prices / valuation multiples have fallen ~6% largely reflecting beta exposure. See report: [Market plunge drags down P&C stocks](#).

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

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