Inside P&C

by The Insurance Insider

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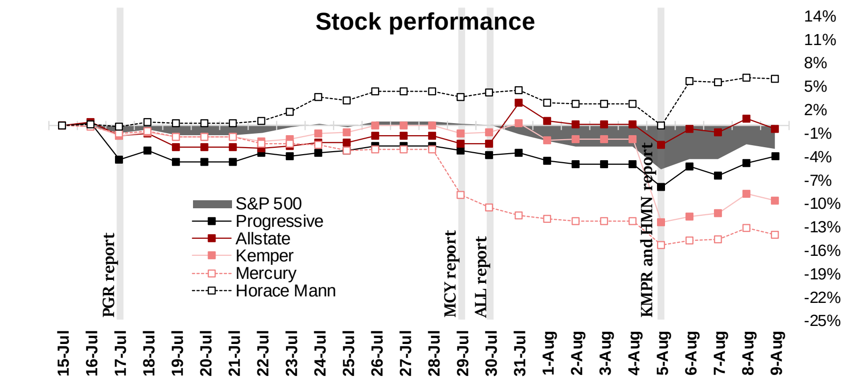
AUTO: THE "OVERSHOOT" RISK BEGINS

Personal lines headline results and margins remain excellent. However, with pricing at a decade-plus lows and growth becoming harder, we expect margin erosion in auto, with risks <u>skewing</u> towards overshoot over the next ~2-3 years.



Headline results at auto insurers remain strong. Personal lines firms on average grew operating EPS by 28%, and largely beat or met consensus estimates. Margins remain at cyclical highs, and some firms have begun talking optimistically of a pivot to growth.

However, the decline in frequency seen since early 2017 that has driven improved performance is in many ways a mystery. Many of the underlying macro-factors used by executives to explain the frequency spike of 2014-2015 have remained in place.

If nothing else, this should serve as a reminder that post-hoc rationalization can often be self-motivated reasoning as much as a well-tested hypothesis, and should not be swallowed whole. Unsurprisingly, executives prefer to explain negative surprises as due to exogenous forces, and not their own pricing or segmentation (and credit their success to idiosyncratic strategy).

Fortunately for most companies, there is safety in numbers, and in the last cycle, few other than Progressive managed to avoid overshooting on price competition relative to loss trends. Underperformance, like misery, loves company.

<u>Our view is that risk around frequency is building</u>. For sure, over the long run, secular trends should make benign frequency a "normal" environment and modal outcome. That said, a slowing economy notwithstanding, there appears to be two building forces in the system that at least increase the risk of higher frequency over the next ~2 years. Some signs of a modest uptick in miles driven is worth monitoring, as is increased competition which skews risks more towards overshooting on optimism.

Now, management teams appear sanguine on current conditions, and have access to better real-time data than we do. Even so, as the market shifts to a more pro-growth stance, the risk of overshooting on price competition <u>always</u> increases. That is the nature of the cycle. <u>More details below</u>.

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Index	QTD	YTD
Large Cap	**4.2%**	**26.4%**
Regional	**0.9%**	**13.1%**
Specialty	**5.5%**	**25.8%**
Personal	**(1.6)%**	**20.5%**
Bermuda	**5.5%**	**32.2%**
Florida	**(5.6)%**	**(21.8)%**
IPC Select	**1.2%**	**11.4%**
S&P 500	**(0.8)%**	**16.4%**
S&P Fin.	**(1.9)%**	**13.7%**

Source: S&P Global, Inside P&C

PERSONAL AUTO: THE "OVERSHOOT" RISK BEGINS

- ***Average EPS growth of 28% led by Kemper and Progressive***
- ***Auto premium pricing growth lowest since December 2007***
- ***Severity somewhat elevated, frequency benign (but risks building)***
- ***Valuations remain at cyclical highs despite some re-rating in Q2***

On a headline basis, Q2 was a positive period for the financial performance of auto and personal lines focussed insurers.

Publically listed personal lines carriers on average grew operating EPS by 28%, though were largely in line with analyst estimates.

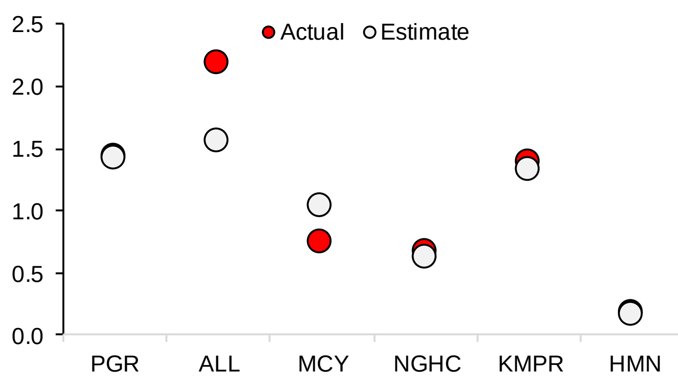
- **EPS Growth:** Kemper and Progressive led the pack expanding operating EPS by 97% and 24% to $1.38 and $1.43 respectively. The only under-performer was Mercury General, which trailed its peers, and showed negative EPS growth of 16% to $0.74.
- **In line with expectations**: Most companies results were in line with consensus estimates, with Allstate and Mercury skewing the results in each direction (see chart). Allstate beat by 41%, while Mercury missed by 28%.
- **Underwriting**: Most firms improved their underwriting margin, with catastrophe results explaining much of the gap at those that didn't. See table below.

EXHIBIT: PERSONAL LINES CONSENSUS BEAT MISS RESULTS

Source: S&P Global, Inside P&C

Personal Auto Combined Ratios

Firm	Q2:18	Q2:19	Var
Progressive	89.9%	89.7%	**(0.2%)**
Allstate brand	92.5%	92.8%	**0.3%**
Mercury Gen.	96.9%	98.3%	**1.4%**
NatGen P&C	95.4%	93.6%	**(1.7%)**
Kemper	100.4%	98.7%	**(1.7%)**
Horace Mann	108.9%	104.0%	**(4.9%)**
Geico	91.9%	95.6%	**3.7%**
Travelers	95.4%	94.0%	**(1.4%)**
Hartford	99.7%	97.2%	**(2.5%)**
Average improvement			**(0.8%)**



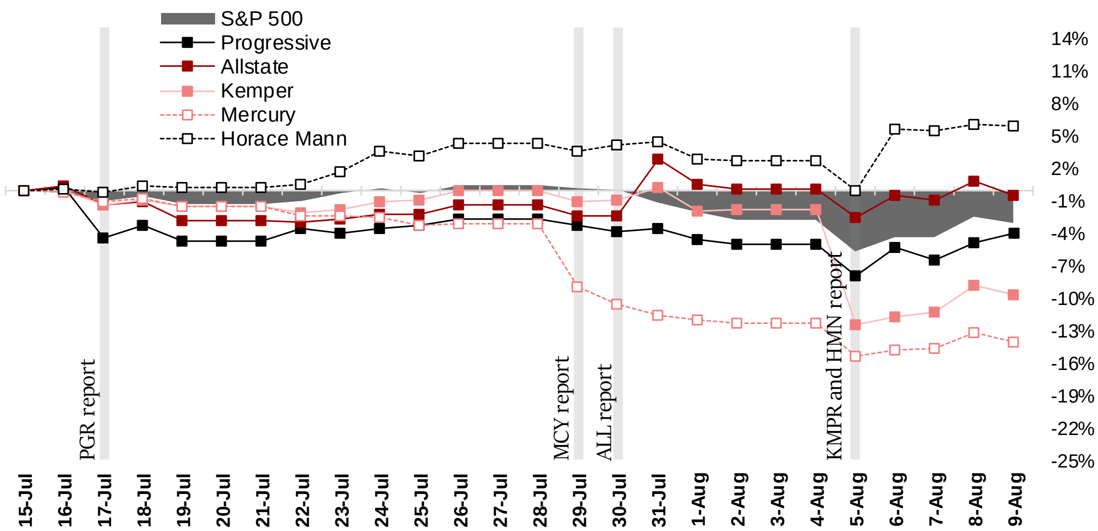
Share prices underperform despite strong earnings

However, even with the positive earnings, **share prices for the personal liens group have fallen 4.5% since Progressive, the first to report, announced Q2 earnings on 17 July.**

The return underperforms the S&P 500 by 1.5%, **likely signaling somewhat lower growth and margin expectations following a continued decline in pricing, and rising severity levels.**

EXHIBIT: PERSONAL LINES STOCK PERFORMANCE THROUGH Q2 EARNINGS SEASON

Source: S&P Global, Inside P&C



Frequency benign, severity somewhat elevated

Recall, since 2017, high pricing in auto, and benign frequency trends have led to strong growth and margin expansion in the auto business from cyclical high-combined ratios in 2015 to 2016.

These trends appeared to continue in Q2. Data points or commentary provided by companies on loss trends suggest that frequency has continued to surprise to the upside in 2019. Against that, severity continues to see some upward pressure, largely related to the cost of parts on newer vehicles. Tariffs are seen to be having some effect based on raw material costs, while the increased cost of parts and labor also lowers the threshold at which point an accident can cause a total write-off of a vehicle and require a replacement expense.

EXHIBIT: GEICO FREQUENCY AND SEVERITY

Source: Company Reports, Inside P&C

Geico claims frequency	Q1:17	Q2:17	Q3:17	Q4:17	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19
Property	0.0%	0.0%	0.0%	(1.0%)	D slightly	(2.0%)	(2.5%)	(3.0%)	(3.0%)	(3.0%)
Collision	0.0%	0.0%	0.0%	(1.0%)	D slightly	(2.0%)	(2.5%)	(3.0%)	(3.0%)	(3.0%)
Personal	(1.0%)	(2.0%)	(3.0%)	(2.5%)	D slightly.	(2.0%)	(2.5%)	(3.0%)	(3.0%)	(3.0%)
Bodily	2.5%	3.0%	0.0%	0.0%	(2.0%)	(3.0%)	(2.5%)	(3.0%)	0.0%	0.0%
Geico claims severity										
Property	5.0%	4.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Collision	5.0%	4.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Bodily	5.0%	5.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	7.0%	7.0%

Other commentary by company:

- **Allstate** experienced severity levels that exceeded expectations, resulting increased severity expectations going forward.
- **The Hartford** saw severity increases in the low to mid-single digit range.
- **Progressive** reported increased severity in bodily injury, auto property, and auto collision. The results stem from higher medical costs, and repair costs associated with newer vehicles.

EXHIBIT: GEICO AND PROGRESSIVE FREQUENCY AND SEVERITY

Source: S&P Global, Company Reports, Inside P&C

GEICO	o Freq. property, (3%) ytd o Freq. collision, (3%) ytd o Freq. personal, (3%) ytd o Freq. bodily, (3%) ytd o Sev. property, 5% ytd o Sev. collision, 5% ytd o Sev. bodily, 7% ytd	**PGR**	o Freq. personal auto, (4%) qoq, (3%) ytd o Freq. collision, (5%) qoq o Freq. auto property, (4%) qoq & ytd o Freq. bodily injury, (2%) qoq o Sev. Bodily injury, 9% o Sev. Property damage, 6% o Sev. Collision, 7% o "Higher costs to repair newer vehicles"

EXHIBIT: ALLSTATE AND HIG AUTO FREQUENCY AND SEVERITY

Source: S&P Global, Company Reports, Inside P&C

Allstate	o Lower than expected frequencies o Higher than expected severity o Revised guidance to reflect higher sev. and lower freq.	**HIG Auto**	o Favorable frequency trends o Low to mid single digit severity o "collision severity remains elevated due to higher repair costs associated with newer vehicles" o Loss cost trends within expectations

Perhaps the best indication of just how benign 2019 has proved to date can be seen at Allstate. The firm reported an H1 underlying combined ratio of 84.3% compared to its original full year guidance of 86-88%.

The firm updated its full year outlook and is now expecting an 84.5-86.5% underlying CR, with the increase from H1 partly explained by a pivot to growth and some investment in the business (perhaps with some conservativism baked in for a less benign H2).

Frequency remains benign but risks elevated

The decline in frequency seen since early 2017 is in many ways as mystery.

Many of the underlying macro factors used by executives to explain the frequency spike of 2014-2016 remain in place over the same period, including an improving economy, an improving labor force participation rate, distracted driving/cell phone use, and proliferation of softer marijuana laws.

If nothing else, this should serve as a reminder that post-hoc rationalization of results can often be self-motivated reasoning as much as well-tested statistical hypotheses – and should not be swallowed whole by industry observers without a healthy dose of cynicism. Unsurprisingly, executives always prefer to explain negative surprises and underperformance due to exogenous macro-forces and not their own pricing or segmentation strategies.

Fortunately for most companies, there is safety in numbers, and in the last cycle, few other than Progressive managed to avoid overshooting on price competition relative to loss trends. Underperformance, like misery, loves company.

Our view is that risk around frequency is building. For sure, over the long run, secular trends around legislative action and vehicle safety features should make benign frequency a somewhat “normal” environment. And there are some signs the economy is slowing, which could act as a safety valve on macro forces that drive frequency.

That said, there appears to be two building forces in the system that at least increase the risk of higher frequency over the next 1-2 years.

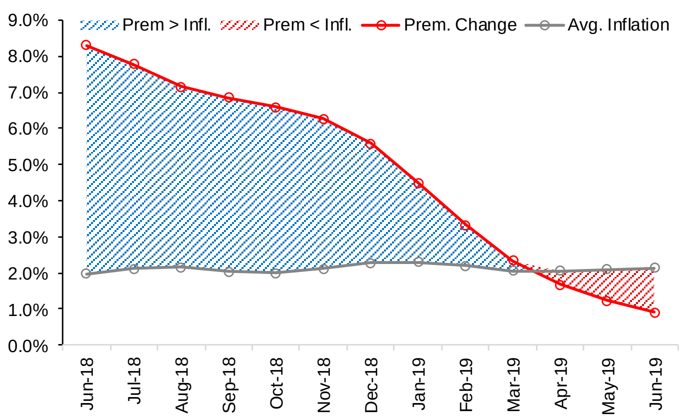
The first is simply increased price competition.

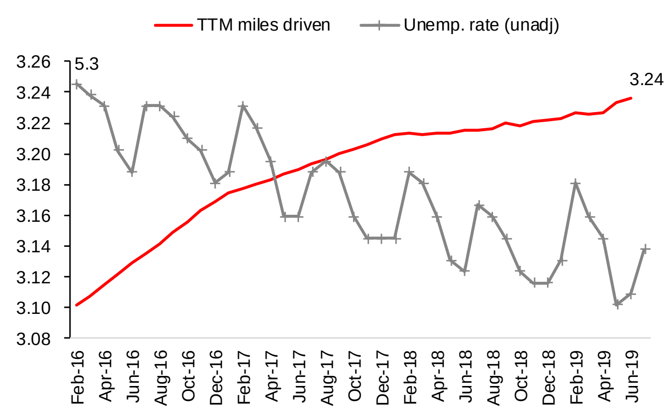
Over the past year, pricing growth has steadily declined to 0.7% in June, the lowest since December of 2007. This is down from near double digits in just over a year.

Interestingly, the figure now sits below the average inflation of various auto components and medical practices, which over time should lead to margin erosion from severity alone, all else equal.

EXHIBIT: PERSONAL AUTO MACROECONOMIC LEVERS

Source: BLS, FRED, Inside P&C





Recall, at many (though not all) firms, frequency is measured as the number of accidents divided by earned premium (more sophisticated firms use estimated “car years” as a measure of exposure rather than a proxy like earned premium).

As such, frequency can be driven by both macro and exogenous factors but also simply increased price competition.

Similarly, increased competition on new business can drive an increase in reported frequency in other ways besides pricing, for example by firm’s loosening their underwriting standards and shifting to less-preferred risks. Even more simply, new business carries more risk and higher loss ratios than older-matured renewal accounts.

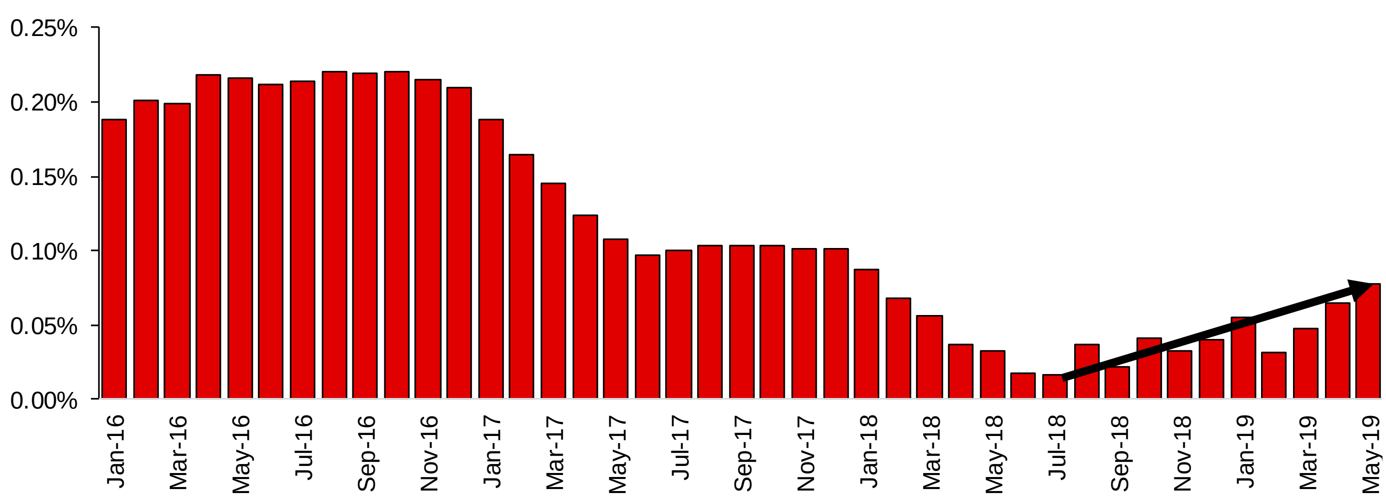
Additionally, even the pure frequency of accidents has some normal amount of variability around a mean. A string of good luck on frequency at times can be too quickly baked into pricing models leading to painful corrections when pure frequency trends mean revert. This was part of the story in 2015, with an above average year following a very benign year leading to something that looked like a step-function change in frequency at firms like Allstate and Geico.

Interestingly, data from the BLS points to an environment that could lead to higher frequency levels. A decline in sequential rate of growth of TTM miles driven starting in 2017 likely led to the reduced frequency levels seen previously. However, the rate of growth has shown some signs of increasing in recent BLS data. It is, of course, too early to call this a trend, nor is there a direct correlation with frequency. Nevertheless, this remains something to monitor closely, particularly given the context of the weakest pricing trends in over a decade.

Note, against this, Allstate said it "*does not see any big changes in the market coming*" and has access to much better real-time data on current conditions than we do due to telematics. Even so, as the market shifts to a more pro-growth stance, the risk of overshooting on price competition always increases. That is the nature of the cycle.

EXHIBIT: MOVING AVERAGE TTM MILES DRIVEN GROWTH

Source: BLS, Inside P&C



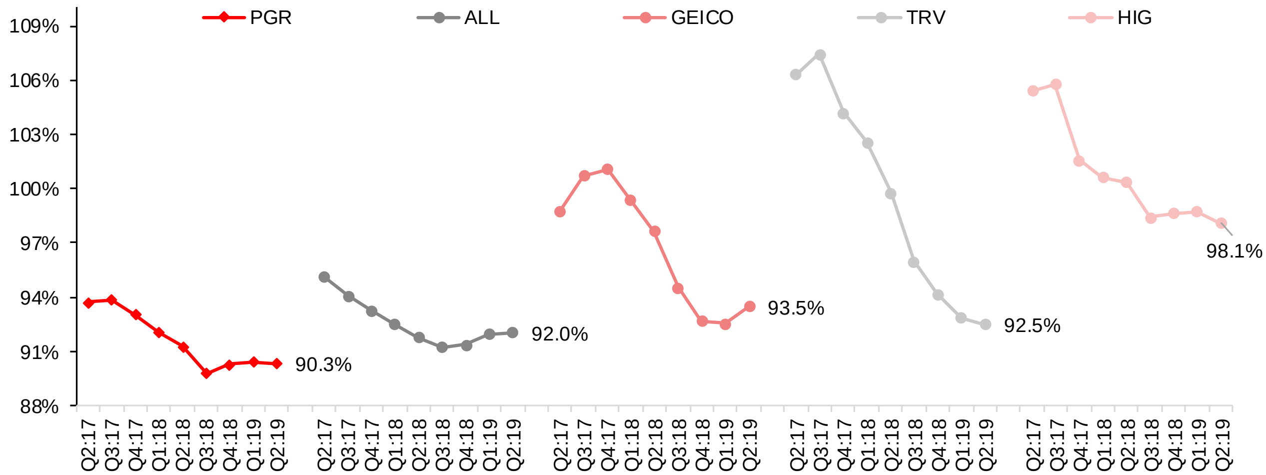
Margins already plateauing

Recall, high price increases coupled with low frequency provided a large tailwind to growth and margin expansion over the past 2+ years.

Q2:19 saw an average TTM combined of 93.3%. This is down 6.6pts from 99.9% in Q2:17. However, even a casual glance at the chart below speaks powerfully to the plateauing of margins following a long period of improvement.

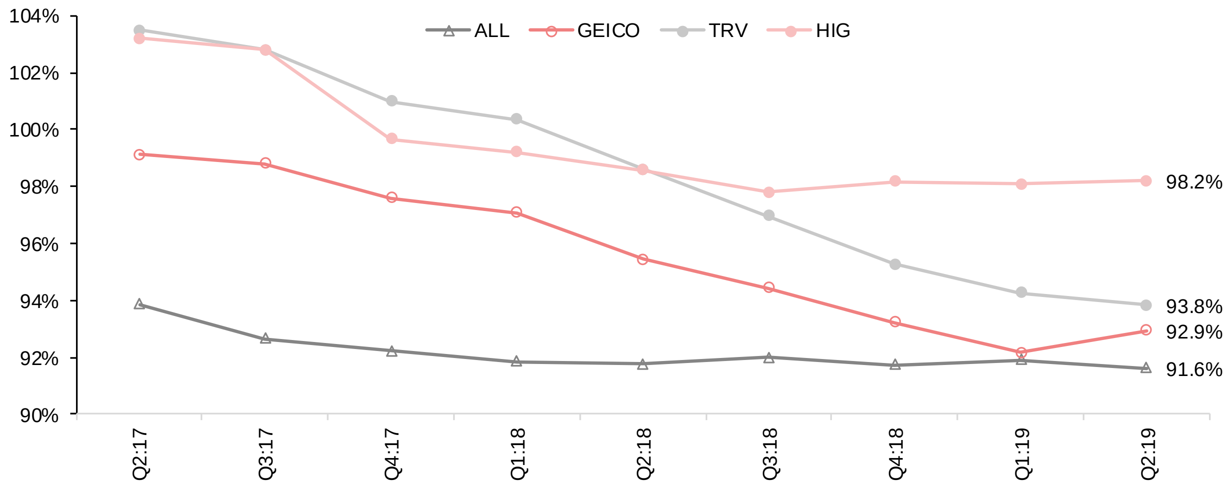
EXHIBIT: PERSONAL AUTO TTM COMBINED RATIOS

Source: Company Reports, Inside P&C



The trend is also visible in the carrier's underlying combined ratios which have largely recovered from their highs in 2017.

EXHIBIT: PERSONAL AUTO TTM UNDERLYING COMBINED RATIOS



Carriers pivot to growth, but competition increasing

The auto business is a constant calibration of managing growth against profits. Managements often bemoan external analysts talking about this trade-off as if it could be managed precisely with easy to use dials. However, the truth is that more than any business in insurance, both can be managed with far more granularity and management control (an admittedly low bar ☺).

Not only do high performing firm's have nimble field operations to tweak pricing in target markets, a more efficient distribution system including online lead-generation, direct marketing campaigns (e.g. advertising spend), and agent commission structures, give easy levers to pull – either to slow growth (and reduce both the loss and expense ratio) to improve margins, or the reverse in a pivot to a more expansive growth phase.

However, the "pivot to growth part" of this can take a little longer in an agency business rather than a direct business = more of a super-tanker. (And though theoretically the slow down in growth can be more rapid, it is often done somewhat slower in captive agency businesses than is possible to manage stakeholders and with an eye to lifetime value of customers).

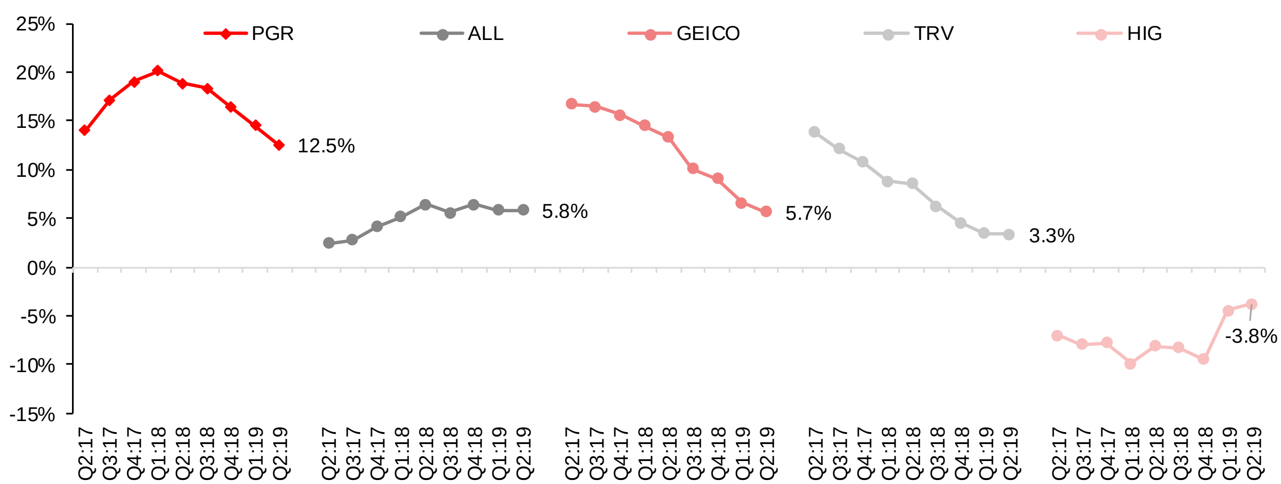
Of course, with margins at excellent levels, a pivot to growth is to be expected, and is the rational response.

Even so, there is some irony to the fact that the pro-cyclicality of most firms' growth tactics tend to make growth exponentially more expensive than at times when all competitors are focussed on margins (e.g. customer acquisition costs in online auction driven lead-gen). This is one of the factors that led to Progressive's monster growth in 2017-2018 as others retrenched.

Note, increased competition can be seen in top line and production metrics across the group. Perhaps most simply, on average, the larger cap personal auto group grew NWP by 4.7%, the lowest since at least Q2:17.

EXHIBIT: PERSONAL AUTO NWP GROWTH

Source: Company Reports, Inside P&C



Recall, NWP growth is driven by both pricing and volume. A quick background:

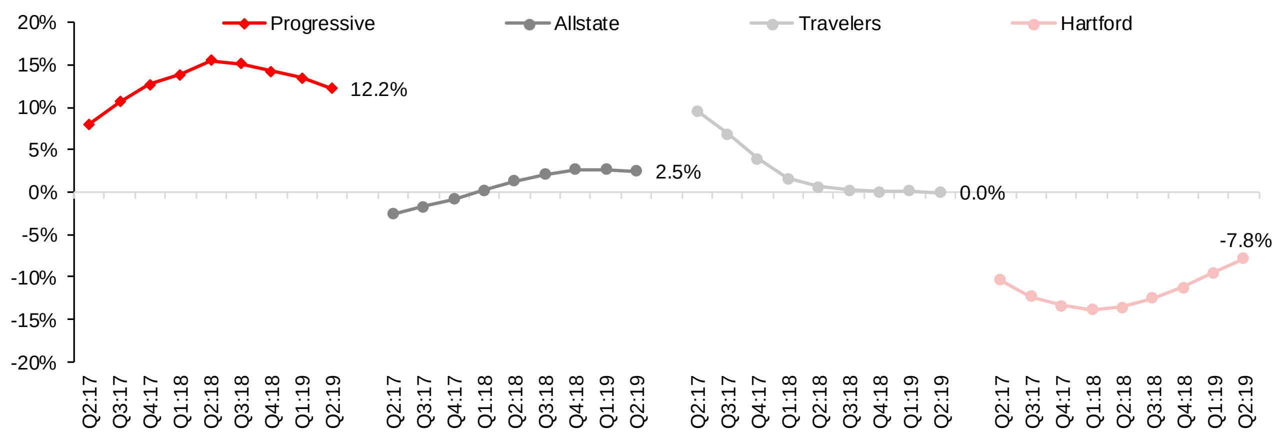
- **Pricing** is typically driven by pure rate increases in rate filings, but can also be influenced by things like mix of business by geography, "symbol drift" (e.g. shifting mix by vehicle type), or shifting mix by demographics (e.g. non-standard to preferred). Note that in some instances, a shift to a positive mix could be a headwind to NPW but be margin accretive.
- **Volumes** are driven by a combination of retention and new business, though the performance of the renewal book is by far and away the most powerful driver of the top line for all but very early stage companies or some very specialty non-standard businesses with high customer turnover.

Even a cursory glance at company production statistics this quarter makes clear that carriers are dialing up competition for new customers.

For example, PIF growth trends are largely slowing or stable at higher growth firms or improving only modestly at others.

EXHIBIT: PERSONAL AUTO SEQUENTIAL PIF GROWTH

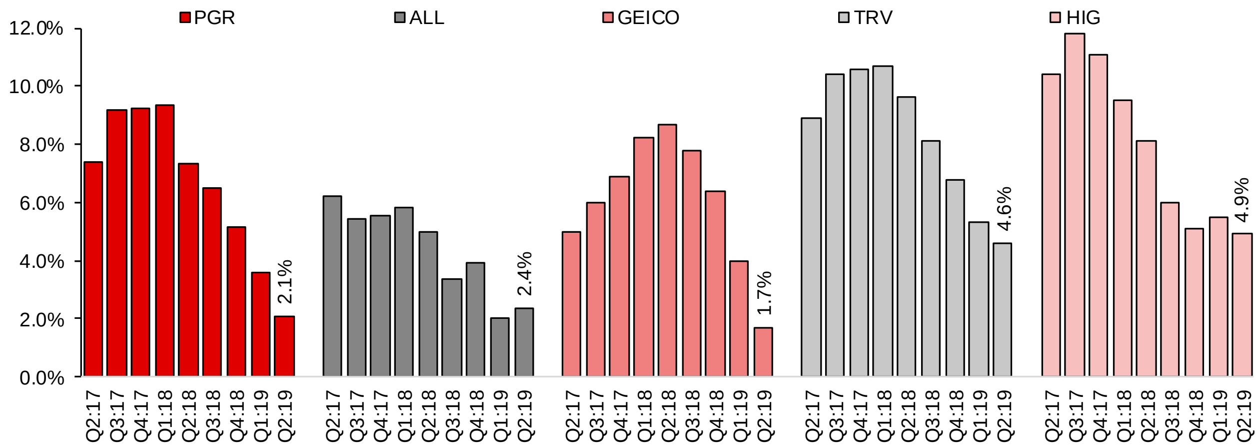
Source: Company Reports, Inside P&C



As noted above, industry pricing data suggests declining pricing. This can also be seen in company specific metrics, with declining growth rates on premium written *per policy*. See chart below.

EXHIBIT: PERSONAL AUTO PREMIUM GROWTH PER POLICY

Source: Company Reports, Inside P&C (PGR and Allstate = change in NWP/PIF)



New business is one of the easiest lever management has to control margins, as it typically runs at higher loss ratios than renewal business (and often inflates the expense ratio due to higher acquisition costs). As such, new business declined at many firms over the period of higher pricing to improve margins. However, the charts below shows clear signs of pivots to growth in production metrics, while retention levels are stable or improving.

EXHIBIT: PERSONAL AUTO NEW BUSINESS GROWTH

Source: Company Reports, Inside P&C

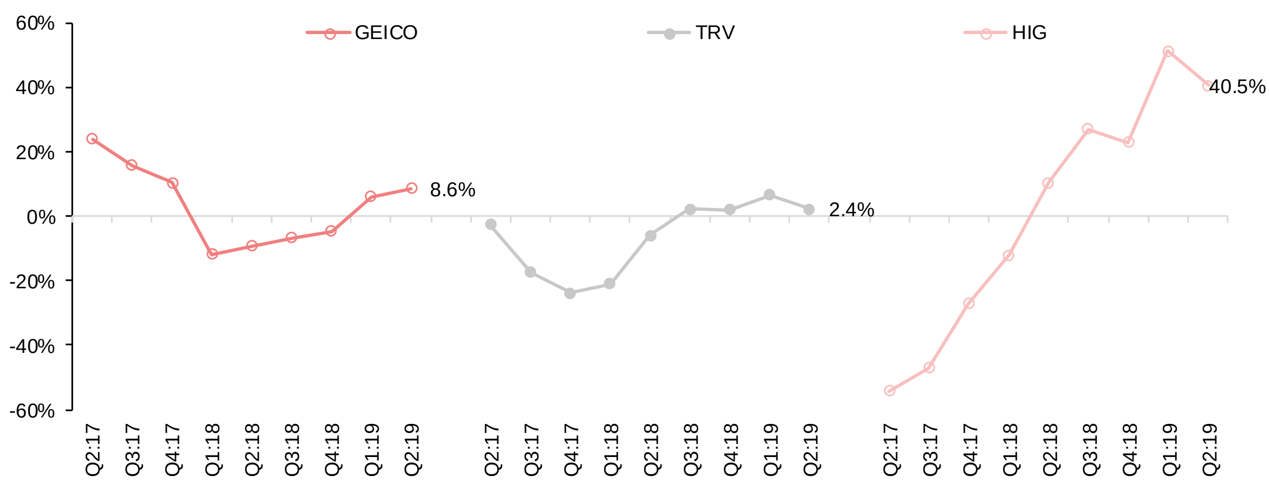
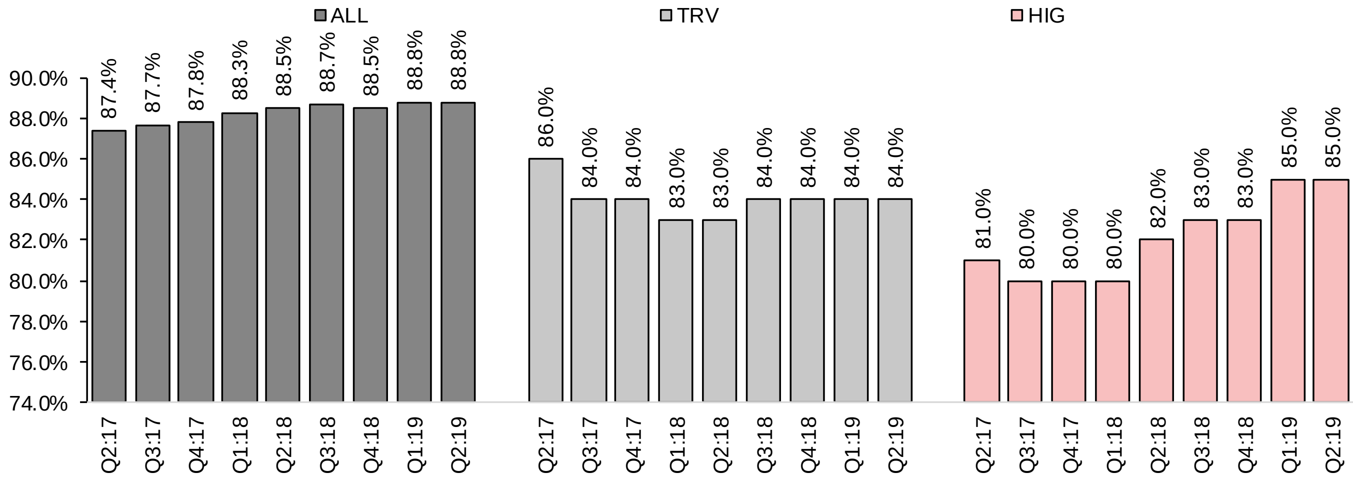


EXHIBIT: PERSONAL AUTO RETENTION RATES

Source: Company Reports, Inside P&C



Valuations at cyclical highs

Even with pricing and margins past the peak, valuations remain high. Progressive and Allstate, with market capitalizations of $47bn and $35bn respectively, remain at cyclical high price-to-book (P/B) multiples. Progressive's P/B multiple of 3.7.6x is well above its 10-year average of 2.5x, and Allstate at 1.5x sits right above its respective 10-year average as well. Note our view of Progressive is that its efforts to increase its addressable market has extended its runway for growth and therefore justifies a higher multiple to historical levels, all else equal.

EXHIBIT: PROGRESSIVE PRICE-TO-BOOK MULTIPLE

Source: S&P Global, Inside P&C

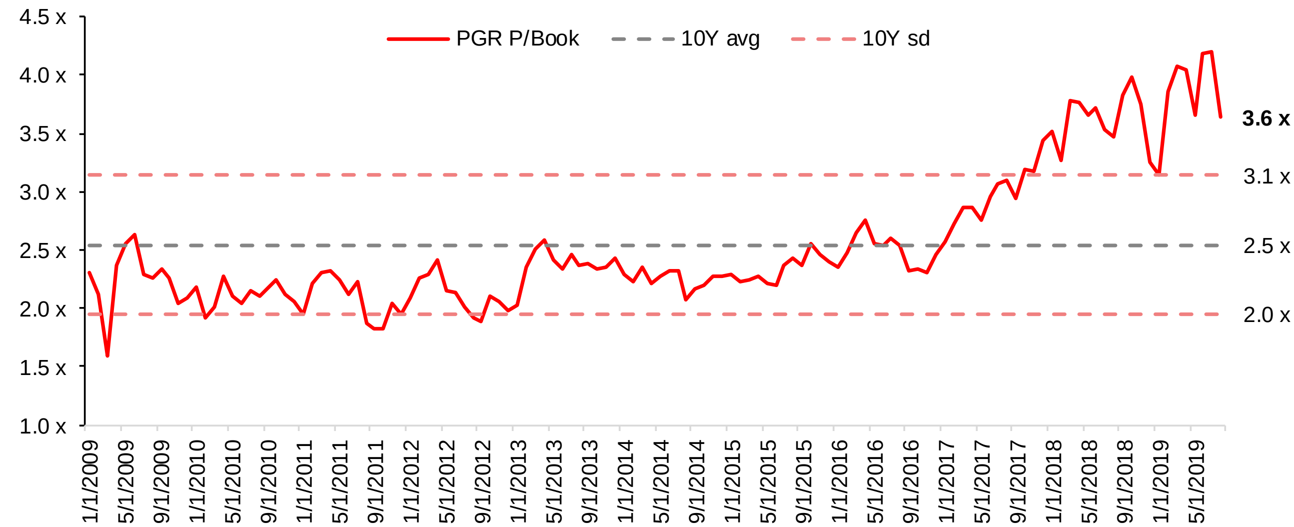
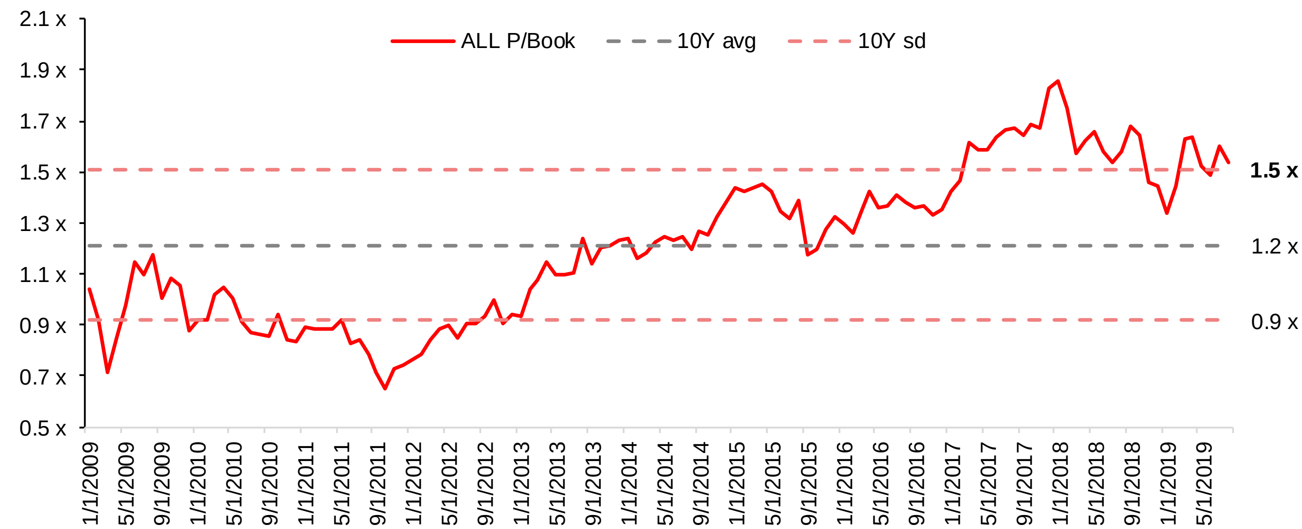


EXHIBIT: ALLSTATE PRICE-TO-BOOK MULTIPLE

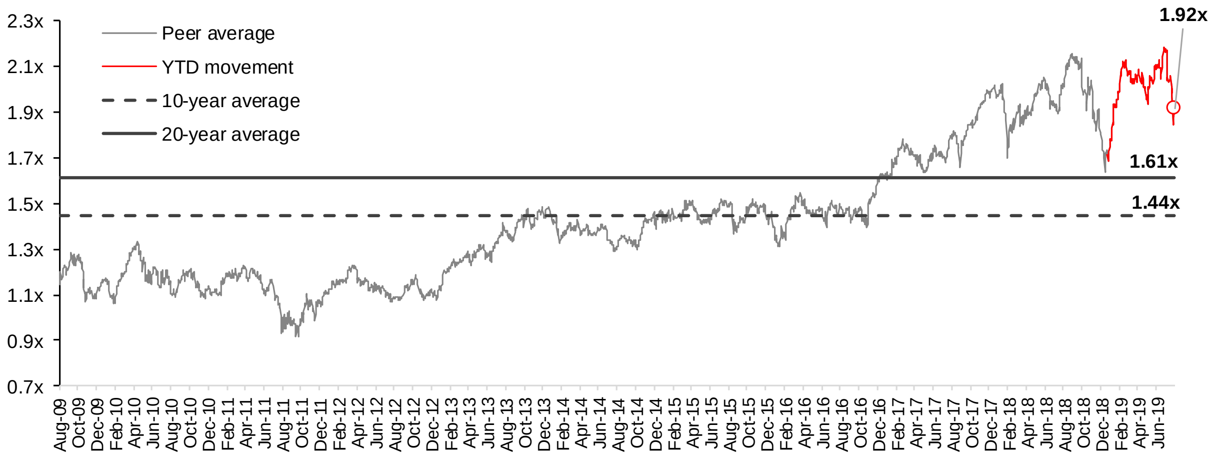
Source: S&P Global, Inside P&C



Beyond Progressive and Allstate, the subsector as a whole is priced well above historical levels.

EXHIBIT: PERSONAL LINES PEER GROUP'S AVERAGE P/B OVER TIME

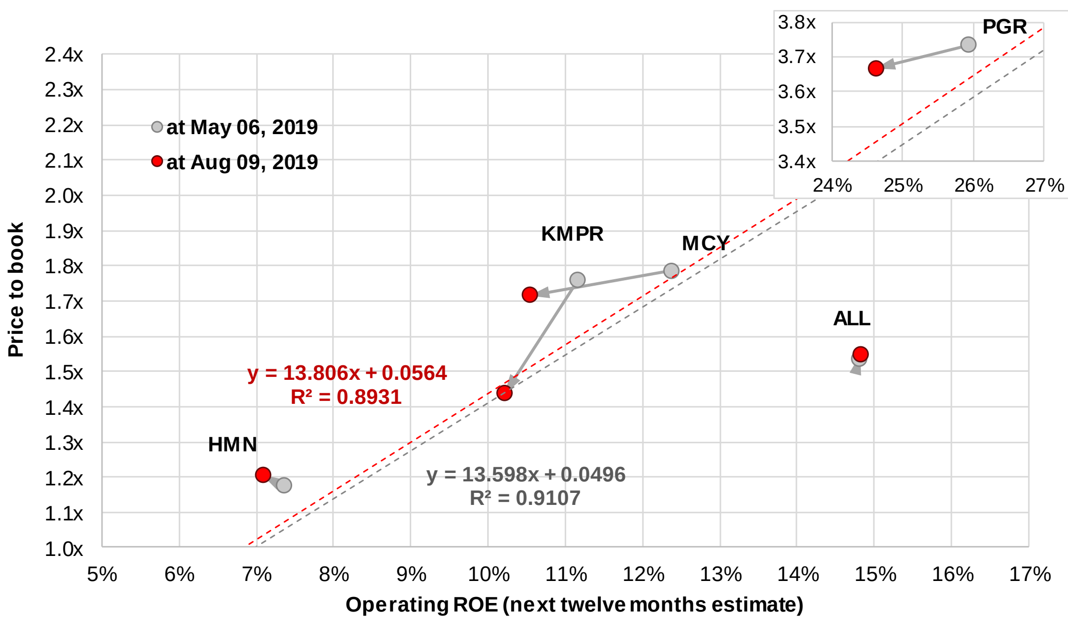
Source: S&P Global, Inside P&C



Comparing valuations to earnings expectations, the personal insurers underwent a series of re-ratings but overall the regression line has not changed much since the Q1 earnings season. (See chart below).

EXHIBIT: PERSONAL LINES PRICE-TO-BOOK TO FORWARD ROE

Source: S&P Global, Inside P&C



Note, the power of determination of the personal insurers' operating ROE estimates against valuations remained very high, evidenced by ~0.9 R-squared in the regressions above.

However, a significant revaluation took place at Kemper (down over 4x turns – a movement along y-axis to the bottom), mostly due to the weaker than expected Q2 results, which also likely reflected in lowered next twelve months operating ROE estimate (down ~1pt - a movement along x-axis to the left).

Similarly, Mercury was revalued down by 0.8x turns due to negative surprise on the Q2 results, accompanied by ROE estimate going down by 1.8pt.

Allstate and Horace Mann remained relatively unexposed to re-ratings.

On the top right corner, the Inside P&C Select's highest valued (re)insurer Progressive experienced slightly negative re-rating due to missing market expectations in July's results.

We view market's impact on the peer group's season-to-season revaluation as limited due to insignificant change in the market indexes in the period (despite high volatility).

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