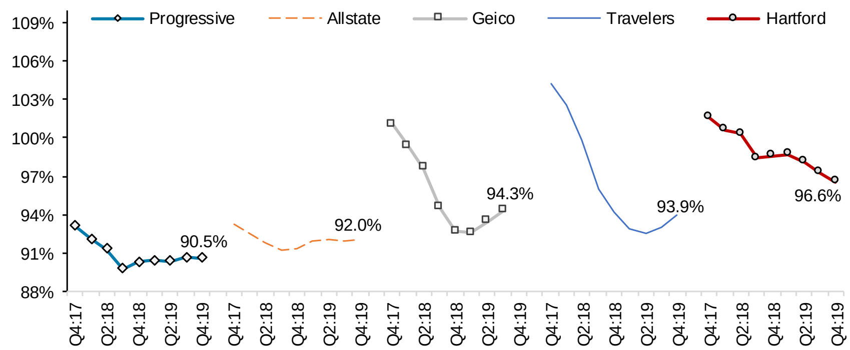
Auto: Expectations vs. Reality



Coming into 2019, with margins reaching cyclical highs, and pricing still elevated, the dynamic in auto changed on a dime. Carriers pivoted from "repair" mode to a pro-growth posture, reducing price increases to be more competitive. Indicative of this price competition, from February 2018 to December of last year, the auto CPI fell from 9.7% to 0%, lows not seen since 2007.

This has led to a situation where elevated expectations on margins appear to be misaligned with the pace of margin compression. For example, throughout the latter part of 2019, Progressive reported monthly earnings that sent the stock materially lower for seven consecutive months. Margins in auto were a factor in Travelers' disappointing Q4 while Hartford's weak guidance for personal in 2020 was also a key driver of a -4% price reaction on the day.

Notably, sentiment appears to still be mixed. Progressive's stock has ripped since October of last year, but only really outpaced the broader market since December's earnings (stock up ~8% since earnings versus 3% for S&P 500). As we explained at the time, we think the report was a false positive, and was roughly in line with prior trend.

Our view is that the next 6-12 months remains a period of peak risk for the auto-exposed names for disappointment relative to near term expectations on both growth and margins. Though it makes sense for each individual company to accept margin compression to head back towards target in order to win more growth, the collective outcomes of these individual efforts exacerbates the risk.

On the one hand, it adds risks of overshooting on the loss ratio as an auction driven market gets set by the most aggressive. On the other, the competitive dynamic makes growth both more expensive to achieve and increases the risk of adverse selection as carriers work harder on retention (= information asymmetries exist for new business). Even for high quality companies like Progressive with fundamental and enduring competitive advantages, the *quality* and *value* of growth is higher when competitors are contracting.

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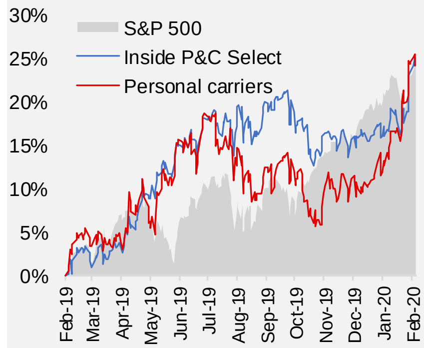
Composite	YTD px chg.	P/B
Large comm.	3.9%	1.1x
Regional	6.1%	1.8x
Specialty	11.1%	1.9x
Personal	11.4%	2.2x
Bermuda	6.3%	1.5x
Florida	(8.8)%	1.1x
Brokers	9.2%	-
IPC Select	6.5%	1.4x
S&P 500 Fin.	0.9%	-
S&P 500	4.5%	-

Day's best performer
Day's worst performer

1YR Price Peformance



Conclusion:

Personal auto exposed names are set to face a period of peak risk as competitive dynamics drive a risk of "overshooting" on margin compression. Though currently a favorable tailwind, frequency remains the wildcard.

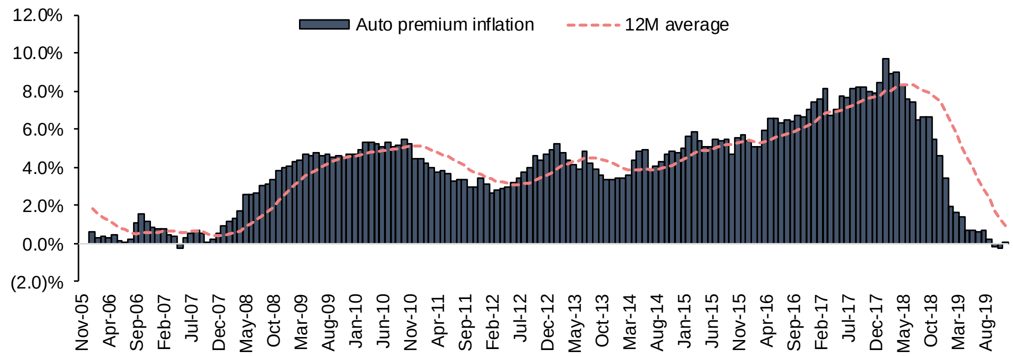
Of course, looking further out, an opportunity exists for companies able to "ride the wave", and be best positioned should any stress emerge, as Progressive did back in 2015-2018. However, we expect Progressive to face a challenge meeting short term expectations, particularly on margins over the next couple of months (reports January results tomorrow), followed by growth. For others, the near-term dynamics risks pressuring the ability of some to respond to the near existential threat posed by the direct duopolies Progressive and Geico, with higher tech spend (e.g. Hartford) and strategic pivots (e.g. Allstate) simply harder to execute as margin headroom narrows.

Auto: Great expectations face a confrontation with the reality of an intensely competitive market in 2020

Coming into 2019, with margins reaching cyclical highs, and pricing still elevated, the dynamic in auto changed. Carriers pivoted from "repair" mode to a pro-growth posture, reducing price increases to be more competitive in the market, seeking to retain more customers, and win more new business. From February 2018 to December of last year, the auto CPI fell from 9.7% to 0%, lows not seen since 2007.

Exhibit: Auto CPI premium inflation

Source: BLS, Inside P&C



Our view has been this is a period of peak risk for auto exposed names. Severity is already elevated, with concerns around the spillover of "social inflation" and a more challenging tort environment into personal auto. With more aggressive pricing action working its way through the system and yet to fully earn in, there is less headroom to shield against any additional volatility should it emerge in 2020.

Exhibit: Auto severity statistics

Source: company reports, Inside P&C

Severity:	Q1:17	Q2:17	Q3:17	Q4:17	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	Q4:19
Geico (YTD)												
Property	5.0%	4.5%	5.0%	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%	5.0%	
Bodily	5.0%	5.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	7.0%	7.0%	7.0%	
Progressive (YTD)												
Total auto	4.0%	4.0%	3.0%	3% - 5%	3.0%	3.0%	4.0%	3% - 5%	8.0%	8.0%	7.0%	
Bodily injury	6.0%	4.0%	3.0%	2.0%	2.0%	2%-3%	3.0%	4.0%	8.0%	9.0%	8.0%	
Auto property	7.0%	6.0%	6.0%	5.0%	2.0%	2%-3%	3.0%	4.0%	7.0%	6.0%	6.0%	
Collision	(3.0)%	(2.0)%		Flat	9.0%	7.0%	8.0%	8.0%	7.0%	7.0%	6.0%	
PIP	7.0%	10.0%	3.0%	4.0%	(1.0)%	(4.0)%	1.0%	2.0%	8.0%	6.0%	7.0%	
Allstate claims (YoY)												
Paid claims (PD)	4.8%	1.6%	4.9%	6.7%	4.7%	3.7%	7.7%	7.4%	6.1%	8.8%	5.1%	6.0%

Though impossible to predict, the most obvious "known unknown" risk is for a cyclical uptick in frequency. Though benign frequency is an expected outcome in most "normal" environments (= vehicle safety tech improvements, regulations, changing norms), the level of frequency recently has been a sizeable benefit to margins, and beyond expectations according to some company commentary. And even though a benign state of affairs is a reasonable base case for "normal", there will still be cyclical swings and normal variance around the mean.

In particular, cyclical upswings in frequency are more likely in an environment of rising employment (like we have seen recently), as driving represents ~85% of commuting (~76% driving, 9% carpooling).

Additionally, if particularly benign frequency is driven by good luck rather than secular reasons, it sets up the risk of a simple mean reversion uptick. Furthermore, it adds an additional more remote risk that a normal variance uptick in frequency screens like a "stair-step" change in environment, as many companies saw in 2015 following a very benign 2014.

KMPR	*"I'm certain that there are economic correlations to some of the trends we see underneath. The example I'll give you, and we've talked about a lot, is that when you see declining unemployment or more people getting jobs, there are more people on the road, they have more disposable income. There's more miles driven, and it usually has a -- causes an uptick in frequency. So that's a good example of where we see it."* **- CEO Joseph Lacher**

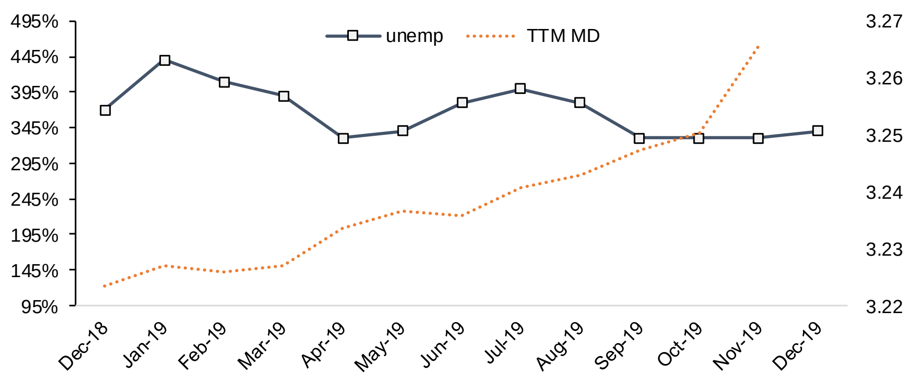
Travelers	*"On the good news front has been frequency. And as I mentioned, we continued to see favorable frequency, better than our expectations throughout 2019."* **- EVP Michael Klein**

Hanover	*"We don't have a crystal ball, obviously. But a key question remains about the future of frequency trends…Frequency has been benign, and in some cases, declining, and the counterbalance to that increase in severity. So where does that go?"* ***EVP Richard W. Lavey***

Looking at miles driven, simply the best proxy we have for trailing "exposure" for drivers of frequency, there has been a clear uptick and acceleration in recent months. Though there is no direct correlation that ensures this maps directly to frequency, it certainly screens as a period of increased risk that deserves heightened attention over the next few months to see if it maintains as a longer-term trend.

Exhibit: USA Unemployment, TTM miles driven

Source: SNL, Inside P&C



That said, frequency is difficult (= impossible) to predict and so far remains benign based on company backward looking disclosures.

There are also plenty of reasons to be bullish on a secularly improving frequency dynamic. For example, there are several fundamental changes in both driving behaviors, technologies, and regulations.

For example, the fleet penetration of advanced driver assistance systems (ADAS) is increasing 2-5% annually according to the Boston Consulting Group. BCG has estimated ADAS could reduce all crashes in the US by ~28% if fully adopted. Though improved vehicle safety tech has been a long term contributor to frequency, recent technology improvements have been more incremental.

Exhibit: Auto frequency statistics

Source: company reports, Inside P&C

Frequency:	Q1:17	Q2:17	Q3:17	Q4:17	Q1:18	Q2:18	Q3:18	Q4:18	Q1:19	Q2:19	Q3:19	Q4:19
Geico (YTD)												
Property	0.0%	0.0%	0.0%	(1.0)%	D slightly	(2.0)%	(2.5)%	(3.0)%	(3.0)%	(3.0)%	(2.5)%	
Collision	0.0%	0.0%	0.0%	(1.0)%	D slightly	(2.0)%	(2.5)%	(3.0)%	(3.0)%	(3.0)%	(2.5)%	
Personal	(1.0)%	(2.0)%	(3.0)%	(2.5)%	D slightly	(2.0)%	(2.5)%	(3.0)%	(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%	0.0%	
Progressive (YTD)												
Personal auto	(4.0)%	(3.0)%	(4.0)%	(3.0)%	1.5%	(2.0)%	(2.0)%	(3.0)%	(3.0)%	(3.0)%	(3.0)%	
PIP	(5.0)%	(6.0)%	(6.0)%	(5.0)%	(3.0)%	(2%)-(3%)	(3.0)%	3.0%	(4.0)%	(5.0)%	(6.0)%	
Collision	(4.0)%	(4.0)%	(4.0)%	(4.0)%	(1.0)%	(1.0)%	(2.0)%	3.0%	(4.0)%	(5.0)%	(4.0)%	
Auto property	(3.0)%	(2.0)%	(3.0)%	(3.0)%	(2.0)%	(2%)-(3%)	(3.0)%	3.0%	(3.0)%	(4.0)%	(4.0)%	
Bodily injury	(3.0)%	(2.0)%	(2.0)%	(2.0)%	(1.0)%	(2%)-(3%)	(3.0)%	3.0%	(3.0)%	(3.0)%	(2.0)%	
Allstate (YoY)												
Paid claims (PD)	(3.2)%	(3.4)%	(9.0)%	(5.2)%	(3.0)%	(3.0)%	0.2%	(0.6)%	(3.6)%	(1.5)%	0.2%	(4.0)%
Gross claims (BI)	(6.0)%	(4.7)%	(5.6)%	(2.9)%	(2.0)%	(2.7)%	(0.7)%	(2.5)%	(1.2)%	(2.1)%	(0.5)%	(3.2)%

Another potential powerful explanation for good news on frequency is telematics. As we're relying on specific nationwide company disclosures in this instance as a proxy for the market, it is possible there are company-specific factors at play. As early adopters and market leaders in telematics, we could be seeing the impact of favorable mix shift. After all, the intent of telematics is, in a nutshell, to find and underwrite drivers who drive less.

However, the problem is Geico essentially had zero telematics in the field until its recent launch of DriveEasy in August, and has seen similar trends, as have others based on broad commentary. Any divergence between the "haves and have nots" on telematics remains something to watch for signs of an adverse selection cycle, particularly as companies pivot more to growth.

The signal from pricing

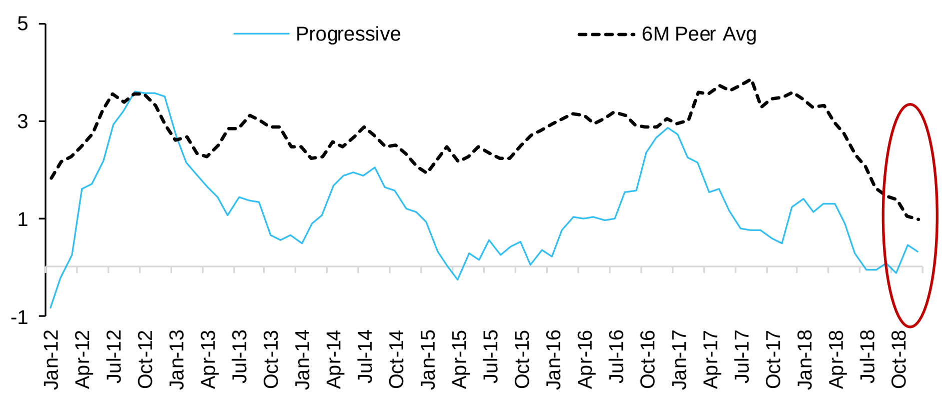
One of the best leading indicators we have on real time loss costs are price filings. That is because we get a view into what field underwriting managers are seeing in terms of loss trend in near real time. Our view is Progressive typically responds to inflection points first as it did in 2014 with pricing ahead of the 2015-2016 loss cost spike that afflicted its peers.

Note, there are a couple of data quirks to be aware of. First, Progressive's rate filings contain a monthly trend factor, which essentially acts to add an estimate of normal inflation indexed to the time the policy is written (it's a very cool innovation for us insurance nerds). This means as a general rule, you should see Progressive's filings as around 2pts under-stated relative to peers. So if Progressive is filing for 1%, and everyone else 3%, they are ~ equal in our minds.

As shown in the chart below, the "gap" is closing implying Progressive is becoming less competitive on pricing relative to peers.

Exhibit: Progressive product rate filings against peers

Source: SNL, Inside P&C



We'd add there is another data quirk in timing around year end that may distort this a little, and it comes after a period of wider than usual pricing gap, implying that a short period of catch up is not anything unusual. However this remains something to watch, and Progressive's monthly earnings and quarterly commentary on loss trends should be followed closely.

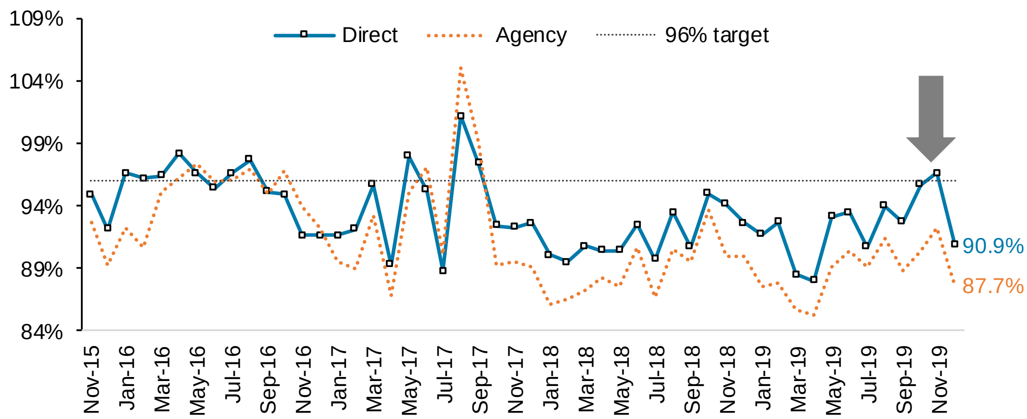
Other potential signals from Progressive

Progressive's best in class track record on "riding the wave" of loss costs, its broad national footprint, and its unique monthly reporting give us the best possible lens into real time auto trends.

Recall there have been some signs of "heat" in Progressive's recent numbers, with direct hitting a 96.6% combined in November 2019 and averaged ~95% between September to November (prior to the December "false positive" accounting distortion).

Exhibit: Progressive direct and agency monthly combined ratios

Source: company reports, Inside P&C



Another potential signal comes from the fact that PYD and current year actuarial adjustments have persistently tracked as negative.

Current accident year actuarial adjustments were $18.7mn in the December, taking the total for 2019 to $120.4mn (0.3pts on firm-wide 2019 CR).

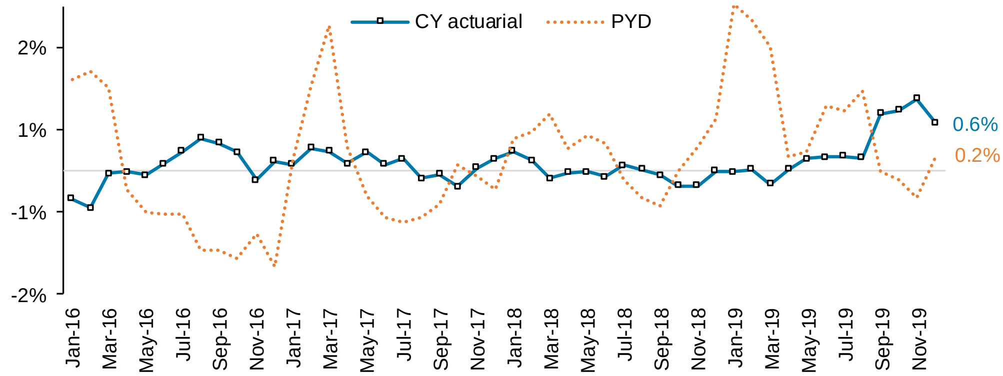
Similarly, in total, prior year development related to actuarial adjustments was $66mn in 2019, with all other development unfavorable $166.5mn for a total net negative impact of $232.3mn (or 0.6pts on the firm-wide combined).

All three of the (1) current accident year adjustments by the actuaries, (2) actuarial adjustments to prior years, and (3) all other claim-related development trending negatively in 2019 and recent periods suggest negative pressure will continue on current accident year loss picks in 2020.

Progressive last had six consecutive negative actuarial calendar year adjustments in the six months through to May 2014 and again through to Jan 2015, a period where most companies were recognizing positive trend, but Progressive was rising prices.

Exhibit: Progressive 3M average CAY actuarial adjustments and PY developments

Source: company reports, Inside P&C



Of course, there can be a certain amount of randomness in these signals from Progressive, which does really try to call balls and strikes as it sees them, rather than shooting for constant favorable PYD. However, the persistency of these negative trends is worth watching. We'd continue to track these in early 2020, as well as any signs of the firm taking its foot off the gas in the direct channel. Key metrics to watch are Direct PIF growth and expense ratio (for signs of lower ad spend).

Retention: The adverse selection risk in a more competitive market

Another metric we like to monitor closely at this point in the cycle is retention across the group. Though a combination of high retention and high new business growth is often considered attractive, our view is that this depends on the context of the cycle.

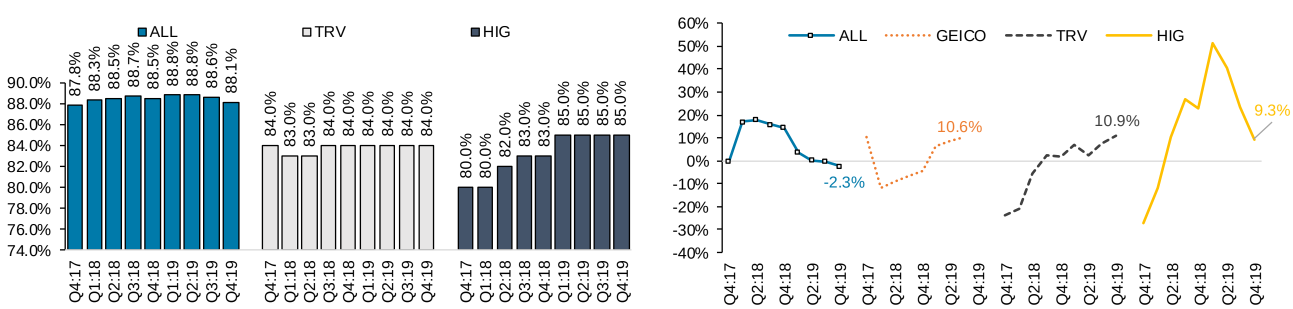
Growth like Progressive's in 2016-2018 when others were reducing retention screens to us as lower risk, as wholesale re-underwriting drives a wide class of customers into the market.

By contrast, high new business growth in competitive, price sensitive channels like independent agency, while competitors are maximizing retention, adds adverse selection risk, as companies aggressively defend good business and allow worse business to leave (and incumbent carriers have asymmetric information to new carriers).

Note, new business always carries a wider variance on potential outcomes, and carriers typically book it with loss ratios of ~10pts higher to reflect this. But we think the context of the cycle increases this risk at competitive points in the cycle.

Exhibit: Auto peer retention (left) and new business growth (right)

Source: company reports, Inside P&C



Balancing the needs of the present versus the needs of the future

In the near term, elevated expectations versus the challenging reality of a competitive marketplace is likely to dominate the agenda.

Over the next few months, with earned premium tailwinds declining and severity already adverse, it wouldn't take much in the way of a frequency blip to suddenly align a lot of bad momentum. Given the lag between recognizing trend → responding to it with pricing actions in the field → then earning through the benefits = the risk of overshooting once margins are trending back from peak levels towards target is meaningful, if not a base case.

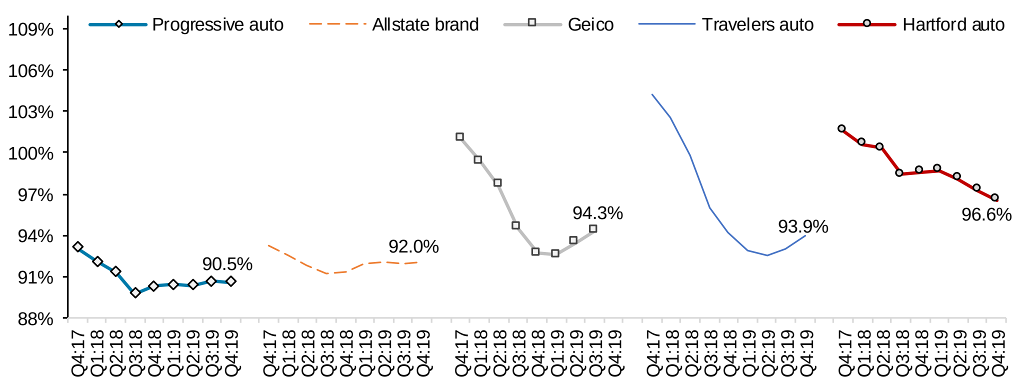
Hanover	*"So it is a competitive environment. We're seeing some potential evidence that these competitive pressures may actually not have that persistency over time. As we had talked earlier, the severity we're experiencing in the industry, both on the phys dam, bodily injury is putting justifiable pressure on profit. So we think other carriers likely will respond. So I think that's a question of how long this competitive environment persists."* **- EVP Richard Lavey**

Allstate	*"We've got a few things going to stimulate growth in what is a very competitive environment right now."* **- President of Personal Property Liability Glenn Shapiro**

And let's be clear, a change in the frequency is not needed for this scenario to play out. The reality of a competitive marketplace means this can play out without a change in the frequency environment, given how steep the path back to target margins appears for some folks. Frequency is simply only the most obvious "known unknown" that could act as a catalyst for a more severe scenario.

Exhibit: TTM auto segment combined ratios

Source: Company reports, Inside P&C



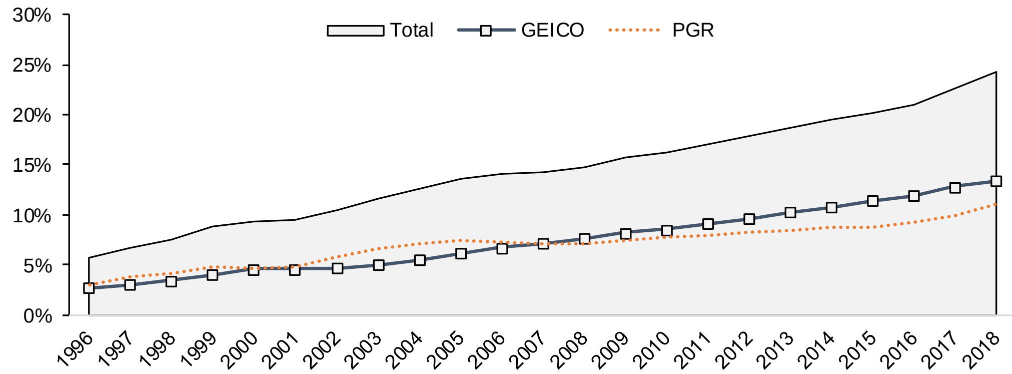
Given these dynamics remain in place, we continue to see 2020 as a period of peak risk for auto exposed names. And though we are not making a prediction on frequency, we're simply pointing out that a small and normal variance uptick could align a lot of bad momentum very quickly.

Of course the real "risk" depends on your time horizon and competitive advantages.

For many, the pressure to deliver near term margins in an environment of rising loss ratio pressures adds to true long-term existential risk around responding to fundamental strategic challenges as consumers switch more to Direct channels.

Exhibit: Progressive and Geico market share, personal auto

Source: SNL, Inside P&C



For example, part of Hartford's disappointing forward guidance for 2020 was increased tech spend. Allstate has announced a strategic re-orientation of its brands, dropping the Esurance brand to maximize its marketing spend behind one master brand. This is likely to require substantial investment and the opportunity cost of focusing management time on internal operational issues instead of externally on the market and the customer (time is the only non-renewable resource at a profitable company).

Allstate	*"We're growing, but GEICO and Progressive are growing auto insurance market share faster through massive advertising spending and low cost structures. Our plan also recognizes that customer needs are changing due to increased connectivity and advanced analytics"* **- CEO Thomas Wilson**

These type of capabilities-oriented, strategic responses are expensive, and require a lot of investment. And the trade-off between the ability to prioritize the needs of the future versus the needs of the present are harder when there is less margin headroom and higher personal cost to management for not "making your numbers".

However, though less immediate, and less likely to make or break any given quarter, these fundamental strategy questions about access to customers where they want to shop, having the capabilities to not get adversely selected against in pricing, and competing against the consumer mind-share of the little British lizard and the nice lady in the white apron are what will ultimately decide franchise value far more than this year's earnings.

For Progressive, the risk is almost the reverse.

The period of overshoot is clearly a huge opportunity, as the firm showed in 2015-2018 when it grew >50% in 3 years, seizing on the wholesale re-underwriting at competitors and lower cost of advertising, lead gen and online traffic to rapidly grow PIF.

In that sense, the risk for Progressive is that a more competitive market place without a stimulus to drive customer shopping begins to slow growth and threatens its multiple, as was the case in the years running up to 2015 when growth in agency slowed amid heightened competition from Travelers (and its Quantum 2.0 launch) among others. Those with a better mouse trap win when there is more volatility that gives them more "at bats". But if there is less customer shopping, the mousetrap counts for less.

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