ASSURED BRIEFING

June, 2018

What's Inside

The *Assured Briefing* is a monthly research note analyzing business development, financial, legal, or claim matters relevant to property/casualty insurance professionals.

In this edition

In the research pipeline

Our annual *Assured Industry Study* updating Atlantic hurricane statistics will be released in early June. We'll be studying the aviation market in a companion piece to our work on marine insurance, and we'll offer insights into investment strategies when we summarize a recent survey of insurance portfolio managers.

Assured Research is dedicated to producing substantive and actionable research for property/casualty insurance and investment professionals. In addition to subscription research, we offer bespoke research and educational services.

Medical Professional Liability: Frequency of Severity on the Rise

With increasing litigiousness, the cycle of larger verdicts/settlements may be hard to break

Two developments caught our attention during the recently-completed first quarter earnings season. First, CNA reported outsized rate increases in its industry-leading healthcare practice - 10% in 1Q18 up from 8% the prior quarter compared to rate increases in the low-to-mid single digits in earlier 2017. Its healthcare retention ratio fell by 5 points, to 81%. Our reaction was the same as at least one analyst on the call – *that sounds like a reaction to rising losses!*

Later that same week, medical professional liability (MPL) specialist ProAssurance released earnings before the market opened and warned in its press release of "…increased industry concern about upward trends in losses." The company's stock price fall by 10% before management even had a chance to explain themselves during their conference call.

We don't miss too many opportunities to investigate claim trends – and this is no exception. And we'll dispense with any suspense and share **our working conclusion:**

The frequency of large healthcare claims is on the rise. The severity of the large claims is not rising at a concerning pace (yet), though rising jury verdicts tend to become a self-perpetuating phenomenon. And while there are myriad reasons for this nascent trend, **we suspect the convergence of a rising litigiousness among Americans** (fueled by money flowing to 3rd Party Litigation Funds and rising legal advertising) **and physicians increasingly employed by large healthcare organizations with deep pockets and larger insurance limits probably explains a good bit of the trend.**

An MPL policy covering a solo practitioner typically has $1M/$3M limits.

If that solo practitioner becomes employed by a hospital or large healthcare group, limits of liability could increase to $30-$100 million.

That's a much bigger target!

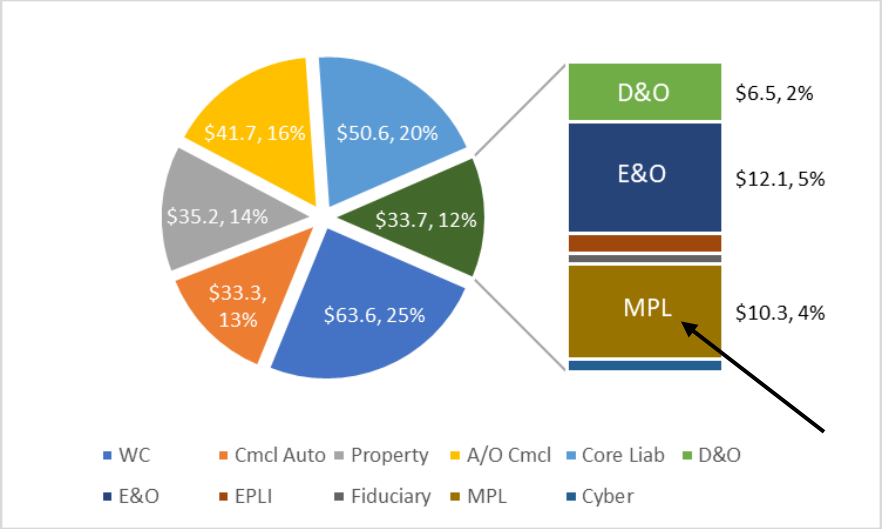
Our opinions were shaped by data presented in the October 2017 edition of the Aon/ASHRM Hospital and Physician Professional Liability Benchmark Analysis. This is the 18th year that Aon has teamed with the American Society for Healthcare Risk Management and we'd strongly encourage any (re)insurance professional with an interest in healthcare liability claims (primary or excess of loss) pick up a copy.

In subsequent references we'll refer to the report as the Aon study or the Benchmark study.

Dimensioning the Medical Professional Liability Market

Before diving into the loss trends, we thought it worthwhile to dimension the MPL market. Figure 1 shows that it accounts for about 4% of commercial lines premiums and represents just over $10 billion of annual premiums. It's a significant portion of 'specialty liability', the $34 billion market segment in which its shown below.

Figure 1 Dimensioning MPL- $10.3 billion of premiums, 4% of Commercial Lines



MPL is a catch-all term that includes predominantly Hospital Professional Liability (HPL) and Physician's Professional Liability (PPL). The Aon study focuses primarily on these two coverages.

Source: ISO MarketStance, Assured Research

Where the Problem with Loss Tend Isn't…

Many will know that the loss trends in MPL have been favorable for more than a decade; frequency of claims has steadily declined and, as with most other lines of insurance, severity hasn't been a problem.

Loss trend isn't a problem when losses are limited to $2 million per occurrence. The authors of the Benchmark study selected a 0% frequency trend and a 2% severity trend to take historical experience into the 2018 year. **The only news in this layer appears to be that frequency is no longer declining** (a comment we also heard made on a recent A.M. Best webinar – *The State of the MPL Market*). **With the calendar year combined ratio around 100% for most MPL writers (and reserve releases slowing), pressures may soon build for MPL rates to (finally) begin rising.**[1]

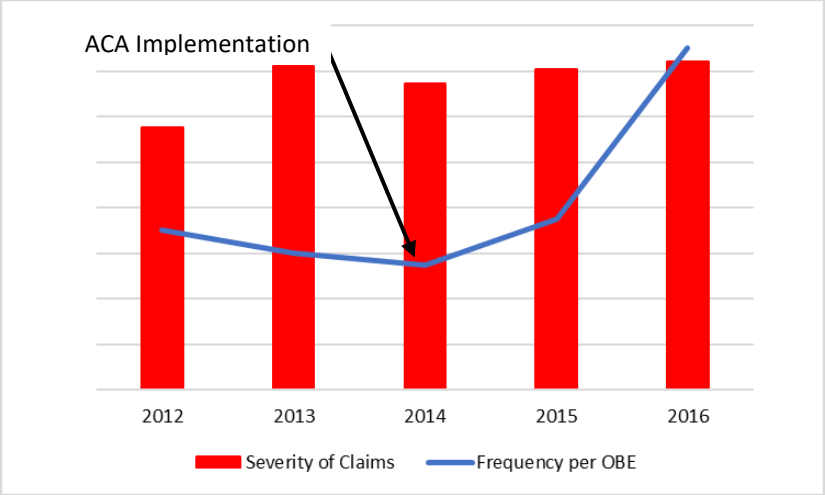
As to why the authors selected a $2 million cutoff – it's both a common retention level for healthcare captives and an area where there's robust statistical credibility.

[1] Data references taken from the *Medical Liability Monitor* (April 2018) by Milliman Inc.

…and Where the Problem with Loss Tend Is

It's in the excess layers – typically in claims valued at $5 million and higher. The authors chose to study the $5 million level because it's where excess insurance frequently attaches. In Figures 2 and 3 we show the directional trends of frequency and severity of claims greater than $5 million for both HPL and PPL. It's clear that **the problem is rising frequency, not severity**.

Figure 2 Trends in the Frequency and Severity of HPL Claims > $5 Mil.

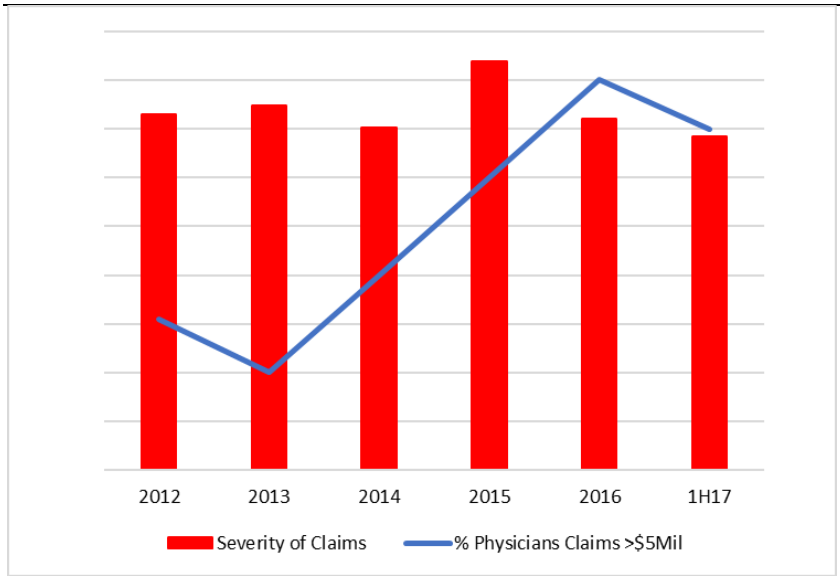


We've removed the scales to preserve the proprietary nature of the data.

Hospital claims are expressed as a function of 'occupied bed equivalent'; the industry standard for exposure.

Source: Aon/ASHRM Hospital and Physician Professional Liability Benchmark Analysis (10/17), Assured Research

Figure 3 Trends in the Frequency and Severity of PPL Claims > $5 Mil.



The measure of exposure for Physician's Professional Liability claims is a 'physician equivalent' or one internal medicine doc covered for one year.

Source: Aon/ASHRM Hospital and Physician Professional Liability Benchmark Analysis (10/17), Assured Research

Why Is the Frequency of Large Claims Rising?

Contributors to the Aon study offer several theories as to why large claims have been rising for the past few years. We'll reiterate the rationale we find most persuasive: *We suspect the convergence of a rising litigiousness among Americans (fueled by money flowing to 3rd Party Litigation Funds and rising legal advertising) and physicians increasingly employed by large healthcare organizations with deep pockets and larger insurance limits probably explains a good bit of the trend.*

> *Industrywide we continue to see a number of reports of large verdicts…when severity increases, frequency often follows due to the publicity that large verdicts invariably generate.*
>
> *Howard Friedman, Chief U/W Officer, ProAssurance*

Batching claims is another explanation

Batching of healthcare claims – or, grouping together healthcare incidents and their damages to be considered one occurrence – is not a new phenomenon. But the authors describe how advances in healthcare, risk management, and the claim reporting culture of hospitals have combined to increase the likelihood that batched claims are identified and grouped into one large loss. The nearby sidebar provides examples of batched claims that may be helpful.

Insurance coverage for batched claims is available and widely purchased, but media reports of large (batched) claim values can feed into the cycle of rising jury verdicts and rising frequency.

> ***Examples of batched claims***
>
> *Recent advancements in the availability and utility of healthcare data allow organizations to discover patterns and connect incidents that would not have been linked in the past. Examples might include contaminated equipment, employee misconduct, serial diagnostic errors, or unnecessary medical procedures.*

Summary

At $10 billion of annual premiums, MPL is only a modest-sized line of insurance. But it is a bellwether of sorts as rising jury verdicts in healthcare probably bleed into the fabric of our society and influence verdicts affecting other professionals and general liability claims. We offer that statement without proof, but the idea that large jury verdicts in healthcare create a self-perpetuating phenomenon (i.e., enticing more claimants to both sue and aim for larger verdicts) seems highly intuitive.

It might be interesting to work with our friends at X Ante, the legal advertising specialists, to study healthcare claims and jury verdicts in areas where legal advertising has spiked. Takers?

Marine Insurance: Strong Economies, Why Isn't this the Best of Times?

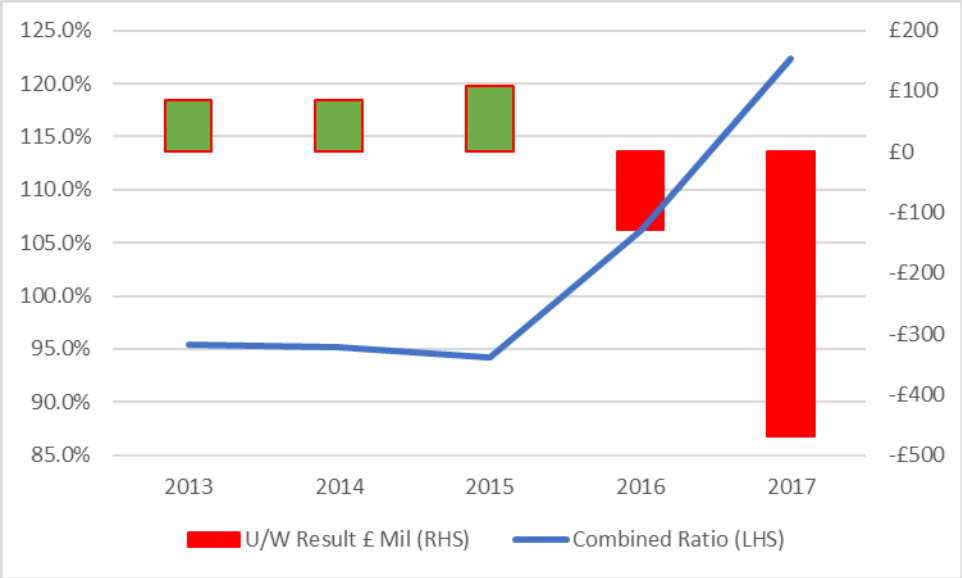
The answer lies with a nemesis as old as ocean marine itself – the pricing cycle!

Depending on which side of the bed we exit on any given day, readers will either hear us argue that the pricing cycle is dead, or that it lives on albeit somewhat more muted than in past decades. Where we're likely to be more consistent is in our observation that **there will be episodic periods of intense competition and underwriting losses within specific lines of insurance**. Most readers will know that we've singled out commercial automobile in the United States as Exhibit "A" for that dynamic. We think we've found its British analog – marine insurance.

We're not ocean marine experts! That seems an important caveat to offer since this oldest of insurance lines is steeped not only in history, but in colloquialisms and quirks that make rigorous diagnostics by dispassionate observers, such as us, a real challenge.

Fortunately, our objective in this report is not to present a rigorous analysis of the marine underwriting line – or its major sublines including cargo, hull, or liability. Instead, our aim is to answer a simple question: **With global economies generally on a synchronized upswing, why isn't the marine line enjoying the best of times?** We know…there are threats of trade wars and even real wars to worry about; but there are always external risks and worries. Instead, **our conversations with knowledgeable marine professionals point to a self-inflicted cause as old as marine insurance itself – overcapacity and the pricing cycle**.

Figure 1: Marine Insurance Results at Lloyd's Of London



U/W losses in 2017 were exacerbated by the active hurricane season. But by all accounts, declining insurance rates are the real scourge of the marine market.

Source: Lloyd's Annual Report 2017, Assured Research

The Economics of the Sea Transportation Can't be Ignored

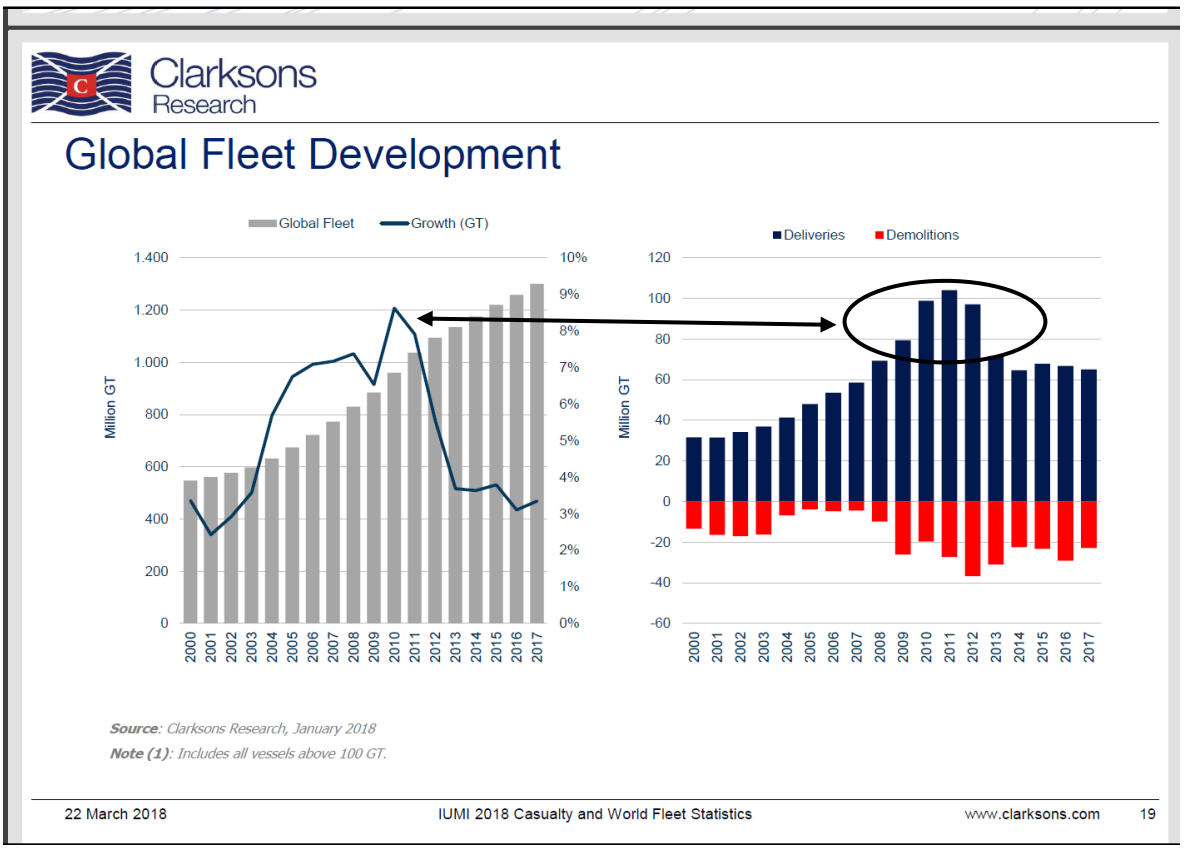
If we're not marine insurance experts, we're *definitely not* experts in the economics of the shipping industry. And yet, we suspect **the insurance pricing cycle and the economics of shipping are** sufficiently **intertwined** that one cannot understand the former without giving some thought to the latter. So, here we go…

The global shipping industry is consolidating..fast

According to a recent article in the *Wall St. Journal*, the 20 largest operators of container ships have consolidated to just seven companies over the past *three* years. They now control nearly three-quarters of the world's total container capacity.[2] That's a massive level of consolidation, and in a theme we'll return to later in the report – that **consolidation can't be good for marine insurers now facing the prospect of both fewer and better capitalized purchasers** of their products.

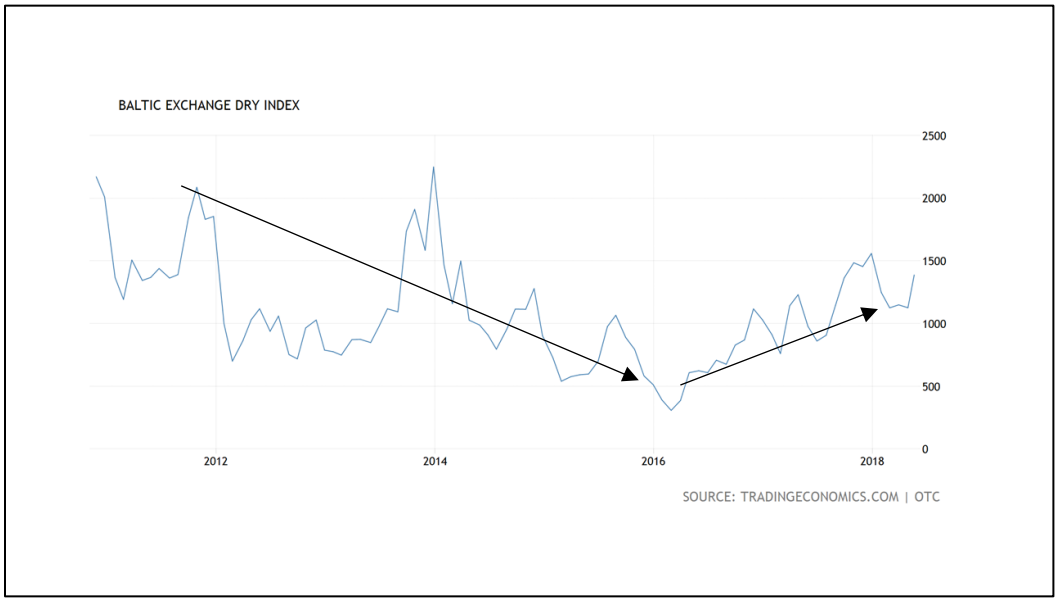
Our next series of graphs offer one among what we suspect is several plausible reasons for consolidation in the global shipping industry.

Figure 2: The Container Shipping Industry is Consolidating Because…

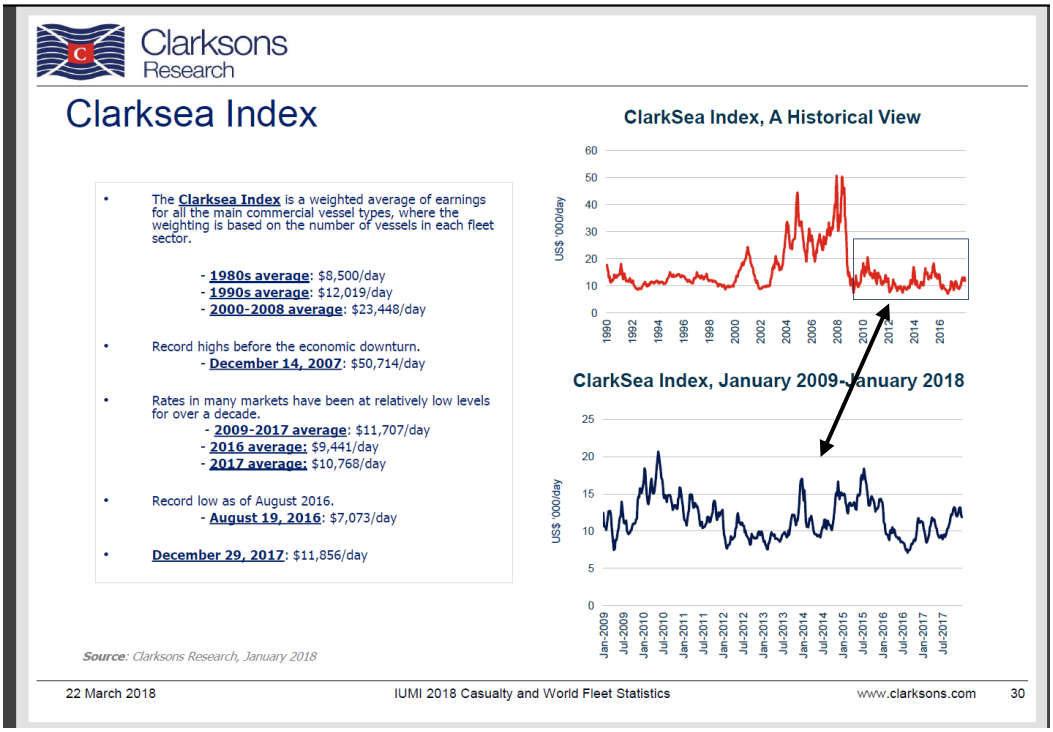


[2] C. Paris and C. Tsuneoka, *Japanese Shipping Merger Follows Trend*, Wall. St. Journal May 12/13, 2018

In the years immediately after the financial crisis the number of ships built to carry containers (finished goods) and dry bulk goods (think commodities) rose dramatically (figure above).



The Baltic Dry Index (figure to the left) measures global supply and demand for the commodities shipped aboard dry bulk carriers, typically raw materials including building materials, grains or natural resources like coal. We don't show a rate index for container shipping, but from our review of publicly available sources the pattern appears similar with a bottoming in 2016, followed by recovery and then range-bound in 2017/2018.



The Clarksea Index (left) calculates average daily earnings for commercial vessels. The historical view shows earnings volatility since about 2000, while ***the current view*** *(on bottom)* ***shows that earnings of commercial vessels have been stagnant since the financial crisis***.

Source: International Union of Marine Insurance, Tradingeconomics.com, Drewry, Assured Research

Shipper's challenges are not abating

Despite freight rates that have improved since bottoming in 2016, a broadly healthy global economy and robust trade, **shippers' financial problems are continuing**. Take shipping leader **Maersk**. The company's **recently reported 1Q18 earnings included a 38% increase in ocean revenue** – 24% from volume and 7% from rate.

What could possibly go wrong with a 38% growth in revenue? **It's ocean shipping EBITDA margins still fell to 7% from 10%** the year earlier on higher fuel costs and terminal rates. **We scoured the Maersk filings and presentations but couldn't find any complaints about the cost of insurance!** And our nearby sidebar explains how Maersk appears to be dodging higher insurance costs despite a looming, 2018 insured loss that could measure $400-$500 million from sources we read.

The Maersk marine renewal reveals the difficulties of underwriting in a soft market – business moves!

Global shipping news source TradeWinds recently reported that XL Catlin was at risk of losing the hull premiums on its flagship Maersk account to a Protection and Indemnity club (think mutual insurer for shipowners) because it sought a material rate increase.

Surely the pending, multi-million loss on the Maersk Honam (a massive container ship fire in March/April 2018) was one reason for the proposed rate increase.

Our conversations surfaced similar anecdotes on a smaller scale. An incumbent insurer looking to raise rates following a loss frequently, in the stories we heard, lost the business.

Sounds to us like buying behavior enabled by a soft pricing cycle.

Economics of shipping industry don't help insurers

There are surely myriad other factors driving the consolidation of the shipping industry. But we'll observe that **a consolidating industry where earnings aren't great doesn't create the ideal backdrop for insurance underwriters**.

In fact, **all these factors take pricing power away from marine insurers**; and it's even worse when there is – from every source we found - overcapacity in the marine insurance market.

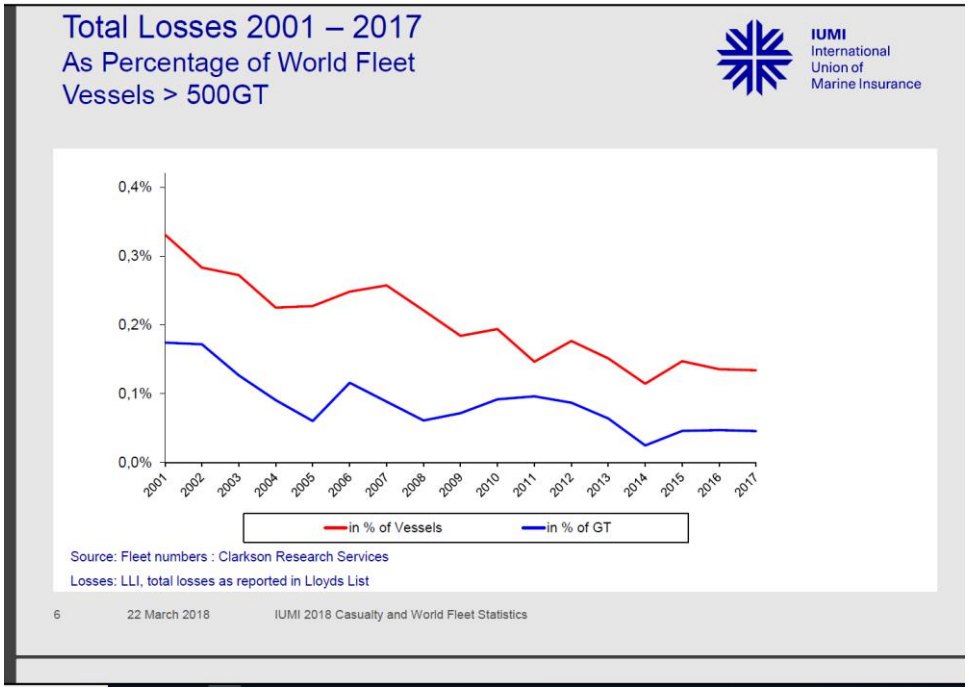
The Problem Doesn't Appear to be Losses…It's Pricing

Shipping losses are happening. The Maersk Honam is one recent example; many will remember the cruise ship Costa Concordia from several years back. And any conversation with a marine underwriter or broker will be replete with stories of spectacular hull or cargo losses that make our desk job seem, well, downright boring.

But as Figure 3 reveals, the global loss trend is broadly favorable. We'll try our hand at explaining the issue using our best marine parlance: *With premium income eroding thanks to*

over capacitation, attritional losses alone put underwriting results at breakeven; there's no money left to fund the big crack ups. Ok, that's not very good…but it makes the point.

Figure 3: Global Marine Loss Trends



Why are hull losses down? Advancing technology has made ships safer…much like cars. Attritional and catastrophe losses appear to be more of a problem for cargo insurance.

Source: International Union of Marine Insurers, Assured Research

Marine insurance rates are down

"A competitive environment persisted in marine lines where capacity, despite some withdrawals, remains high." Lloyd's Annual Report, 2017

The Beazley syndicate is one of the five largest writers of Marine, Aviation, and Transportation business at Lloyd's, and according to graphs shown in their 2017 Annual Report it appears to us as if **marine rates are some 22% below their 2008 levels and even 5-10% below their 2001 levels**. The nearby comment from the Lloyd's annual report as well as our anecdote about XL Catlin trying to raise rates on Maersk show that **some underwriters are trying to form a market bottom, but it's our sense that rates at their current levels will produce an underwriting loss even in a normal loss year**.

And that's the story of a pricing cycle

We ventured into the economics of the shipping industry to explore some confounding factors, but at its core the pricing cycle isn't difficult to understand: insurance prices barely keep pace with attritional losses, leaving no room for the extraordinary claims…which happen with surprising regularity and in the marine line are always the source of a colorful story.

Business Development: A Tax Reform/Small Commercial Case Study

Economic tailwinds may be gathering, research still needed to uncover opportunities

Earlier this year, in our analysis of the second-order effect of tax reform, we reached two conclusions:

1. A bullish estimate of the incremental P/C premium created by the reform could reach $215 billion over ten years; and

2. To the extent tax reform is good for the economy, it should stimulate growth in small commercial businesses. Further, three specific elements of the law seem likely to help small businesses, including: 1) the lower individual tax rate; 2) the additional deduction afforded to pass-through entities (some 80% of small businesses); and 3) an increased cap on allowable expensing of business equipment.

Although it's too soon to begin measuring actual changes because of the *Tax Cuts and Jobs Act (TCJA)*, our interest in staying on top of business opportunities created by this one-in-a-generation reform was aided by a new, small commercial diagnostic tool available through our alliance partners at ISO MarketStance.

In this note we wed publicly available data with market intelligence from ISO MarketStance to consider how an insurance carrier might study business opportunities in small commercial.

A Small Commercial Case Study

We're going to assume that our carrier is predisposed to pursing growth opportunities in very small commercial businesses (1-9 employees) offering professional services in a predominantly office-based setting. Reasonable questions to answer include:

1. What's the market opportunity measured by premiums and the number of businesses?

2. What's the forecasted growth rates of those businesses?

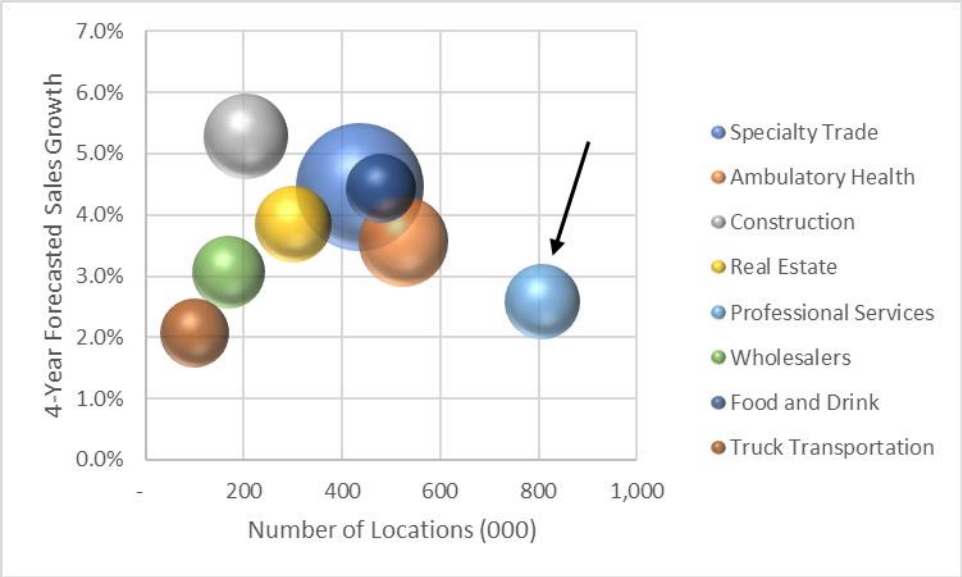
3. Where are the businesses and what types of insurance products do they buy?

Over the balance of this note we'll show our analytical process, with a heavy reliance on graphs and bullets to illustrate our work and observations. Readers will understand that our case study has been simplified relative to a 'real world' undertaking, but we hope this effort stimulates thoughts or motivates readers to ask questions or share observations.

Triaging the World of Small Commercial

As a starting point, we reviewed the premium size and growth characteristics of all employers with between 1-49 employees (one definition of small commercial). With our predisposition to professional, office-based exposures, we still wanted to understand where that group fits into the broader universe of small business. In Figure 1 we've included only industries purchasing more than $3 billion annually.

Figure 1: Premiums, Growth Forecast, and Locations for Small Businesses (3-digit NAICS)



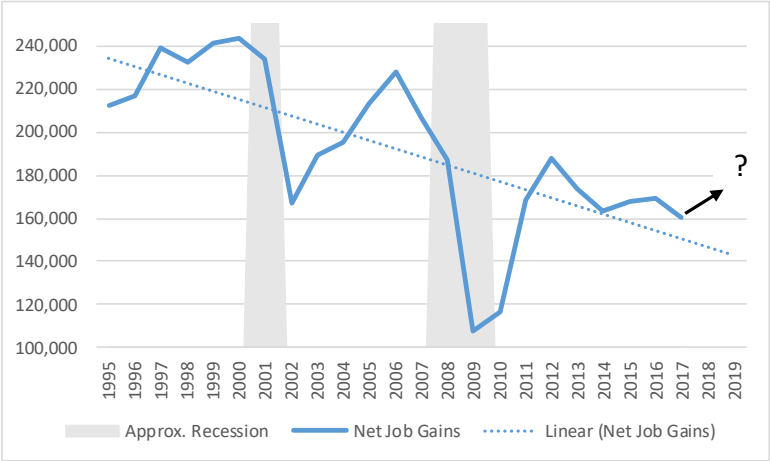
Small professional service firms purchase about $4 billion of annual premiums. Their forecasted growth rate isn't great, but there are lots of these firms!

Source: ISO MarketStance, Assured Research. Data shown for employers with between 1-49 employees.

Past trends in job growth provide context

Having decided to go 'hunting' in the professional services sector, we thought it useful to consider the historical net job production of small professional service firms (those in our target space of 1-9 employees). We further refined our focus on firms that had been in business for four years or less. Our thinking was that this would provide some insight into the dynamism of the sector; important with consideration for whether it would be responsive to tax reform.

Figure 2: Net Job Gains of Small Professional Service Firms



Source: BLS.Gov (Business Employment Dynamics), Assured Research. 1-9 employees

Less dynamic than expected…but perhaps a cyclical (if not secular) rebound lies ahead

The small professional service space is less dynamic than we might have expected; witness the downward sloping trend in Figure 2. But with optimism for the stimulative impact of the TCJA, we press ahead in the hopes that we'll at least catch a cyclical upward inflection in their net job creation over the next few years.

Drilling into Professional Services at the Small End of Commercial (1-9 Employees)

Our next undertaking involved consideration of where, within professional services, we should focus our attention. We're assuming here that our company's current skill set (U/W, claims, actuarial) and distribution partners are capable of pursing most of the office-based occupations residing within professional services (otherwise, some classes might be excluded from this consideration set in a real-world scenario).

The table in Figure 3 narrows our focus relative to the groupings in Figure 1. Here we refine our scope both *within* professional service firms and within *small* commercial. That is, the data in Figure 3 focuses on firms with between 1-9 employees.

Figure 3: Forecasted Growth Rates and Premiums for Professional Service Categories

Industry	Payroll 4-Yr Forecast	Sales 4-Yr Forecast	Premiums $(000)
Architects and Engineers (A&E)	2.0%	1.2%	312,336
Legal Services	1.7%	1.6%	261,272
Mgmt. and Consulting	4.7%	4.3%	234,199
Accounting, Tax	2.8%	2.5%	189,210
Computer Systems	4.8%	3.5%	142,491
Other Professional	4.0%	3.7%	136,031
Specialized Design	1.7%	0.7%	89,586
Advertising, Public Relations	2.4%	1.9%	73,507
Scientific Research	3.1%	3.6%	31,841

Source: ISO MarketStance, Assured Research. Data shown for employers with between 1-9 employees.

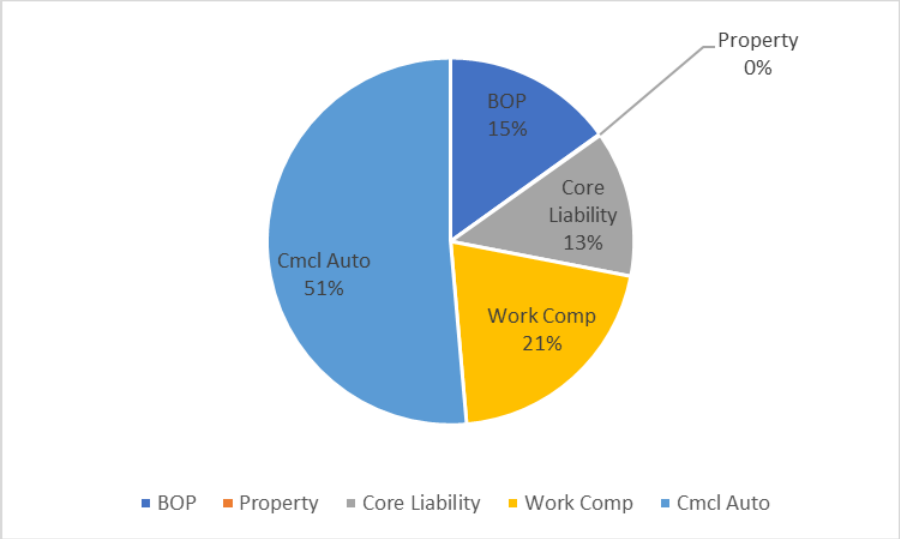
Although the forecasted growth rates are only middling, let's assume our company wants to pursue Architects as the largest category.

What products do Architects and Engineers (A&E) buy?

Having set its sights on the A&E category, it's probably safe to assume that our company next wants to know what mix of products they typically purchase. Does the company have approved policy forms at rates that can be sold to A&E offices? What insurance packages might need to be created?

These and many other relevant questions would form part of the feedback loop that we're glossing over in this simplified case study.

Figure 4: Premium Mix for Architects and Engineers; 1-9 Employees



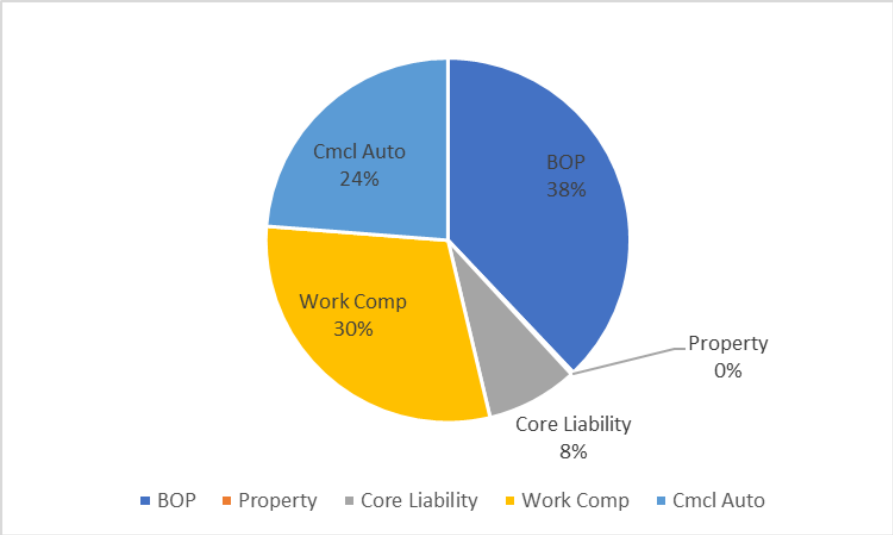
Why so much commercial auto? We explain below, but we'll assume this turns off our company and that other classes of professional services need to be vetted.

Source: ISO MarketStance, Assured Research. Data shown for employers with between 1-9 employees.

Our company doesn't want this much commercial auto!

The professional service category of Architects and Engineers also includes landscaping and building engineering businesses as well as building inspection and mapping services – people who need to be out of the office to earn their living! This is why, we assume, commercial auto is a surprisingly large share of this group's premium spend.

Figure 5: Premium Mix for Management and Consulting Services; 1-9 Employees



Management and Consulting services appears to include more office-based exposures than Architects and Engineers. It also enjoyed higher forecasted rates of growth (Fig. 3).

Source: ISO MarketStance, Assured Research. Data shown for employers with between 1-9 employees.

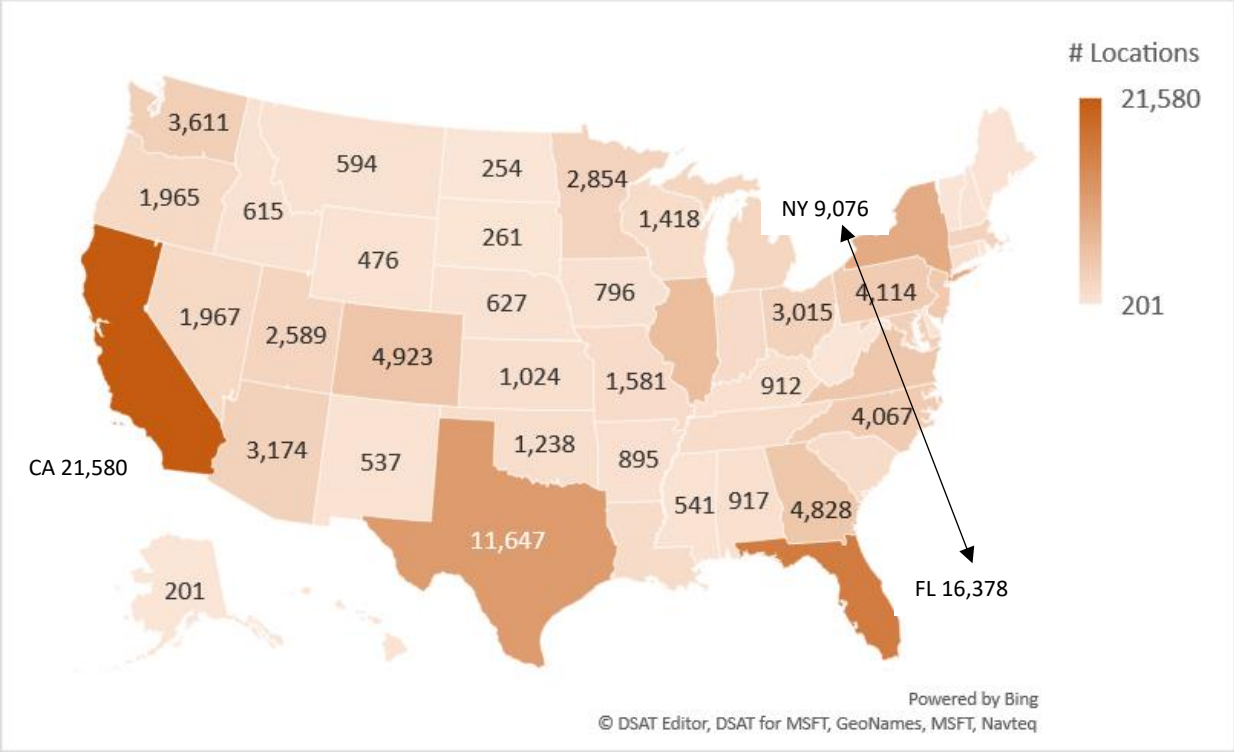
We'll assume our bosses are happy pursing the broadly similar, but more office-based exposures found in the Management and Consulting business sector (less auto and more BOP!)

The next question is where can these small offices with fewer than ten employees be found?

Location of Small Management and Consulting Firms

Figure 6 shows the present locations of the offices; it's interesting to note the gap between Florida and New York businesses, for instance. Also, it looks like states including Colorado, Georgia, and North Carolina punch above their weights relative to Pennsylvania, Ohio, and Michigan.

Figure 6: Location of Small Management and Consulting Firms; 1-9 Employees



Source: ISO MarketStance, Assured Research. Data shown for employers with between 1-9 employees.

At this stage of the analysis we'd expect our company to begin giving serious consideration to distribution. Identifying opportunities is the important first half of the battle; selling the products profitably matters too!

Summary

It will be some time before we can measure the secondary impact on P/C premiums from the Tax Cuts and Jobs Act. We hope our bullish estimate of $215 billion of incremental commercial premiums is of the right order of magnitude, but what we can relay with more confidence is that the impact of the TCJA won't be spread evenly across the U.S. economy.

We think small commercial businesses can prosper post-reform, but insurers investing the time and effort to find those economic tailwinds will be best positioned to take full advantage.

Financial Analysis: Commercial ROEs Higher than Personal Insurance

Further mining of our annual ROE dispersion data

In this note, we again utilize data from our *Assured Industry Study of ROE Dispersion*; this time comparing the results of personal and commercial insurers.

Commercial insurers win! Our work shows that the five-year average return on equity for the commercial lines carriers was 7.6% compared to 5.1% for the personal lines companies. The overall industry return was 6.6%

Personal Insures Succumb to Auto Claims and Cats

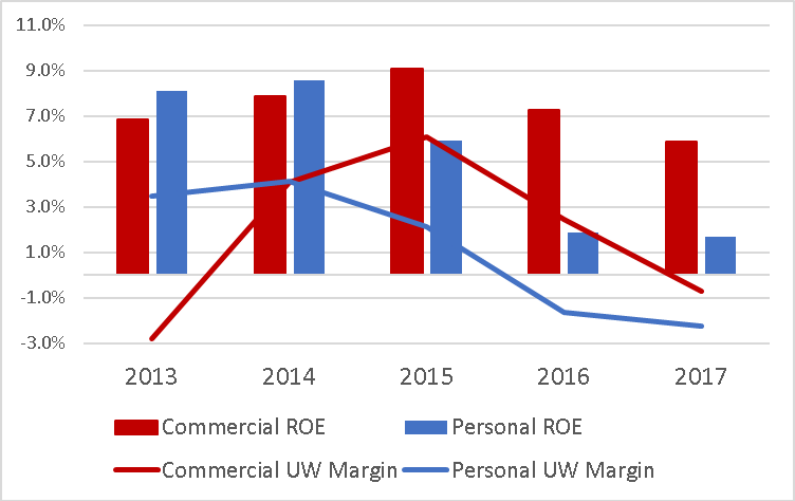
Figure 1 shows the 2013-2017 ROE trends as well as the underwriting margins for the two groups.

For the last three years, the commercial companies have had higher returns as the underwriting margins of the personal lines companies slipped over the past three years.

In April we released our Annual Study of ROE Dispersion report where we contrast the returns and ROE levers by ownership structure (stock vs. mutual) and geographic focus (national vs. regionals). The report showed that stock-owned insurers produce higher returns than the mutuals and that the national companies produce higher ROEs than the regionals.

In this note, we use the same data but divide the companies into those that are predominantly commercial lines carriers and those that are mainly personal lines.

Figure 1 Return on equity and underwriting margin:2013-2017



Personal lines underwriting declined more than commercial in the last three years; a more competitive automobile environment combined with rising claim frequency in 2014/2015 and catastrophes, particularly in 2017, sealed their fate.

Source: S&P Global, Assured Research

Quintile Analysis

To delve more deeply into the data, we divided companies into quintiles based on their five-year average returns. We designate Quintile 1 as the companies with the highest returns and Quintile 5 as those with the lowest ROEs.

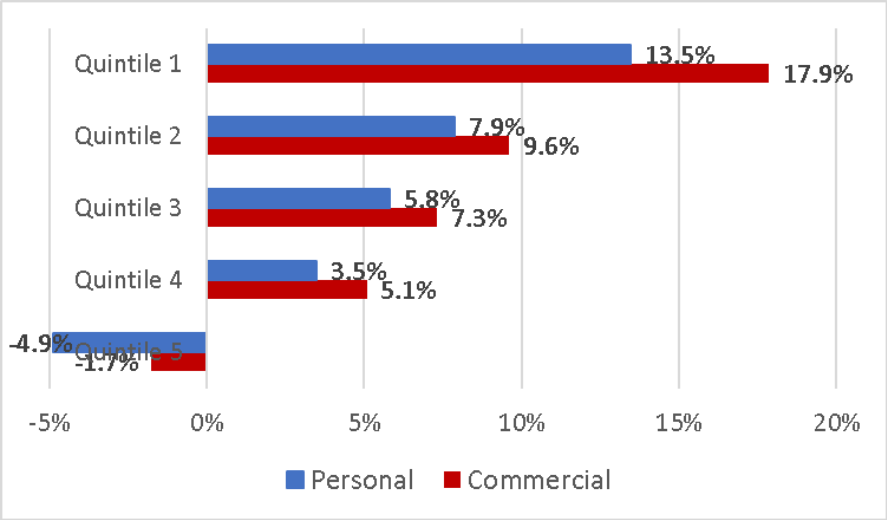
Figures 2 and 3 show the ROEs and the combined ratios for the quintiles.

The commercial ROEs exceed those of the personal lines companies in each of the quintiles (Figure 2). In almost all the cases (Quintile 5 being the exception), **the higher returns are derived chiefly from better underwriting results** (Figure 3, next page)**.**

A word on our data

We are using the companies designated by S&P Global as predominantly either personal or commercial lines oriented. In the universe there are 135 commercial companies with $166 billion of premiums and 148 personal lines companies with $337 billion premiums. The average size difference occurs because the personal lines companies consist of the largest U.S. insurers, such as, State Farm, GEICO, Allstate and Progressive.

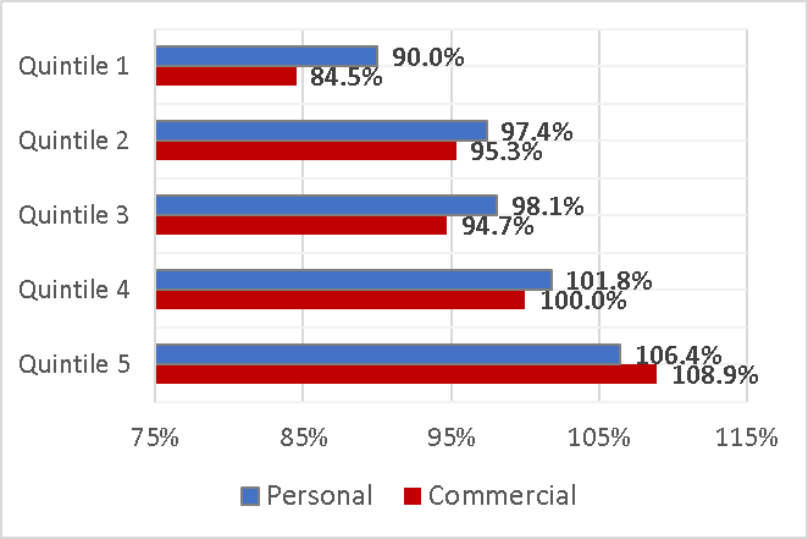
Figure 2 Returns on equity by quintiles: Average 2013-2017



Commercial companies have higher returns in each of the quintiles.

Source: S&P Global, Assured Research

Figure 3 Combined ratios by quintiles: Average 2013-2017



The higher returns of commercial insurers are derived chiefly from better underwriting (except Quintile 5).

Source: S&P Global, Assured Research

Leverage Profiles Differ: Personal Higher Underwriting; Commercial Higher Asset

Looking at some of the other profit drivers besides underwriting, Figure 4 shows that the **personal lines companies have more underwriting leverage**. This is because there is less volatility (risk) in underwriting (mainly personal auto), so the companies need less capital. Additionally, **the commercial companies have more asset leverage since they have longer tailed reserves**.

Figure 4 Personal vs. Commercial ROE derivation: Average 2013-2017

	Commercial	Personal
Combined ratio	96.8%	98.8%
Pretax returns		
Underwriting margin	3.2%	1.2%
Leverage (Prem/Surplus)	0.98	1.38
Underwriting return	3.2%	1.6%
Return on assets	2.6%	2.3%
Leverage (Invest./Surplus)	2.30	2.06
Investment return	5.9%	4.7%
Misc. other	0.2%	-0.5%
Pretax return	9.3%	5.8%
Eff. Tax rate	18.2%	12.4%
ROE	7.6%	5.1%

Source: S&P Global, Assured Research

Note the leverage differences.

Personal UW leverage higher; Commercial investment leverage higher.

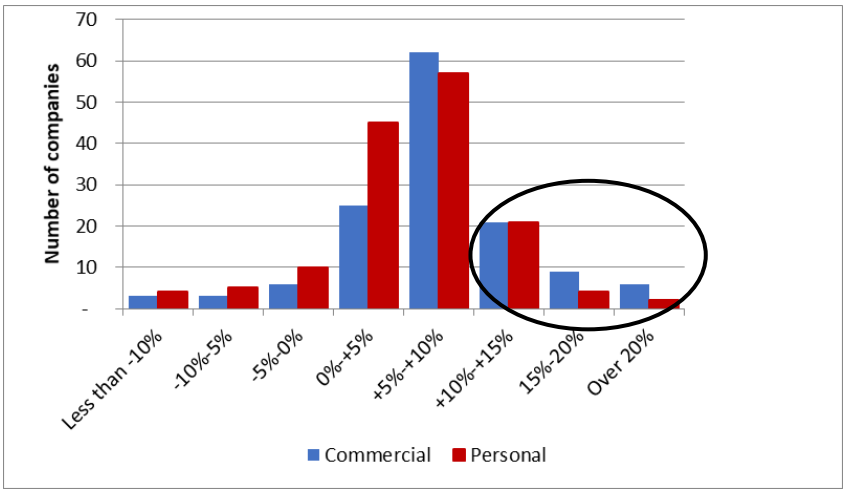
Dispersion Analysis

Another point we continually make regarding the P/C industry is that even though it is a mature business with slow premium growth and sub-par returns, there are numerous companies with excellent long-term returns that do well despite the macro-environment. The dispersion of returns between the highest and lowest earning companies is broader in P/C insurance than in other industries; underwriting is the main differentiator between the best and the worst.

Even though the industry ROE was only 6.6% over the last five years, over 20% of insurance companies produced returns of more than 10%.

Figure 5 shows that the wide range of dispersion also applies to both the commercial and personal companies. Specifically, **27% of the commercial companies had ROEs of greater than 10% while 18% of the personal lines companies exceed that level**.

Figure 5 Return on Equity Ranges: 2013-2017 (%)



A large number of companies have greater than 10% annual returns: 27% of the commercial, and 18% of the personal lines companies.

Source: S&P Global, Assured Research

Summary

Our overall opinion of the industry—which is that with good underwriting skills it is possible to have acceptable returns—also holds true whether an insurer concentrates on the commercial or personal lines.

Personal Auto: Direct Writing Esurance Turns the Corner

Comparisons to Progressive Direct still unflattering, but profit margins near targets

Being compared to Progressive is nobody's idea of fun; particularly for a direct-writing auto insurer. But thanks to the financial transparency of Progressive and Allstate, we find ourselves like bugs drawn to a light – we couldn't look away if we wanted.

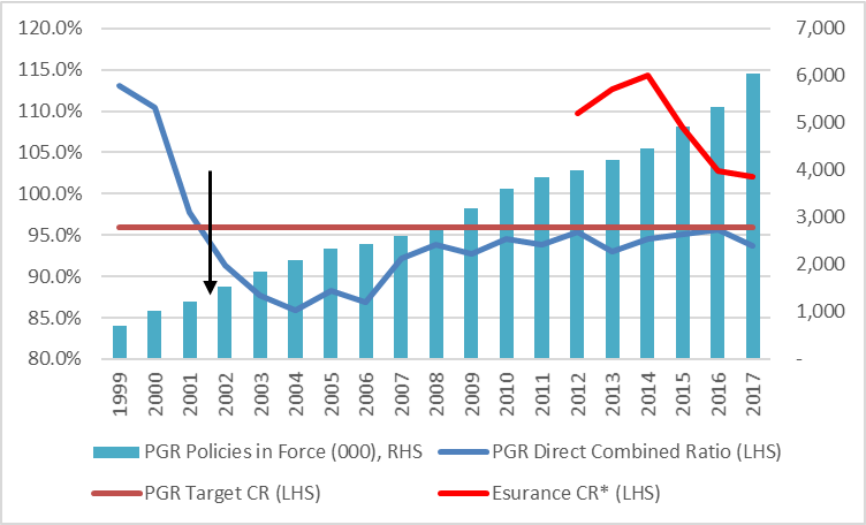
And so it is that we offer another installment of our analysis of the profitability and growth metrics of Esurance – the nearly $2 billion (premium) direct writing unit of Allstate. The acquisition statistics compel us also. Allstate paid roughly $1 billion for Esurance in late 2011. Since then, the insurer has produced around $1 billion of underwriting loss after accounting for more than $1 billion of advertising expenses. It's been a big bet and we want to see if, or when it will pay off.

The good news: We estimated that Esurance's accounting combined ratio would reach 100% in 2018, and indeed the company touched that mark in 1Q18. It's economic combined ratio - where advertising is expensed over policyholder life expectancy rather than immediately - was 96% in 2017. With those milestones reached, Esurance's rate increases have decelerated and in the 1Q18 matched the industry after being higher since 2013.

And more good news: Esurance's policies in force grew for the first time since 2014. It's still spending more on advertising than its direct-writing competitors (5-7% of premium for GEICO and Progressive Direct) vs. 8% for Esurance…. but that is at least in the same ballpark.

And yet…the comparison to Progressive Direct is tough: Figure 1 tells the story.

Figure 1: Esurance's Current PIF Put it, Developmentally, Near Progressive Direct in 2001/02



Esurance's auto PIF (1.4 mil.) is about the same as PGR Direct had in the 2001/2002 timeframe (indicated by the arrow)

And yet, it's combined ratio today is nearly 8 points higher than PGR Direct at that time. This is a tough business!

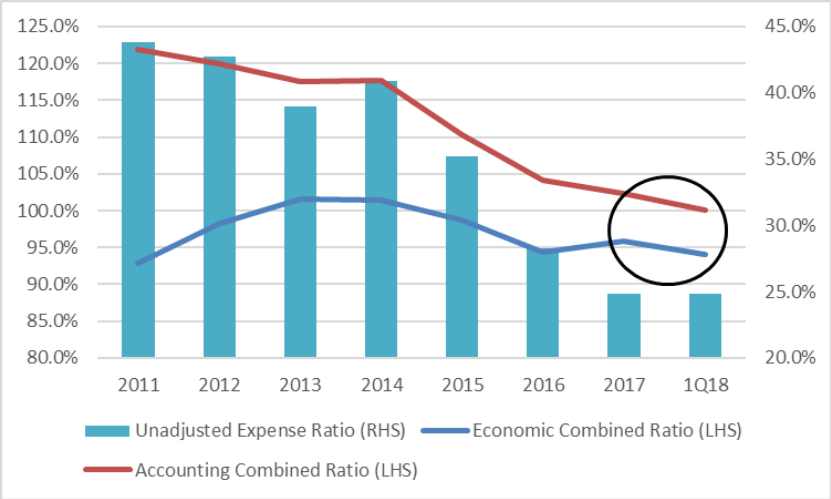
Source: Company Documents, Assured Research. *Esurance's CR excl the amortization of intangibles for better comparability.

Profitability and Growth Metrics Improving at Esurance

Notwithstanding the difficult comparison shown in Figure 1, we write with a good news story – profitability and growth metrics at Esurance are moving in the right direction. And yet, our message from previous notes on this topic remains unchanged:

Esurance's slow build to profitability provides a sobering, if not cautionary tale to would-be disruptors in the personal insurance sector. Patience is vital, and success is not guaranteed!

Figure 2 The Accounting and Economic Combined Ratios (CR) of Esurance are Converging



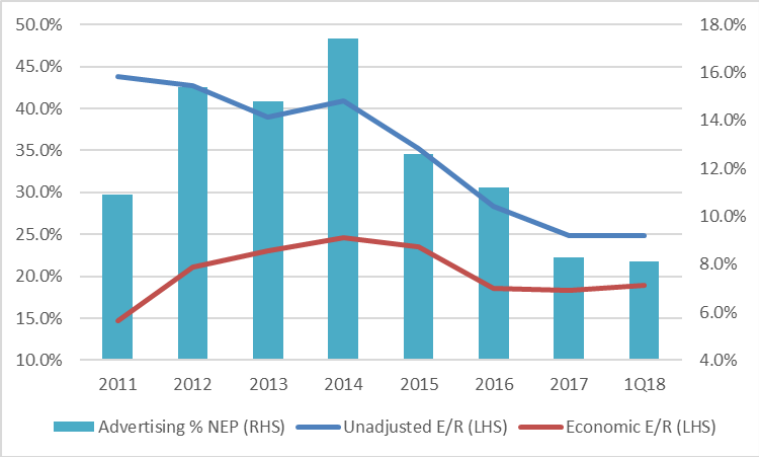
To arrive at an economic CR, we remove the amortization of purchased intangibles from the expense ratio and amortize annual advertising expenses over est. policy life expectancy (PLE) of 4 years.

Source: Company Documents, Assured Research. All assumptions used to estimate the "Economic CR" are our own.

It's notable that Esurance's (accounting) combined and economic combined ratios approached, and then achieved critical targets of 100% and 96%, respectively, in 2017 and 1Q18.

Expense ratio reduction by slowing advertising

Figure 3 Expense Ratio Reduction on the Back of Lower Advertising Spend



Advertising spend peaked at 17.4% of premiums in 2014 but has since been halved – 8.2% in 2017/1Q18.

Advertising yield is still not great – PGR Direct and GEICO spend 5-7% on advertising and are steadily growing PIF.

Source: Company Documents, Assured Research. "PLE" refers to policy life expectancy which we estimate at about 4 years given Esurance's 82% retention ratio.

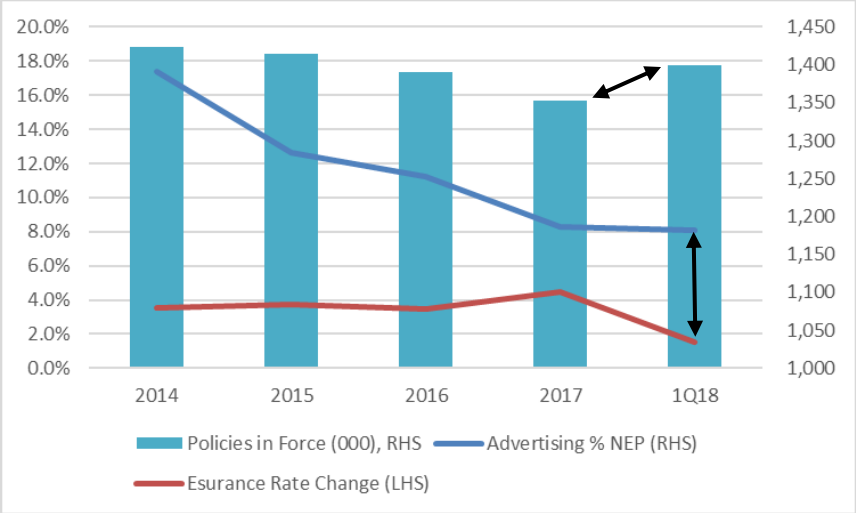
Figure 3 reveals that the shrinking gap between Esurance's accounting and economic CR has come primarily from expense reduction – chiefly a rapid decline in advertising spend.

With improving profitability, advertising is stabilizing, rates decelerating, and PIF rising

Esurance's PIF peaked in 2014 (as did its combined ratio – see Figure 2), but since then management has been in profit-improvement mode. **The levers to fixing profitability are the same for most insurers – and direct writing is no exception: raise rates, advertise less, and allow policy retention to fall.** Management at Allstate/Esurance took all those actions from 2014-2017. They raised rates by nearly 2x the industry average in 2014 and 2015. That differential slowed to roughly 30% more in 2016 and 2017 and during that time policy retention stagnated around 80%.

Figure 4 tracks two of those three levers to fixing profitability. Declining advertising and steady rate increases led to declining PIF through 2017. But 2018 was off to a brighter start as PIF increased for the first time since 2014 on rising applications and policy retention.

Figure 4 Policy growth has returned as advertising stabilizes and rate increases slow



Maybe it's coincidence that Esurance's accounting and economic CRs reached 100% and 96%, respectively, then advertising stabilized, rates decelerated and PIF reaccelerated.

But we don't think so!

Source: S&P Global, Company Documents, Assured Research

Summary

With its profit improvement phase now in the rear-view mirror, Esurance seems poised to reenter growth mode and recoup some of the nearly $1 billion of underwriting losses it has generated since the 2011 acquisition. It bears mentioning, however, that Progressive Direct earned $1 billion of underwriting income in just the past two years.

As we said, being compared to Progressive Direct is nobody's idea of fun.

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