Root, Inc. NasdaqGS:ROOT

Earnings Call

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Call Participants

EXECUTIVES

Alexander Edward Timm
Co-Founder, CEO & Director

Daniel Harris Rosenthal
Chief Revenue & Operating Officer & Director

Frank Phillip Palmer
Chief Insurance Officer

Jodi Emmert Baker
VP & Secretary

Matt Bonakdarpour
Chief Technology Officer

Robert Harold Bateman
Chief Financial Officer

ANALYSTS

Charlie Lederer

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

Thomas Patrick McJoynt-Griffith
Keefe, Bruyette, & Woods, Inc., Research Division

Weston Clay Bloomer
UBS Investment Bank, Research Division

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Root, Inc. Q4 2022 Earnings Conference Call. I would now like to turn the call over to Jodi Baker, Corporate Secretary. Please go ahead.

Jodi Emmert Baker
VP & Secretary

Good morning, and thank you for joining us today. Root is hosting this call to discuss its fourth quarter 2022 earnings results. Participating on today's call are Alex Timm, Co-Founder and Chief Executive Officer; and Rob Bateman, Chief Financial Officer. During the question-and-answer portion of the call, our presenters will be joined by Dan Rosenthal, Chief Revenue and Operating Officer; Matt Bonakdarpour, Chief Technology Officer; and Frank Palmer, Chief Insurance Officer.

Last evening, Root issued a shareholder letter announcing its financial results. While this call will reflect items discussed within that document, for more complete information about our financial performance, we also encourage you to read our 2022 Form 10-K, which was filed with the Securities and Exchange Commission last evening. Before we begin, I want to remind you that matters discussed on today's call will include forward-looking statements related to our operating performance, financial goals, and business outlook, which are based on management's current beliefs and assumptions. Please note that these forward-looking statements reflect our opinions as of the date of this call, and we undertake no obligation to revise this information as a result of new developments that may occur.

Forward-looking statements are subject to various risks, uncertainties, and other factors that could cause our actual results to differ materially from those expected and described today. In addition, we are subject to a number of risks that may significantly impact our business and financial results. For a more detailed description of our risk factors, please review our Form 10-K for the year ended December 31, 2022, where you will see a discussion of factors that could cause the company's actual results to differ materially from these statements as well as our shareholder letter released last evening. A replay of this conference call will be available on our website under the Investor Relations section.

I would also like to remind you that during the call, we will discuss some non-GAAP measures while talking about Root's performance. You can find reconciliations of those historical measures to the nearest comparable GAAP measures in our shareholder letter released last evening and our Form 10-K filed with the SEC, which are posted on our website at ir.joinroot.com. I will now turn the call over to Alex Timm, Root's Co-Founder, and CEO.

Alexander Edward Timm
Co-Founder, CEO & Director

Thank you, Jodi. In 2022, we significantly strengthened the foundation of the company by achieving profitable pricing levels in the majority of our markets and reducing our capital consumption by 48%, all while much of our competition continued to see rising loss ratios and deteriorating earnings. We did this through the worst inflationary environment in auto insurance in decades, showing the differentiation of our pricing and underwriting technology and our ability to quickly detect and respond to changes in the environment. This has positioned the company to achieve profitability with the capital we have. We drove a 17 point improvement in gross accident period loss ratio year-over-year in Q4. We and we continue to see our loss ratio decline through January.

In 2023, we plan to release our newest segmentation model, which is showing large improvements to our pricing accuracy. We believe our data science and technology competitive advantage is a major contributor to our loss ratio progression over the last 12 months. This has resulted in taking us from over 10 points worse than the industry to now beating the industry average since the third quarter of 2022. All of this positions us to scale our business profitably. As we announced, we are continuing to expand our embedded business with a national digital financial services company. We continue to see momentum in

the funnel for future partners who evaluate speed, innovation, and commitment to customer experience. We believe that embedded insurance will be the next large secular trend in distribution, and our flexible tech stack and insurance product give us a leading advantage to build differentiated access to customers in this growing channel.

In 2022, we grew our embedded new writings more than 8x. This success, combined with our new partnerships is setting us up to scale our embedded platform through 2023. With command of our loss ratio and underwriting results and dramatically reduced fixed expenses, we are well-positioned to drive both new writing growth and profitability in the year ahead. We are excited for the year and are deeply grateful to our team, investors, and customers. I'll now turn the call over to Rob to discuss our operating results in more detail.

Robert Harold Bateman
Chief Financial Officer

Thanks, Alex. Results for the fourth quarter of 2022 reflected our continued focus on strengthening underwriting performance and reducing expenses across the company. Our full GAAP financial results are disclosed in the shareholder letter we published yesterday evening, but I want to focus on a few key highlights. Gross written premium for the fourth quarter of 2022 was $122 million, a 23% decline year-over-year. Gross earned premium was $143 million, a 25% decline. We expected this lower premium from the rate we have taken in stricter underwriting in underperforming geographies and customer segments, along with the significantly lower level of marketing spend compared with the fourth quarter of 2021. These actions caused new business writings to decrease with renewals making up 81% of gross earned premium this quarter as we focus on profitability.

The gross accident period loss ratio was 77% for the fourth quarter, a 17 point improvement versus the fourth quarter of 2021. We recognized and responded to loss trends early, which has driven this year-over-year improvement. In 2022, we implemented 53 rate filings with an average increase of 37% across our total book. We filed revised policyholder contracts in 33 markets to tighten underwriting and refine our fee schedules. We plan to increase rates again in 2023 where needed to offset loss trends from persistently higher than historical severity. The combination of rate increases, strengthened underwriting and meaningful segmentation improvements continue to drive decreases in our loss ratios quarter-over-quarter, moving us closer to our long-term target of 65%.

The operational actions we took in 2022 demonstrate our commitment to lowering the loss ratio and expenses to improve our financial performance in the fiscal foundation of the company. During 2022, our operating loss was $263 million, a 46% improvement compared to 2021. Adjusted EBITDA approximation of operating cash consumption improved 58% over the prior year. We ended the fourth quarter of 2022 with $559 million of unencumbered cash compared with $629 million at the end of the third quarter. We reduced our operating cash consumption by $193 million in 2022 from $403 million in the prior year. We took actions to significantly lower our head count and non head count fixed expenses by 38% on a run-rate basis.
Turning to 2023. Our results reflect the actions we are taking. We expect contraction of premium again in 2023 as our in-force policy decreases outpaced new writings from our embedded platform and profitable direct markets. We look ahead to continued year-over-year improvement in adjusted EBITDA and operating loss in 2023 from a lower loss ratio and a significantly smaller expense base. We are making progress against our strategic priorities, and we'll continue to drive them forward in 2023. By focusing our efforts and capital deployment in areas we believe will hit our profitability targets. We expect to significantly reduce our operating capital consumption again in 2023 and believe we are positioning the company to achieve profitability with the capital we have. With that, we look forward to your questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Joshua Siegler from Cantor Fitzgerald.

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

I was wondering if you could provide an update on the pipeline for future embedded partnerships.

Alexander Edward Timm
Co-Founder, CEO & Director

Absolutely. I think as we announced today and as we said last quarter, we are seeing really because of our differentiation in our product and our technology and our ability to really seamlessly integrate with these partners, we are seeing real momentum in our embedded funnel and in our pipeline. And that's as evidenced by -- as we announced, we signed our commercial agreement with our second embedded partner, and we're expecting 1/3 to follow soon. But I'll turn it over to Dan, who can talk a bit more about the pipeline.

Daniel Harris Rosenthal
Chief Revenue & Operating Officer & Director

Yes. I think Alex is right. We're seeing real differentiation in the marketplace. We see it with the new partner that we were delighted to announce overnight, but also in the pipeline that we talked about, just given the better consumer experience that our product offers, it's just we are able to produce a bindable quote much faster than anyone else, and we're meeting customers in a moment of need.

Secondly, we're seeing better unit economics and business results across the product and that provides an opportunity to scale. And then third, it's really the thing I'd highlight most is our differentiated technology and the insurance product design allows us to seamlessly integrate with partners, and that is what provides a leading advantage that's going to help us build and scale this channel. It's not going to happen overnight, but we know we're on the right track, and we're excited to move forward.

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

Understood. That's helpful. And then looking out into 2023, I know your soft guidance calls for a contraction in revenue. But as these embedded channels grow, do you ultimately expect the policy in force to start improving in the back half of '23? Or I guess, when do you expect the revenue to start showing signs of improvement moving forward?

Robert Harold Bateman
Chief Financial Officer

Josh, this is Rob. If you look at what we're looking at for growth next year is, we expect our direct writings. We expect our renewal book to continue to shrink. But as the new embedded partners come on, our new rates will increase quarter-over-quarter throughout the year.

Operator

Our next question comes from the line of Charlie Lederer from Citi.

Charlie Lederer

In the shareholder letter, you mentioned leaning into direct writing in certain markets. Can you talk about what segments, I guess, you're seeing as attractive and whether this is going to translate into kind of higher marketing spend relative to the fourth quarter?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes. Thanks, Charlie. This is Alex. I think really, what we're seeing right now is, in 2022, we really invested to lower the loss ratio substantially and reduced our fixed expenses. And what that has allowed us to do is really reset the foundation of the company and deliver profitable underwriting results because of those loss ratio levels. Now we still have some work to do on loss ratios, and we think those are going to continue to trend down. But when you look at the market, there are very few competitors that can actually profitably deploy marketing dollars right now because of the elevated loss ratio environment.

And so, what we're seeing is a unique opportunity in the near term to strategically deploy direct marketing dollars in areas that we are seeing hit our return thresholds. I'll pass it to Matt, our CTO, who can talk a bit about where those are. We do believe that because of the hard work we did in 2022 to get ourselves to really what right now is close to an industry-leading loss ratio, that has now allowed us a very unique opportunity in the short to medium term to return to that direct channel.

Matt Bonakdarpour
Chief Technology Officer

Yes. And our focus is on channels where we have a right to win. So we're focused on the channels where we believe data and technology gives us an outsized advantage. Today, those are our performance marketing channels. So boat aggregators, search engine optimization and direct mail, it allow us to leverage granular models to ensure we're deploying our capital in a disciplined manner in a way that hits the targets, as Alex said. And what we've been able to show is that over time as these models become better, we're able to scale those channels with no degradation to efficiency. So we're taking a disciplined approach in the way we invest our capital, and we expand and scale it through the year.

Charlie Lederer

Got it. So I guess as we think about capital consumption coming down further in '23, is more of that this year going to be on like loss ratio improvement relative to last year? Or would it be just because it sounds like marketing spending maybe ticks up a little bit? Or is it, I guess, other areas?

Robert Harold Bateman
Chief Financial Officer

Charlie, it's Rob. It's a couple of things. Number one, on the cash burn, if you think about what we did, we burned about $400 million in cash in 2021, another $200 million roughly in 2022, and we expect to halve that again for 2023 roughly. The primary driver is the loss ratio. We expect the loss ratio to come down substantially again in 2023 as well as work we continue to do around our cost structure.

Operator

Our next question comes from the line of Tommy McJoynt from KBW.

Thomas Patrick McJoynt-Griffith
Keefe, Bruyette, & Woods, Inc., Research Division

Yes, my first question, just continuing on that topic of capital. You talked about being capital self-sufficient with your current outlook. So in your internal forecast, how much of a cushion at the trough cash level do you have? And at what year or quarter do you envision that occurring.

Robert Harold Bateman
Chief Financial Officer

Thanks for the question, Tommy. Could you just -- I'm trying to understand exactly what you're trying to ask. What's the -- are you asking are we at the bottom of the cash burn?

Thomas Patrick McJoynt-Griffith
Keefe, Bruyette, & Woods, Inc., Research Division

Just when do you think you'll be at the bottom of your cash level?

Robert Harold Bateman
Chief Financial Officer

We haven't disclosed that publicly yet, but we do expect it to be in the next 2 years.

Thomas Patrick McJoynt-Griffith
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Okay. Yes, that's where I was getting at. And then the other thing, so your head count is now down about 50% year-over-year. Do you feel that you now have the right kind of workforce and personnel in the fixed expense base going forward? Or do you envision any further actions?

Robert Harold Bateman
Chief Financial Officer

Yes, thanks for that question. We -- I think what we're doing is looking at our expense base constantly. And we've taken a number of head count actions, but we do have work to do around our non head count expenses still. If you think about what the company was -- we were scaling for commitments to a bigger company, we have some commitments in '23 that we have to take down for '24. We've done already some of that from '22 to '23, but we've got some more work to do there.

Operator

Our final question comes from David Motemaden from Evercore ISI.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

I just had a question just in terms of selectively turning on the marketing spend and how you think about balancing profitability with that. I look at the improvement in the loss ratio over the last couple of quarters and a lot of that, obviously, you guys are taking rate and it's sort of come through as just a higher portion of your book being renewal as opposed to new business. So could you just talk about how you're balancing the sort of new business penalty as you think you can ramp up some of these new writings in 2023 within your outlook for showing continued improvement in the loss ratio.

Alexander Edward Timm
Co-Founder, CEO & Director

Yes, that's a good question, and thanks for that. I'll start -- this is Alex, and then I'll pass it over to Matt. I think where we are today and the progression that we've made on our loss ratio and reducing it almost 14 points in one year is really tremendous. And we think that, that is mostly because of the way -- how fast we were able to react to the environment and the inflationary trends, leveraging our technology and our really flexible pricing and underwriting stack. And what that's allowed us to do is to get to a much better position and to understand our loss ratios at a very granular level and really by customer segment. We've also really improved our underwriting. And so a lot of that first term, what we're actually seeing is a lot of our first term new business penalty has actually really come down.

And so when we think about deploying our marketing dollars, one, we are now, and we've been deploying more marketing dollars really through January and February, and we are seeing very good results. And we're doing that while we're continuing to see loss ratio progression. And I think that's evidence just really of the strength of our ability to, one, target the right customers through our technology; and then 2, making sure that we're just really disciplined on making sure that whoever we bring in the front door is the right customer for us. And so, I believe you will see us be able to grow and continue that -- grow new writings and continue to show that loss ratio progression.

Matt Bonakdarpour
Chief Technology Officer

Yes. I'll echo what Alex said. We continue to deploy our capital in a disciplined manner. So with a delicate balance between calendar year results and lifetime results. Over the last few quarters, we've been able to gain confidence as leading indicators come in as we've kind of re invited the direct channels. And that explains why we are scaling even further in the coming quarters. So as we do our financial forecasting, our planning, our cash burn analysis and provide this guidance, all of that is taken into account as our confidence increases with the leading indicators will continue to scale.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

Got it. Now that's helpful. I appreciate that color. And then I guess maybe just thinking about you guys have obviously taken a decent amount of rate, and it's clearly a hard market in personal auto, so it's still conducive for that to continue. I guess when you think about how much rate you still need to take just to keep pace with loss trend and continue on the right trajectory on the loss ratio. Could you help us think about how you're thinking about how much rate you still need to take as well as what you embed from a frequency and severity expectation for 2023?

Frank Phillip Palmer
Chief Insurance Officer

Sure. This is Frank. Thanks for the question. As we think about the rate need, I think about your question, I want to think about it not just on a countrywide basis but on a state-by-state basis. So as we think about those markets, and we go back to your earlier question around marketing and starting to think about growth, we can find states that have certainly lower loss ratios in other states as well as segments within those states that are more profitable. And so, it's that insight on being able to find the states and/or the segments that are profitable that have the lower loss ratios where we have less rate need that allow us to turn on the marketing selectively.

Now certainly, we still have some states that when you look at our countrywide loss ratio, there are some states that are ahead of that countrywide loss ratio. That's where we can do more of the marketing in some states that lag behind. So we will be taking rates more aggressively in the higher loss ratio states. As a baseline kind of countrywide, I'd say our average overall trend, we're thinking is around 7% to 8%. So if we needed no rate in any state. In order to stay at that same rate level, we need to raise rates around 7%, or 8%, which is about twice what historical rate trends have been. If you think over the last 40 years, the loss trend has been about 4%. We're thinking all in, it's about 8%. So that will be about 8% and then plus more in the states that need it more and maybe a little bit less in the space that needed less.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

Got it. That's helpful. Yes. That sounds about in line with what we were thinking in terms of loss trends. So that makes sense. And then lastly, I guess, just -- I know you guys are reinsuring a decent amount of the book. I guess could you just comment -- it's a hard reinsurance market, at least on the property cat side. I'm not sure if that really -- how much impacts you guys on the auto side. But wondering if you could share any perspective you have as you sort of navigate more difficult reinsurance renewals just generally across the marketplace.

Robert Harold Bateman
Chief Financial Officer

David, it's Rob. We saw it -- last year, we renewed all of our quota shares XOL and our cat. And we've not had any problems getting the capacity we needed. I think it's a combination of things. Number one, as our loss ratio has come down, we have a more attractive auto book that has more stability than property cat. And two, we really are slowly pulling back on our quota shares and taking more participation on our XOL and cat. So we've been able to go out and set pretty aggressive for order terms, and we we've not been able to fill those for more turns, just taken out a little bit more coinsurance ourselves.

Operator

And we do have another question from the line of Weston Bloomer from UBS.

Weston Clay Bloomer
UBS Investment Bank, Research Division

I was curious, you've now revised policyholder contracts in 33 states that was up from 25% last quarter. I was hoping you could maybe quantify the impact that, that had on your loss ratios in 2022? And then do you expect additional revisions in 2023? Or should most of the improvement from here just come from additional rate actions through your book?

Frank Phillip Palmer
Chief Insurance Officer

Yes. So this is Frank. Thanks again for the question. As we think about those contracts, it's mostly a onetime revision. Now there's still some states where we're implementing those and still seeing the benefits. But we think of that contract revision is kind of a state-by-state onetime overhaul. So we will expect to see continued earnings improvements from those. So we changed our contracts in November.

We still expect to see throughout this year as renewal customers renew onto those. Some improvements kind of going forward, but wouldn't expect to see kind of the same type of like, hey, we took contract changes and got this much benefit, and then we take more contract changes and get more benefit the way you do with rate changes. So it would be more of a one-time change that we would see earning into our book throughout this year and into next year.

Weston Clay Bloomer
UBS Investment Bank, Research Division

Great. And so the 62% on-level loss ratio kind of contemplates that continued earning from those revisions?

Alexander Edward Timm
Co-Founder, CEO & Director

The 62% on-level loss ratio, that is really reflective of the rates that we have taken, and we do not actually on level the loss ratio for changing of contracts. And so that should be incremental benefit.

Operator
There are no more questions. Thank you, ladies and gentlemen. This does conclude today's call. Thank you for your participation. You may now disconnect.

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