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ROOT.OQ - Q3 2023 Root Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Chris, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Root Inc. Q3 2023 earnings conference call. (Operator Instructions) Thank you, Matt LaMalva, IR. You may begin.

Matt LaMalva - - *IR*

Good morning and thank you for joining us today. Root is hosting this call to discuss its third quarter 2023 earnings results. Participating on today's call are Alex Timm, Co-Founder and Chief Executive Officer, and Megan Binkley, Chief Financial 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 third quarter 2023 form 10-Q, 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, as well as our shareholder letter in third quarter Form 10-Q. 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 route performance. You can find reconciliations of those historical measures to the nearest comparable GAAP measures in our shareholder letter in our Form 10-Q 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, Co-Founder and CEO.

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Thank you, Matt. Q3 marks an excellent quarter for Root. We broke company records for both gross written premiums and direct contribution this quarter. For the third consecutive quarter, we saw material growth in new writings in our direct channel. We grew total new writings 141% over last quarter and 376% over the third quarter of 2022. Our posting a gross loss ratio of 66%.

Management's top priority remains driving route to profitability. We developed a three-part plan to get us there. One drive to healthy margins on our business by hitting our target loss ratios. Two reduce fixed expenses to materially lower our burn rate and three efficiently grow to scale profitability. We have successfully executed on one and two as has been demonstrated in previous quarters.

Our performance in Q3 shows our ability to execute on all three. We believe this combined with advancements in our reinsurance strategy, which Megan will detail has put us on a clear path to growth and profitability. Strong growth this quarter was primarily driven by our direct channel. This can be attributed to our rapid response to inflation, our advancements in segmentation and underwriting and our ability to leverage favorable marketing conditions with our automated marketing approach.

Today, we are in a strong position as we continue to exceed profitability targets on our new business. If we see changes in the environment or degradation in our loss ratios, our systems are designed to automatically pull back on growth. Our objective remains to optimize our profit. Root's embedded channel is a core part of our distribution strategy, and we continue to believe it is a meaningful part of our foundation for long-term growth. Our embedded product is now active in 33 states with new writings and premiums up quarter over quarter.

Additionally, we launched several partnerships this quarter and we believe we have a strong funnel for future launches. All of this is made possible by rich technology and data science. The strategic advantage allows for quick responses to an ever-changing environment, more accurately priced business and seamless quote to bind experiences with continued investment in our data and technology, we are building an enduring company and driving route profitability with the capital we have, we are grateful to our customers, employees and investors.

Lastly, I would like to announce that Frank Palmer will be leaving route at the end of the year. We are grateful for his contributions, and thanks to his leadership, have established strong pricing and underwriting teams to have fully assumed his previous duties.

I'll now turn the call over to Megan, to discuss our operating results in more detail.

Megan Binkley - *Root, Inc. - CFO, Principal Accounting Officer & Treasurer*

Thanks, Alex. Overall, we are very pleased to report the progress in our financial results this quarter. Our growth trajectory continued with total new writings and policies in force higher on both quarter-over-quarter and year-over-year basis.

Gross written premium was $224 million, of 55% increase quarter-over-quarter and a 49% increase year-over-year. Gross earned premium was $160 million of 22% increase quarter-over-quarter and a 3% increase year-over-year.

We achieved this growth while also posting a gross loss ratio of 66%, which is flat quarter-over-quarter and a 12 point improvement year-over-year. This is a testament to the power of our technology and data science. During the third quarter, our net loss was $46 million of 31% improvement year-over-year.

Adjusted EBITDA improved 58% over the prior year to a loss of $19 million. Compared to the second quarter our net loss and adjusted EBITDA loss increased $9 million, $8 million, respectively. This increase was primarily the result of higher acquisition expenses and one-time reinsurance costs of $6 million associated with commutations executed during the quarter.

Our higher acquisition expenses were largely concentrated in the direct marketing channel. It's important to note that we do not defer the majority of customer acquisition costs over the life of our customer, which leads to accelerated expense recognition relative to earned premiums.

Overall results for the third quarter reflect the sustained momentum towards management's top priority of reaching profitability with our existing capital. And to that end, we are vigilantly managing our capital position. Unencumbered cash was $502 million as of the end of Q3 compared with $520 million as of the end of Q2.

Our unencumbered cash consumption rate continues to improve on a year-over-year basis following a reset of our fixed expense base and was partially offset by an increase in customer acquisition costs as we continue to position the business for profitable growth.

As Alex outlined, we have improved the loss ratio, reduced fixed expenses and are now scaling the business. This execution allows us the opportunity to optimize our quota-share reinsurance strategy. We have been reducing our sessions to third party reinsurers on new treaties and commuting existing treaties. These actions reduce the overall session percentage and result in further retention of underwriting results on a net basis.

We believe the resulting reduction in reinsurance costs going forward is a pivotal component in driving the company to profitability. And in the near term, we expect to narrow the gap between the growth in net loss and LAE ratios to single digits. We expect to continue managing volatility in our loss ratio through a catastrophe and excess of loss reinsurance programs.

When considering our improved underwriting results, careful expense management and strong capital position, we believe there is a bright future ahead. We appreciate your time and look forward to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Joshua Siegler, Cantor Fitzgerald.

Joshua Michael Siegler - *Cantor Fitzgerald & Co., - Research Analyst*

Yeah hi, team. Good morning. Thanks for taking my call. As you pivot back towards expanding direct marketing channels, and turning back on growth, I was wondering if you could give us any insight into the payback period for some of the new policies brought in, especially at these lower loss ratios. Thank you.

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Thanks, Josh. We're seeing, particularly driven by these lower loss ratios is really a very large improvement in our payback periods and so we are seeing very tight payback periods we are monitoring that. And that's really driven by the large improvement in our loss ratios as well as very favorable customer acquisition costs. So the improvement is has really been encouraging for us.

Joshua Michael Siegler - *Cantor Fitzgerald & Co., - Research Analyst*

Great. Glad to hear that. And then I was curious, what have you seen that's persisted through the beginning of 4Q that gives you confidence in maintaining these lower loss ratios. Are there any notable trends in accident or severity frequency or severity?

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

I think we're still seeing -- we're seeing on the macro environment, some of the indicators there, Manheim and others really begin to level off. We still are assuming a fairly significant trend and don't believe that we're back into normal trend environment. And so we're pricing to that -- we're still pricing to a high single digit to low double digit net trend. And so we're certainly not banking on inflation really abating at this moment in time.

We have seen and continue to see our unit economics. And so that's loss ratios, retention all come in more favorably than what we had anticipated and that's one of the reasons why you continue to see us accelerate our growth as we continue to see these cohorts come through in perform more favorably than what our initial expectations were. And that's been very consistent, really over the last nine months, and we're seeing that continue.

Joshua Michael Siegler - *Cantor Fitzgerald & Co., - Research Analyst*

Understood. Thanks for taking my questions today.

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Thanks, Josh.

Operator

Tommy McJoynt, KBW.

Thomas McJoynt-Griffith - *Keefe, Bruyette & Woods, Inc., - Analyst*

Hey, good morning, guys. Thanks for taking the questions. Can you start off by just walking through the components of the other insurance expense and perhaps would be helpful just to bridge the change either on a quarter-over-quarter basis or year-over-year basis, whichever you think is more helpful?

Megan Binkley - *Root, Inc. - CFO, Principal Accounting Officer & Treasurer*

Yeah. Thanks, Tommy. I appreciate the question. I think what you're getting at is, or what you're seeing in terms of other insurance expense during the quarter, a lot of the change quarter-over-quarter is really driven by changes in reinsurance. So over the past 18 months, we've been constantly evaluating our reinsurance structures just to make sure that we've got the right terms for the business.

This is certainly not new, we've been decreasing our external quota share percentage as the underlying business has improved. Historically, we've been seeing a lot of our business through quota share reinsurance, and we've been reducing those sessions over time.

So we took several actions during the quarter, which we believe are very positive after strict underwriting and pricing discipline where we are sitting here today with a fundamentally improved book. So those improvements have really opened the door for us to further our reinsurance strategy to towards benefit.

So, what you're seeing come through this quarter is really a result of us reducing our quota share sessions over time. On a net basis we did well, we commuted several agreements during the quarter and really what that involves is a settling for an amount today and what we're getting in return is future underwriting profits as we take that business back onto our books.

So you're going to see less ceding commission going forward and what you see come through this quarter is really a one-time hit to our P&L, relate -- primarily related to one commutation. So given the improvements that we're seeing in the underlying business, we do believe this is a necessary part of our strategy and is going to significantly improve net income next year.

Also what you're seeing in terms of OIE this quarter is an increase in acquisition costs. So as we're paying commissions on our embedded partnerships, and as we're deploying marketing spend, which does run through the sales and marketing line item as we're deploying that marketing spend, that is resulting in an increase in underwriting costs, which also flow through the OIE line item.

Thomas McJoynt-Griffith - *Keefe, Bruyette & Woods, Inc., - Analyst*

Thanks. And just to clarify, you did mention earlier that the one-time reinsurance costs on the commutation was $6 million and that's what flew through this line?

Megan Binkley - *Root, Inc. - CFO, Principal Accounting Officer & Treasurer*

Yeah, that's flowing through this line. So essentially, it's primarily related to the commutation so that's representative of the unwind of deferred feeding commission revenue that we don't expect to earn in.

Thomas McJoynt-Griffith - *Keefe, Bruyette & Woods, Inc., - Analyst*

Okay. Got it. And then just my second question is, as you ramp up premium growth, both on a gross basis and then effectively on a net basis as well since you're increasing your retention. Can you talk about how much statutory capital you have and how much net written premium that allows you to write.

Megan Binkley - *Root, Inc. - CFO, Principal Accounting Officer & Treasurer*

Yeah. Thanks, Tommy, for the question. I mean, as we sit here today, we've got about a $0.5 billion in unencumbered capital plus surplus across our insurance subsidiaries, supporting roughly $600 million of trailing 12 months gross written premium. That premium is and continues to be supported by our volatility covers, which protect us from large losses and tail events. I want to make sure it's clear that we'll continue to purchase those covers going forward.

We believe we're in a good capital position. Our regulated insurance companies are more than capital adequately capitalized. Our subs continue to exceed the minimum required capital levels, and we are monitoring these capital levels constantly.

Of course, growth does require capital and our first priority is maintaining capital adequacy, second priority is driving the business to profitability, and our third priority is growth. And those are our priorities in order, we believe that we are on the path to execute on all three of these priorities. We have put in significant work over the past 18 to 24 months to really right size the business, execute on pricing and underwriting improvements and execute disciplined expense management initiatives. So you're seeing that really reflected in our year-over-year operating improvement.

I think it's also important to note that the majority of the business that is returning to us net from these commutations that we executed, this quarter is really seasoned renewal business that has more favorable loss ratios and also business that we've underwritten recently with improved pricing and segmentation. So we're ready and able to take this profitable business back onto our books. We believe that the strategy further supports our underwriting profitability over the long term.

You also mentioned growth in your question. So I also want to make sure it is clear that the capital that we are deploying right now for growth that is purposeful. We are attracting business that we believe is accretive to our long-term profitability and goals for scale. Again, incremental growth does require capital, but our capital requirements are also contemplating the favorability that we've seen in the loss ratio and the expense ratio. So we're constantly modeling these capital needs and we do not intend to sacrifice capital adequacy and profitability for growth.

Thomas McJoynt-Griffith - *Keefe, Bruyette & Woods, Inc., - Analyst*

Thank you.

Operator

Yaron Kinar, Jefferies.

Yaron Kinar - *Jefferies Financial Group Inc. - Analyst*

Hi, guys, good morning. This is Charlie on for Yaron. I recognize that this is going to be a bit of a generalization, but could you guys just discuss in a little bit more detail, what the risk profiles customers coming through [D to C] look like relative to your embedded partnerships?

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Yeah, that's a good question. Thanks, Charlie. So yeah, I'd say that in general, when you look at our direct business, we tend to obviously attract very good drivers and so our number one target is safe drivers and good drivers. We have the vast majority of our direct business is telematics, has telematics incorporated in the pricing and underwriting and so we know that really serves that target customer well. That tends to be younger, they tend to be more male. I think the average age is in the mid-30s. When we look at our embedded channels, those customer segments are really whatever the partner's customer segment may be on.

The beauty of our technology is that a lot of the benefits that it provides seamless and instant quote combines, really great pricing via pricing and automation, flexibility for the customers, transparency for the customer, all of those things really extend quite nicely to lots of customer segments. And so we really have a diverse set of customers across lots of different demographics and really fit with most all of our partners regardless of what their customer demographic may be.

Yaron Kinar - *Jefferies Financial Group Inc. - Analyst*

Okay. Thank you.

Operator

Elyse Greenspan, Wells Fargo.

Elyse Greenspan - *Wells Fargo & Company - Analyst*

Hi, thanks. Good morning. My first question, I was hoping to get a sense of your thinking about going forward and your views there surrounding our growth arm, how much price are you looking to take across your book of business. I know in response to an earlier question, you said you expected that loss trend rate could remained in the high single to low double digit. So, what does that mean for your pricing needs from here?

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Yeah. Thanks Elyse. The vast majority of our footprint right now, we believe is rate adequate. However, as we did comment earlier, we are seeing some of the macro trends and signals in inflation abate somewhat, but we are still planning for that high single digit, low double digit trend, which means you should anticipate that will continue to take that rate on a go forward basis. If we see trend come through lower, that means we will back off rate right now, that we certainly are conservative in our trend selections and are still assuming that we're not in normal trend, low single digit environment, we're still assuming a healthy trend.

Elyse Greenspan - *Wells Fargo & Company - Analyst*

Okay, thanks. And then within the shareholder letter, when you guys talk about severity trends, right, you called out that accident period severity was 10% in the Q3, I think that had been about 8% in Q2 and so I think you also said frequency was flat, whereas it went down around 6% in the Q2. So what did you notice sequentially from a loss trend perspective, if both severity and frequency went up Q3 versus Q2?

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Yeah, I think the one, I'd say it's still very early on an accident period severity trend for Q3. We are a lot of that is still forecasted I think we saw paid severities quarter-over-quarter roughly flat. However, what we are still projecting is that we're going to be seeing healthy severity trends in bodily injury and collision PD. And so we're still have -- we're still forecasting again, that severity trend to be pretty healthy.

I would say that the quarter-over-quarter differences in that severity trend are well within the bounds of normal variation and so I don't think there's anything that we particularly saw in Q3 versus Q2, that was really statistically significant in terms of believing that we saw something out of the realm of normal for the severity trend, given our current levels. I would say the same thing about frequency, -- frequency was roughly flat on year-over-year basis. Again, that's10 year adjusted so we look at the age of the business that we're bringing on. And again, I would say that's probably within the band of normal variation.

Elyse Greenspan - *Wells Fargo & Company - Analyst*

Thank you.

Operator

Alison Jacobowitz, UBS.

Alison Jacobowitz - *UBS - Analyst*

Hi, thanks. I'm here for Brian, couple of questions. I was wondering if you could talk about your marketing spend and how you're thinking about that over the next couple of quarters and into [2024], how might we see that accelerating? And then to follow up on Elyse's question, you said the vast majority of your footprint is rate adequate and what areas are not what hotspots are there and how big are they to you and how you tackling that?

Alexander Timm - *Root, Inc. - Co-Founder, CEO & Director*

Yeah. First on rate, I would say there's probably a couple of states that we have rate filings and that we're looking to get approved and there's just some small delays. They're not huge there -- there's certainly not where we're writing the majority of our business and we expect that those when those rate changes are approved, that then will be rate adequate.

In terms of marketing, I think it's important to note, we are seeing a very favorable marketing environment and the way that our direct marketing works and functions is really it is not that we spend up to a certain budget or review budgets and then say, let's go spend up to that number. But what we do is we set a profit, our goal for the machine as long as we are attaining those unit profitability levels will continue to spend.

If we see anything change in the environment and increased competitive landscape in marketing degradation and loss ratios, anything change we are fully prepared to pull back on the growth and then allow really the company to go profitable with the book of business that it currently has.

And so, although we saw very strong growth this quarter, we don't necessarily expect that level of growth to continue and we're always monitoring the environment and are ready to react as needed.

Megan, pass it over to you for some more comments on the what we're anticipating maybe through the end of the year.

Megan Binkley - *Root, Inc. - CFO, Principal Accounting Officer & Treasurer*

Yeah. Thanks, Alex. So Alex, and I think it's also key for us, right. But the key for us continues to be not sacrificing profitability for growth. As Alex said, we do continue to see a favorable environment for us to deploy our capital at higher returns. We have identified opportunities in the market to invest up to $50 million in Q4 that $50 million again is dependent on continued favorable development and our unit economics in the marketing environment.

One point to clarify to that $50 million that's overall acquisition expense around half of that is expected to be in performance marketing and then the remaining [$25 million] would be gross embedded commissions and in report costs. From a comparison purposes perspective, we increased our acquisition spend to $27 million in Q3, and that's again in light of the favorable unit economics that we're experiencing.

As Alex said, we are optimizing for profit so the amount of investment that we deploy in Q4 is going to continue to be dictated by the competitive landscape and most importantly, our internal profitability metrics. We look to 2024 at this point, we are not giving 2024 guidance, but what I can say is our growth appetite in 2024 is going to be highly dependent on the competitive landscape. As Alex mentioned, as we see opportunities for growth with strong economics, we will continue to invest in a disciplined manner.

Alison Jacobowitz - *UBS - Analyst*

Thank you.

Operator

(Operator Instructions) And it appears that we have no further questions. And this will conclude today's conference call. Thank you, everyone, for participating. You may now disconnect.
