Call for Analysts and Investors

Transcript

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Speakers:

CFO Carlos Rodríguez-Ugarte

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Presentation

Beatriz Izard: Good morning and welcome to our conference call to discuss December 2022 results. I am Beatriz Izard, Head of Investor Relations. As usual, our CFO Carlos Rodriguez Ugarte will first walk you through the slides and then we will be happy to take any questions you may have.

Now let me turn the call over to Carlos.

Carlos Rodríguez-Ugarte: Thank you, Beatriz, and welcome from my side as well.

We start, as usual, with the highlights for the period in slide number 5.

2022 was a year marked by significant headwinds: inflation, war in Ukraine, energy crisis, capital markets turmoil… This unique combination of macro factors resulted in sky-rocketing prices affecting the claims side of the P&L. On the other hand, we are presenting strong performance on the commercial side of the business:

- Premiums grew 4.4% and policyholders 3.4%. Motor is gaining momentum with premium growth of 4.6% in the 4th quarter. We are also presenting strong increases across Home and Health.
- Combined ratio rose to 96.3% because of cost inflation. Expense ratio stood at an excellent 20.6%.
- We are displaying once again resilient capitalisation with a Solvency ratio of 188% as of year-end.
- Finally, return on equity stood well above our cost of capital at almost 18%.

Moving to the next page, we'd like to provide a short summary on our huge improvement on disclosure as a listed entity and ESG integration during the year.

Notably, the Company included non-financial criteria and the recommendations of the Code of Good Governance in the Remuneration Policy of the Board of Directors. We published, among others, a Sustainable Investment Policy, an Environmental Management and Climate Change Policy and a Responsible Purchasing Policy. We also applied to the Dow Jones Sustainability Index for the first time ever, achieving a remarkable score of 64 points (cut off mark stands at 81 for the Global index). We have also rated our investment portfolio from an ESG perspective. Finally, we also reduced our environmental impact and made even further progress on the social front. I will stop here, but you will find detailed information in the 2022 Non-Financial Information Report.

Moving on, slides 8 and 9 provide our regular update on the Spanish Motor market. In a nutshell, inflation has hit the sector hard.

- Inflation remains high. Despite lessening in the last few months of the year, CPI closed the year at 5.7% with underlying inflation rising to 7% and industrial index prices at 15%.

- As with regards sector premiums, the market has barely reacted in 2022 and there is still a long way to go. Average premiums are on the rise yet positive impact in terms of P&L will be seen in future quarters as gross premiums convert into earned premiums. The market has experienced a strong margin squeeze.

Turning to slide 9, vehicle registrations decreased 5.5% in the year. New vehicles sold stood at around 800 thousand, far away pre-pandemic figures (about 1.3 million)

Additionally, manufacturing and supply bottlenecks, rising interest rates and prices and declining household disposable income has resulted in a vehicle population that contributes to age.

Home, conversely, continues with a positive development. Let's please turn to slide 10. Activity and prices in the real estate market have continued to increase, although there are signs of a slow down with rising interest rates and bleaker economic outlook. Still, house sales were up 14.7% for the whole year.

The insurance Home market grew 5.5% as of December with prices rising across most of the sector.

As with regards the Spanish Health market, turnover for the industry continues to report significant growth at 7.4% yet the inflow of new customers is slowing because of economic conditions.

Let´s move on to the main figures for 2022.

The year was marked by strong pressure on margins

- On the positive side, premiums are gaining momentum, up 4.4% in the year and 5.1% in the 4th quarter. Customers increased by 3.4% with excellent retention rates.
- Technical result and cost of claims was explained by rampant cost inflation and higher frequency in Motor and Home as compared to last year. I will provide additional details on the loss ratio further down.
- Expense ratio was excellent; and
- Financial result, up 14.7% includes realised gains in mutual funds with the aim of reducing P&L volatility prior to the entry into force of IFRS 9 in 2023. Additionally, we also realised capital gains in currencies profiting from appreciating USD. Excluding such effect, financial result would have grown 2.6%.

So, all things considered led to a combined ratio of 96.3% and a profit after tax of €59.5 million, down 46%.

Please turn to page 14, where you see the breakdown of policyholders and Gross Written Premiums by line of business.

All segments display solid growth and Motor reflects the change in trend.

- The portfolio increased by 3.4%, and policyholders reached 3.5 million.
- Company premiums grew 4.4%. Motor displays positive momentum with premiums up 3.3%. Home and Health continue their very positive trend.

Moving to page 15, the Motor segment grew 3.3%. This line of business recorded a solid growth in a very competitive environment. Average premiums are clearly on the rise, in both new business and the portfolio. This pricing trend will be gradually reflected in the third and fourth quarter of 2023.

On the technical front, combined ratio stood at 95.4% with an expense ratio, again, superb at 17.7%

However the performance of the loss ratio was driven by:

- sharp cost inflation, having strong impact in repair and replacement property costs,
- higher personal injury cost and an increase in fatal accidents. Let's also bear in mind the injuries' scale "Baremo" was increased at an unprecedented 8.5% for 2023.
- In nutshell premiums are being earned at a lower rate than the cost of claims and this situation is expected to last for another couple of quarters.

Moving to the next slide, Home premium growth continues its good performance at a rate of 9.5%, 4 percentage points above the growth rate of the market.

- expense ratio is gradually decreasing and stood at 32.5% for the full year, more than 2 percentage points below that of the market.
- loss ratio, however was affected by frequency of water and glass damage.

Moving now to slide 17, premium growth in the Health segment stood at 10%. We are experiencing slowing growth as economy deteriorates. We continue nevertheless to improve our technical result with a prudent risk selection and underwriting.

Please let's move now to slide number 18, where we breakdown management ratios by line of business:

- Motor loss ratio increased by more than 8 p.p., in a very difficult context of cost inflation and, to a lower extent, a rise in frequency. Also, the loss ratio in the Home segment increased by 7.7p.p. On the other hand, Health remains stable.
- Expense ratio stood at 20.6%. It is noteworthy to mention the excellent levels in the Motor segment and the decreases in both Home and Health.

- Overall, combined ratios reflect the impact of sharp cost inflation on the claims' side and robust performance on the Company's expenses.

If we move to slide number 19, consolidated loss ratio was driven, as I explained before, by severe cost inflation.

- Specifically, in the 4Q standalone, 100% of the Motor claims increase is explained by higher average costs, whereas frequency was slightly lower than that of the 4Q of 2021. Motor is enduring heavy cost inflation and premiums have a longer cycle to be earned.
- As with regards the Home segment, 46% and 54% of the increase is explained by higher average cost and frequency, respectively, as compared to the 4Q of 2021.

As with regards the expense ratio it was again remarkable. We continue with our strategy of efficiency and commitment to technology together with a strong control of overheads. Acquisition expenses also reflect increased efficiency in policy retention.

Now we move to the investment result. During the year we realised gains in mutual funds prior to the arrival of IFRS 9. Since 2023, changes in their market value will be accounted through the P&L. As such, the Company decided to reduce P&L volatility. Also, the Company profited from the US Dollar appreciation and realised 3.7million in currency gains. Excluding such gains, financial result would have grown 2.6%

On slide 22 you can see equity mutual funds have fallen to 6% of the total portfolio composition while government bonds were gaining weight. As with regards investment returns, the rolling 12 overall yield of the portfolio stands at 4,39% (2,61% excluding net realised gains).

Moving on to our solvency position, the Company's capitalisation remains strong at 188%. The main impact on eligible own funds was the Best estimate liability factoring increasing margins because of higher premiums.

For its part, SCR increased by 5 million in the quarter with positive and negative effects. On the positive side, lower market and counterparty risks were offset by the increase in underwriting risk with business volumes.

To conclude, claims inflation heavily affected 2022 results and also harmed the entire sector. On the positive side, I would like to reiterate premium development is encouraging. We are confident that our pricing strategy, strict cost control and high retention ratios should and will provide a positive development in the medium and long term.

Thank you. I will now hand the call over to Beatriz to begin the Q&A session.

Q&A

Beatriz Izard: Thank you very much for the presentation, Carlos. First, we'll begin with the questions received from the conference call.

Conference call operator: Ladies and gentlemen, we will now begin the Q&A session. If you would like to ask a question, please press * 5 on your telephone keypad. If you change your mind, please press *5 again. Please ensure that your device is unmuted locally before proceeding with your question. Our first question comes from the line of Max Mishyn from JB Capital. Mr. Max Mishyn, please go ahead.

Max Mishyn: Hi, good morning. Thanks for the presentation and taking our questions. I have three. The first one is on motor and I was wondering what will your strategy be for 2023 considering customers? Do you plan to keep on growing your base or focus on keeping it stable? Have you noticed any change in churn rates after price increases? And do you think that potential market consolidation in motor insurance market can help you growing faster?

The second one is on frequencies. Could you update us on evolution of frequencies in January and February? And what are your expectations for 2023?

And then the last one is on health insurance business, the slowing pace and growth. Does it have any implications for your target to breakeven by the end of 2024? Thank you.

Carlos Rodríguez-Ugarte: Thank you very much, Max. Regarding the first question, looking forward, I mean, the strategy for the company in 2023 is to keep on increasing average premiums for the business. I think that is necessary in order to cope with a still strong inflation in Spain. So, the focus will be that, and trying to keep on increasing average premiums. Of course, we are not in the mood of saying that we don't want any new clients. I think it's important to gather clients and I think probably in the second half of the year, there will be an opportunity to increase the number of clients of the company. But if I were to say, the main goal is keeping on doing what we have done on the fourth quarter specifically, which is increasing average premiums, not only on the new business but also on the portfolio.

In terms of frequency, I think the year 2022 was a good year in terms of frequency as a whole. I mean, on summer we suffered quite a bit, not only Línea Directa, but also the sector, but looking at the entire year I think frequency was fine and it was even below that of 2019. My expectation looking forward, I think the economic situation will help to have a lower frequency, or milder frequency than 2019. It is yet too soon to see a trend, but January has not been a bad month in terms of frequency. It's still affected by the cost inflation, but I don't think frequency is a problem as of today.

And regarding health, we are growing more than the market. I think the market is growing at 7% in terms of premiums. We are growing at 10%, so we are above the market. I think we are more or less on track to reach that break even that we've said in 2-2.5 years. It is true that what we are seeing is signs of a slowdown in new customers coming into the private health insurance. Private health insurance is very much linked to the economic situation. But still today, I think we are more or less on track with good evolution in customer growth and very good evolution in the claim side of the business.

Conference call operator: The next question comes from the line of Freya Kong from Bank of America. Ms. Freya Kong, your line is open.

Freya Kong: Hi, good morning. Thanks for taking my questions. Firstly, could you give us some sort of steer on the combined ratio outlook for next year, given the run rate of 106% in Q4. It's tough to see this coming down below 100% in the coming year, given that market prices, like you said, have barely reacted.

And secondly, what's the impact of weaker profitability on your non-life capital requirements and what tools do you have to manage capital requirements if rates continue to move and impact solvency?

And last question is just on home. Could you give us the atmospheric impact that you saw in Q4? Thanks.

Carlos Rodríguez-Ugarte: Well, starting from the last question. I mean, in terms of atmospherics in the home insurance. Looking at the entire year, I think we experienced a very good first half of the year in terms of atmospherics. Of course, we were comparing with a very bad year in 2021. But it is true that after the summer and for the third quarter and for the fourth quarter, we had some events in terms of raining and we had some events in terms of fire in some houses. So, that really impacted the claims side of the home insurance business, you know? It's not that we are worried. I think the combined ratio that we have in the home insurance is still very much in line with the sector but it´s true that the last part of the year, I mean, having some atmospherics, which include rains and fire, really hit the combined ratio on the last part of the year.

In terms of combined ratio looking forward, I think I explained that in many of my presentations. I expect it to be in the neighbourhood of 95/96 during the year. I might say that it's going to be a difficult 2023 in terms of combined ratio for the first half of the year. Inflation is still there, Baremo increased 8.5% for the year on the bodily injury claims. So, this is going to be a difficult year. But my expectation is that in the second half of the year, you will start to see an improvement on the combined ratio. I don't see combined ratios in the neighbourhood of 100%, I see combined ratios more in the neighbourhood of 95 and 96.

And the first question was…

Beatriz Izard: In terms of capital requirements

Carlos Rodríguez-Ugarte: Well, in terms of capital requirements. We´re very happy with the evolution of the solvency ratio. I mean we are in 188%. It is true that, with this year, we really had a negative impact on the portfolio up to September. I think the last quarter, you know, the unrealised gains of the portfolio were more or less stable. Well, if interest rates will keep on the rise, of course, it will have an impact on that. It's true that we are reinvesting our portfolio at a higher rate than we used to do. I mean, last year we had more than 150/170 million euro in maturities, which we reinvested in a much better interest rate. But of course, if interest rates keep on the rise, it will have a negative impact on the solvency ratio.

Having said that, we are managing that with our liquidity, managing our equity exposure to the market… I'm not concerned that Línea Directa will have a problem with the solvency ratio. I think you should expect 2023 to be above 180% solvency ratio for sure.

Conference call operator: The next question comes from the line of Patrick Lee from Santander. Mr. Patrick Lee, please go ahead.

Patrick Lee: Hi, good morning. Thanks for the presentation, Carlos, and thanks for taking my questions. I just have two questions on the cost of claims.

Firstly, referring to your slide 19, you have provided some useful colour on the combined ratio. And one specific question I have on that slide is your disclosure on the fourth quarter standalone level versus 2021, where frequency is down 4% according to that disclosure. Is that a comparison of fourth quarter alone versus full-year 2021? And I guess I want to get a feel for how much of that is due to seasonality in the quieter winter months.

And looking ahead, have you seen any signs of slower frequency because of lower economic activity or higher fuel prices? I just want to get a general sense of how much that could potentially offset inflation impact in 2023.

And secondly, on premium pricing, what's your general view on the level of competition in the market you are seeing now? And if I asked you to split the premium pricing into new business versus renewal, what levels of premium inflation can you put through to your customer base currently? Thanks.

Carlos Rodríguez-Ugarte: Well, on the frequency on the fourth quarter, I think I tried to explain that during my presentation. Really, the fourth quarter increase on the claim cost was really due to cost inflation because, in terms of frequency, I think it was even below that of the previous year. I think it's something that we thought that we expected a milder frequency in the fourth quarter and that really happened. I think mobility is somewhat slowing down especially on weekdays, you know, and that really had an impact on the frequencies, so frequency was almost down by 4%, so basically the entire increase on the claims side of the business has been due to inflation. Keep in mind if you take a look at the entire year by the first half, the increase in claim cost was 50% due to inflation, 50% due to frequency. When we reached September, 80%

was due to inflation and 20% was due to frequency, and now we are in that at almost 100%. So that is the case.

In terms of average premium, what we are seeing on the market, I think clearly the market is on the rise, as well as we are. You know, I think we have read from many of our competitors that it is time to increase prices. We have been saying that since probably June. I explained in my previous presentation that I think the market was somewhat slow in turning the cycle. But of course, today what we are seeing is companies increasing average premiums in new business and in the portfolio.

If we were to do a split for Línea Directa, it is true that for us, we have increased average premiums more on the portfolio than in new business. Especially in the 4Q, I think the increase on the portfolio was very close to 5% in average premiums. And looking forward, I think the trend will be, important increases in average premiums, both in the portfolio and in new business. Of course, that will jeopardise somewhat the increase in volumes (clients, although we hope to keep on increasing in clients, but probably you will see a slow-down in new clients coming into the company, whereas you will see clearly an increase on average premiums that will have an impact probably in the second-half of the year.

Conference call operator: The next question comes from the line of Thomas Bateman from Berenberg. Mr. Thomas Bateman, your line is open.

Thomas Bateman: Hi, good morning. Thanks very much for the presentation, and I have three questions. Just coming back to solvency again, I think I missed the answer on how much the non-life capital requirement is going up because of the weaker performance. So, if you could just clarify that.

But also more broadly, is there anything else that we should be watching out for in terms of solvency during the year? Any changes to the capital model? I think you've flagged that interest rates could hit a potential headwind, but any other things that we should be looking out for would be helpful.

Also, there seems to be a bit of an uptick in the expense ratio in Q4. Clearly, for the full year it was a good number for Q4, I think we're about 22%. Were there any one-offs or things that we should be looking out for in terms of the expense ratio?

And finally, just going back to cost inflation, you obviously highlighted the Q4 motor was mostly driven by the cost inflation rather than frequency. Were there any contracts, renewals that kicked in Q4, for example, suppliers, that made it so much worse in Q4? And is there anything else, other key dates, to watch out for in 2023? Thank you.

Carlos Rodríguez-Ugarte: Thank you very much, Tom. Regarding solvency, the first thing I want to say is that we are very comfortable in the numbers that we have. We are very comfortable looking forward. I think, for this year 2023, you should expect solvency to be in the grounds that we have posted by the end of the year, above 180%. Of course, one of the things that affected the most the solvency ratio is the evolution of the portfolio linked to interest rates. I mean, what we have done this year, of course, we have decreased a little bit our exposure on the equity market, due to the new accounting rule, but also, managing that, because as you know the equity portfolio in terms of capital consumption is the highest one. We have managed our liquidity, we are a company with a high degree of liquidity, which has a lot of impact in our counterpart capital requirements. So, we have managed that by investing in more short-term instruments that require less capital, and that is what we do. It is true that it has not been a very good year in terms of the evolution of the portfolio unrealised gains. But again, the good part there is that our reinvestment yields of the portfolio are very close to the entire portfolio yields. So, that is good news, not only for the portfolio but also for the investment income of the company.

So, again, to summarise, you should expect the solvency ratio to be on those grounds, above 180%. Are we thinking about doing something on capital adequacy? No, that is not on the road map. I think we feel comfortable on the levels that we are, and we don't have anything on the road map, in order to become more efficient on capital. I think being in the neighbourhood of 188%, whereas the market should be more or less around 160-170%, if you take out the mutual companies, we would say it's a good number.

In terms of expenses, it's the evolution of the company. I think numbers on expense ratio are very good. On the motor insurance we posted at 17.7%, which is a very similar number, or even the same number we posted on September. In terms of the company, I think expense ratio was 20.6%, I think the last number we posted was 20.5%. It's the evolution of the business. I mean, there haven't been any one-offs there. Maybe there's a little bit of impact also of inflation, but no worries on the expense ratio. You should expect it to keep on improving, it depends very much on the moment of the year, but I'm not concerned about that.

And then, on the cost inflation, the reason why we keep on being impacted is not a matter of new contract renewals. It's probably a matter of the evolution of the repair side of the business. What we have tried to do during the year on the inflation side, especially with the repair side of the business, is try to negotiate with our suppliers longer contracts in order to put less pressure coming on to 2023 and 2024 on inflation. What we have tried is to raise prices, but we have tried to compensate that in order to not have a strong impact looking forward.

So, many of our contracts, instead of being one-year contracts, we have tried to sign longer contracts in order to cope, with future inflation costs. But nothing new on the Q4. I think it's the natural evolution of the claims side of the business and the natural evolution of the inflation.

Conference call operator: The last question comes from the line of Francisco Riquel from Alantra. Mr. Francisco, please go ahead.

Francisco Riquel: Yes, hello. Can you hear me?

Carlos Rodríguez-Ugarte: Yes, Paco. Hello, how are you?

Francisco Riquel: Yes, thank you. Hello. Nice to speak to you, Carlos and Bea.

First question I want to ask is about motor, and more in relative terms. I mean, you stand out in terms of the expense ratio, but the loss ratio is higher than the sector average for the first time in our records, even if the average premium has also increased in line with the sector. So, I would like you to explain the gap. If you believe that you are more affected than the sector by the cost inflation, any change in the risk taking and risk profile of the new clients? So, do you expect to recover this historical gap that you had in the past, and how?

And the second question regarding motor is more in absolute terms and regarding the guidance you've given, for 2023. Well, for the whole company, a combined ratio 95-96% on average, but you ended the year at 106%. So, meaning that for that average in 2023 you need to end the year in the low 90s, unless you start below 100%. So, have you front-loaded any impact in the Q4 that makes you comfortable that you will be in this guidance, for example, the Baremo, or will you be already below 100% in the Q1? So, if you can explain a bit more the guidance for 2023.

And just a last question on the solvency ratios and the impact of the mark-to-market of the investment portfolio. You mentioned there is limited impact from the available for sale portfolio in the ratios, but I wonder how much is under available for sale. I want to ask specifically about the real estate assets. If you have updated appraisal valuations, if you think that the unrealised capital gains have come down or not and this is affecting your capital ratios. If you can explain the accounting impact and solvency impact of the real estate assets and how do you offset this in the solvency ratio. Because I was expecting a headwind on the mark to market from the investment portfolio, but the fourth quarter has been neutral. Thank you.

Carlos Rodríguez-Ugarte: Thank you, Paco. Well, in terms of the motor insurance, it is true that if you take the last quarter isolated and compare that to the market, it is true that the deterioration of the loss ratio for Línea Directa was higher than that of the market. I think in our case, it's more than the 300 or 400 basis points, whereas the market has been going 100 basis points. I mean, if you take the entire year, we are still a lot better than the market. I think we are in 95s whereas the market is more close to 98s, something like that. So, we still have, on a yearly basis, a positive gap.

Are we more affected by inflation than our competitors? I don't think so. In my personal view I don't think so. We've been really affected on the Q4. I don't know about competition. But I don't have a perception that Línea Directa is more exposed, to cost inflation than our competitors. It is true that Q4 number reflects that our loss ratio was worse, but again in general terms, we still have a positive gap.

It is true that, and I'm trying to go to the second question, it is true that in the last quarter we have been very conservative on managing claims that will be affected by the entrance of the new Baremo, 8.5% increase. As you know, that will affect, those bodily injury claims that are yet to be stabilised. So, we, more or less on the portfolio, we know which of those claims will be affected and we have been very conservative, you know, in managing those claims. That probably has increased a little bit our costs.

Looking forward, I think that will help next year because we have been conservative on the last part of the year, and that will help us to again start improving our loss ratio on the motor insurance by the second half of the year.

And in terms of solvency ratio, we have done upright sales on our real estate assets. We do that every two years as required by regulators and the outcome of that has been very positive. We didn't have to deteriorate any of our real estate assets. So, all those assets are being re-evaluated by the end of the year.

And on the investment portfolio, well, we had a hit of unrealised gains which impacted the solvency ratio in September of €19 million, and in the last quarter, that has remained stable. Looking forward, 2022 has been a very bad year in terms of that. Keep in mind that in 2021 we ended the year with unrealised gains of €54 million, and we have ended this year with unrealised losses of €19 million.

What we are doing is, what I tried to explain, try to manage a little bit, the equity portfolio, and also try to manage a little bit our liquidity portfolio to cope with that deterioration of the investment portfolio. Of course, as you know, the portfolio starts to mature. This year we have maturities in the neighbourhood of €170 million. Next year, we´ll have maturities in the neighbourhood over €100 million. So, that will help to reposition our investment portfolio, especially on the fixed income side, and try to mild any impact or increase on interest rates.

Beatriz Izard: Just to complement what Carlos is saying regarding real estate, Paco, which is the only thing that, as Carlos is explaining, we revaluate every two years. We have unrealised gains on the balance sheet of €32 million before taxes. So, we didn't have any loss, and on the contrary, we have €32 million to be added to the carrying value on the balance sheet.

Conference call operator: There are no further questions at this time.

Beatriz Izard: Thank you. Now we continue with the questions received through the webcast. All right, I think we have no written questions received from the webcast. So, thank you very much, Carlos. This concludes our meeting and thank you very much for your time. Bye.

Carlos Rodríguez-Ugarte: Thank you. Bye.