Direct Line - 2013 Full year Results

Interview with Paul Geddes, CEO

Results and targets

Q: First of all, can you give us an update on how you performed across 2013?

A: I'm pleased with how we did in 2013. It was a challenging year latterly for the weather. It was a very competitive marketplace. But despite that we delivered a profit of £526.5m, which is up 14%.

We beat our combined operating ratio target which was a 98% target and we came in at 96.1%. And we exceeded our return on tangible equity target which is 15% on an ongoing basis and we delivered 16%.

So I'm very pleased we delivered financially. I think we did a good job for our customers in the year and a good job for our investors. We were able to give a dividend of 20.6p and that's composed of 12.6p of a regular dividend which is up 5% and then two special dividends for a total of 8p. So 20.6p in total.

So I think a good year. Our people delivered for our customers and we delivered for our investors.

Q: It looks like from the results, you've already hit two of the financial targets that you set at the time of the IPO. Does that suggest that they were perhaps a little bit too easy? And how are you progressing with the other targets that you set?

A: Well, we actually have plenty of targets. Our 15% return on tangible equity target endures. It's an ongoing target. We have the £1 billion cost target still to hit and we have a 100% combined operating ratio target for 2014 for commercial still to hit.

So we have plenty of ongoing targets and of course, sustaining this level of performance is not a walk in the park. We need to continue to work really hard to deliver this level of performance in a very competitive marketplace.

Q: So going back to your cost base, you've made good progress on your stated cost target of £1 billion costs by 2014. Might you be resetting that now considering your progress?

A: Well, listen the target is barely six months old. We set a new target in the middle of 2013 to aim at the billion. It's not in the bag yet. Whilst we exited at £250 million for

the final quarter, we obviously have to offset inflation which is part of our cost base and we're continuing to invest in the business.

So I don't think it's a walk in the park, but obviously we think we can do it as we reiterate the target today of £1 billion. Of course cost is something which we continue to wage war on. As a total organisation, we need a culture which keeps our costs down because ultimately our customers want low prices. And therefore we can only do that if we have a really low cost base.

UK floods

Q: Now obviously the UK has been severely impacted by recent weather events. What impact has that had on your bottom line? And are premiums going to have to go up as a result of this?

A: Well, the first thing to say about the storms is our people have been extremely busy serving our customers over quite a tricky time of year, across loads of holidays. People have given up their holidays, worked weekends and generally I'm really pleased with how our people have responded to look after our customers. And of course that effort continues because floods take months and months to fully restitute and make sure that customers are back to where they started. In terms of the cost of it, about £65 million in the fourth quarter.

Q: So what does that mean for premiums?

A: Well, premiums are set according to lots of things including obviously claims costs, but also set with reference to the competitive marketplace which we operate in. We invest a lot in making sure that we have an increasingly efficient business and that means that last year premiums came down quite a lot.

So I'm not going to predict the prices in the future. But of course weather is only one of the constituents which goes into the pricing of our Home business and we've got a good track record of delivering good value to our customers.

Q: Now obviously this has been an extraordinary set of weather circumstances. Has Direct Line also been responding in an extraordinary kind of way?

A: We have. I mean the first thing to say is this weather clearly broke over Christmas and New Year and our people were great in terms of sacrificing their own personal plans to make sure we were there for our customers. And I want to thank all our people for that.

We really do think it's important to get people on the ground to face-to-face interact with customers. We actually have our own emergency response vehicle. I was down with it a couple of weekends ago in Staines. And customers really like the fact that we're there on the ground helping to guide them, helping to make sure that the claims are notified. And where for example, flooding happens, we've re-housed the customers so they can start this really long process which is drying out their homes.

And the sooner you start that, obviously the sooner you finish and get people home, which is obviously what we all want to achieve.

Market and outlook

Q: So focusing in now on the UK motors market, what do you see is currently going on with it and what's your take on premiums?

A: So the market's been extremely competitive and rates have come down quite a lot. Some surveys are suggesting around 10% or more reductions. We've reduced our prices about 3% which I think is good for customers. We think it's merited by what we've seen in our own claims data. The government's helped with the legal reforms. We've also done a lot of our own self-help in terms of our claims programme and we feel very justified at delivering those price reductions that we've seen.

Clearly the market looks like it has made more reductions than we have and that's why our policy accounts have come down a bit. We lost about 1% of our policies in the second, third and fourth quarters.

Now I'm broadly comfortable with that because I think it's value maximising for our investors to make sure that we don't chase volume, but really are very strict about the value which we write our business at. And therefore I'm pleased with the trade-offs that we've made and the value which we've created in 2013.

Q: And looking more broadly beyond just motors, what do you see as the outlook for your markets across the next year?

A: Well, listen, we work on the basis that all our markets will be very competitive. In the home marketplace, prices again went down on home last year. And I think it's important that we do what we do to make sure our business is as efficient as possible. So our huge self-help plans, improving our pricing, improving our distribution, improving our claims, improving our costs.

We continue to have significant programmes at work to make sure we make our business better, which means that we can thrive in very competitive marketplaces, deliver great value for our customers and good returns for our investors.

Q: And just thinking about technology, how is that affecting the markets you operate in at the moment? And what has the take up of your telematics proposition been like?

A: Well, technology touches our markets as it touches every other consumer facing business in the world. And in the UK motor market for example, telematics is starting to take off. About one in five of our young drivers in Direct Line is now taking up a telematics box, which is good. We're also testing a self-install box, which means that we can mail a customer a telematics box which they fit into a port in their car. We think that could be a big thing for the future.

But technology is wider than that for us in our business. We have our own data centres now. We're building new capability all the time to make things much easier for our customers and much more efficient for us. And generally I see us having an increasing digital business, but helped out by some of the very best people in the marketplace at the same time.

Q: And how does telematics actually specifically help your business?

A: Sure. So that's something quite interesting. The people that take up telematics we think are better drivers because better drivers will tend to want to have their driving monitored. Knowing that their driving is being monitored actually improves how people drive and then of course then we get the data to prove it.

So generally we think telematics not only tells us about the one in five that takes the telematics box, but also about the four in five that don't.

Q: Regulatory reform is clearly weighing on the industry. How is Direct Line adapting to that?

A: So I'm a big supporter of good regulation in our industry. We think that both good conduct and good prudential regulation ensures a level playing field and it's good for our customers. So we're much at the forefront of both influencing, working with the regulator and also at the forefront of making sure that regulatory reforms are well implemented.

Q: And just finally, how satisfied are you with the progress that Direct Line has been making since its IPO?

A: I'm pleased with what we've done and I'm certainly confident as a result of us being able to execute such a wide agenda and deliver it so well. But I'm by no means complacent. We face very competitive marketplaces. We still have an awful lot to do and I'm very, very focused on making sure that we do that. We continue to deliver excellently for our people, for our customers and for our investors.

John Reizenstein, CFO

Financial performance

Q: Despite competitive markets and challenging weather conditions, you're reporting a 14% increase in operating profits while gross written premiums were down 4.1%. So can you talk us through the key numbers?

A: The first thing is that we make it very clear to all our investors that we're going to look to drive value in our business rather than volume. So when it comes to the reduction in premiums that in a way is to be expected because we operate in very competitive markets and we've been defending our profit.

I think we've been doing better than defending because obviously our profits are up 14% as you've said. And that profit's been driven by our performance mainly in Motor, Home and Commercial.

The second thing to look at is our combined operating ratio which is probably the best measure of our underlying operating performance. And there we've improved from a ratio of 99% last year to 96.1% this year and we've beaten our target of 98%.

The third key measure is our return on tangible equity. Again we had a target of 15% and we've achieved 16% for the year.

And finally, dividends, where we've increased our dividends, our regular dividends by 5% and also paid 8p of special dividends.

Q: Now a large part of your profits do seem to come from reserve releases. So can we expect to see that again in future years?

A: Yes, you're right. Prior year releases were an important part of our profit. They were 12% of our premiums this year, 2013. They are a feature of a conservative insurance company such as ourselves and therefore can be expected to continue.

We have said that they won't be quite at the level we've achieved in 2013, but they still will be significant. And remember a lot of these reserve releases are driven by actions we've taken in 2013 and in prior years to improve our claims and our risk mix.

Q: Given the low interest rate environment that we're currently in, what's your investment strategy?

A: Fundamentally, our investment strategy is driven by the need to balance risk and reward and we think we've had decent success in doing that in 2013. Our yield has gone up slightly from 2% to 2.1% and that's mainly because of actions we've taken to adjust our portfolio.

When we look at that portfolio, we look primarily at the duration of the liabilities and we try and match those as best we can. And that's meant that we've invested in real

estate to back our long-term liabilities and we're now looking at infrastructure bonds also for that purpose.

We also have positioned our investment portfolio to benefit when interest rates rise which they will in the medium term.

Divisional performance

Q: So looking now a little bit more closely at each of your business divisions, if we could start with Motor and Home, your two biggest divisions, how would you weigh-up performance there?

A: In Motor, our objective is to drive profit and we've been successful in 2013. Profits are up more than 30%. The strategy behind Motor is to defend the value of our business and not to give it away through volume. And that's been something we've stuck to very, very clearly.

If you look at our pricing data and we've published some more today, you'll see that the pricing we've seen has come down. But it's come down much less than some of the surveys you may have seen in the market.

The result of that is that our combined operating ratio has improved considerably by 8 percentage points. And obviously our volumes are down but we believe that underlying policy decline of 5% is a decent result given those other factors. And we're pretty proud of the result we've achieved in motor.

And we've continued to invest because this is a very competitive market and we need to show our customers the very best products.

Q: So that's Motor. What about Home?

A: Home is a slightly different story. It's a very profitable business and our strategy here is to defend that profit and defend a very strong market position. Again it's very competitive and we see a movement in business channels towards price comparison websites where we aren't very active.

So in home, on an underlying business, our policy count is down 2%. Our pricing has held up pretty well and our profits are up and our core is down. So we think that's overall a good result.

Q: And turning to commercial, are you still confident that you'll meet your target of a sub-100% COR?

A: Yes, commercial is on track and it's had a good year in 2013. Their premiums are up 2%. They've improved all their ratios, loss ratio, commission ratio and expense ratio, so obviously their COR is quite a lot better. If you discount the weather in the last few weeks, their COR is just under 104% compared to a 108% in 2012. So we think they're well on track to achieve the below 100% COR that they've committed to for 2014.

Q: Can you talk us through now performance in your international markets, where Germany saw some growth, but Italy remained flat? What was driving those performances?

A: Two quite different markets there. Germany has been a very stable solid market and we've used that opportunity to grow, particularly at the early part of the year during the annual renewal cycle. And we're pleased with the business we wrote at that point. The underlying performance of Germany is therefore improving. However, that was offset by some hail in the summer and so the profits are down a bit in Germany.

Italy; a quite different picture. You have a very soft market. You have increasing penetration by price comparison websites. And we're present on that channel but it's a market to be very cautious about. In that environment we're pretty pleased with our performance on the profit side which is a stable performance.

Q: And finally you've made a profit in your rescue and other business. But that business does seem volatile. So can you give us some more detail around that?

A: Yes. Well, the thing you have to note in that business is that there are some structural changes taking place. We have a creditor business that's running off which was very profitable in 2012, but very small in 2013. And we've sold our life business during 2013.

If you adjust those out you have the underlying business which is rescue primarily and then pet and travel. And as a whole, those three businesses made around £38m for the year. And it would have been more but we had abnormally high medical claims on the travel side. And we're saying that in a normal year, those businesses going forward ought to make in the £45m range.

At the same time, we're investing in our rescue business. That's Green Flag. And we've had new marketing campaigns that have been very successful and we're building more on our direct presence in that market. So we're pleased with our performance.