Transcription

Domestic & General's Q3 FY21 Results

25 February 2021

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Domestic & General's Q3 FY21 results call. Today's discussion may contain some forward-looking statements relating to future events and expectations. As usual, the factors that could cause actual results to differ materially from these projections are set out in the latest results statement. In addition, we have included some non-GAAP financial measures in our discussion, reconciliations for which can also be found in the results statement.

With that, let me hand over to Chief Financial Officer, James Davies.

James Davies

Thank you, Keith, and good morning and welcome to our Q3 financial year '21 results call. This is now my third bondholder call, having joined the business in August last year and what an interesting six months it has been. So, what are my three key learnings to date?

Firstly, our ability to drive value is impressive despite lockdown. Both new business wins and renewal success have shown year on year growth rates ahead of expectations. Secondly, our customer service measures are also consistently strong as our product offering and brands are increasingly relevant as we see a trend where homeowners are caring more about all things home related. And thirdly, I joined the business remotely, but I'm delighted that the company's creativity and resilience in navigating the uncertainty of the pandemic has not waivered. Our team's remote performance continues to be strong across all areas, from the contact centre teams based in the UK, to the US team who are deep in launch preparation mode.

Now let's move through our presentation and focus on our latest results.

So, turning to slide two. The theme for this slide is the same as the equivalent slide last quarter: the demonstration of growth and resilience. Firstly, let's discuss our financial performance. Year to date, the volume of new business subscriptions and the volume of renewal subscriptions have grown by 12% and 11%, respectively. These are two very important data points since they demonstrate a real increase in the lifetime value of our customer base. Each time we increase the number of live subscriptions across our base, the embedded value of our business increases.

Group EBITDA is broadly flat. There are two themes within these Group EBITDA results. Firstly, as mentioned at the time of the Q2 results back in November, we have experienced higher claims costs within the UK market within Q3 as COVID-related factors have placed pressure on our repair networks. Whilst we have offered a full service across all appliance types and fulfilled usual levels of customer demand, peaks and troughs in demand have led to a strain on the repair networks.

On top of this lumpiness, there has been some disruption to parts and replacement product supply which has led to increased levels of appliance write-offs and an increase in the cost of sourcing replacement products. Whilst we have strong protection from factors such as these within our fixed margin agreements, we have suffered from higher claims severity and cost on business lines which lack this protection. We believe that these factors are temporary, since we are seeing more usual patterns of claims costs within the UK business as we progressed through quarter four.

Secondly, the international cases have performed ahead of expectations, predominantly due to COVID restrictions having the opposite effect with claims costs being lower than expectations. This is as a result of the nature of our product and offering on the continent. In the same way the higher claims costs within the UK were temporary, we see the international lower claims costs as also being temporary and more normalised levels were returned to the UK and international division as lockdown restrictions are relaxed and as we enter our next financial year.

Operational progress has continued at pace and we are comfortable that the key objectives within our five-year plan are being delivered on time. One data point I wanted to share first, is that for the nine months to the end of Q3, there has been year on year growth of 130% in new subscriptions being signed up digitally.

There are a number of KPIs within our contact centre which have a direct impact on value. One of these KPIs is the conversion from incoming calls. This particular KPI remains strong in Q3 and has been particularly pleasing as we progressed through Q4. There's been a notable year on year increase on this data point for a number of months.

Our US launch is progressing nicely. The team in the US is being built out. Key contracts have and are being signed, and everything is on plan to launch later this calendar year.

Cashflow and capital. Underlying cash generation of the business remains strong despite temporary timing issues arising from the Brexit response in the form of the successful completion of the Part VII transfer. We continue to be well covered from a Solvency II perspective with our qualifying capital resources of £160 million at the end of the quarter, comfortably exceeding the capital requirements of £84 million and our regulatory solvency ratio was 190% at the end of the period.

Now that the Part VII transfer is complete, we will continually assess the appropriate capital structure. As a reminder, we have a commitment to not drop below 130% coverage. We also expect there to be further capital efficiencies within our European business as we progress through 2021.

Moving on to slide three. I would like to cover two highly relevant topics on this slide: Brexit and COVID.

The previous slide showed the great job the contact centre, digital, marketing, and data science teams are doing in winning new business and optimising the level of renewals plus the operational progress we are making as we progress through our five-year value creation plan. This slide provides further reassurance around our resilience and stability as a business to absorb shocks and headwinds.

Firstly, let's cover off Brexit. As part of our positioning for Brexit we established an insurance entity in Germany back in November 2019. This entity is called DGIEU. You will recall that we have been writing all new European business from DGIEU since this date. The Part VII transfer of the back book to DGIEU was successfully executed on the 31st of December 2020.

I would like to publicly thank the internal and external teams for achieving this key milestone. Even though I've already been here for six months, a large chunk of the preparatory work had already been completed by Joe and team before I'd even started.

The Group Solvency II cover ratio was adversely impacted by the Part VII transfer. This is due to certain capital inefficiencies arising from the need to have two regulated entities: one in the UK and another in Germany. However, we continue to have plenty of excess capital available as required. We also expect our capital needs in the international business to reduce later this calendar year since we are now able to progress our German USP application. D&G is now technically secure in a post-Brexit environment and it really is time to move on from the Brexit process and planning. All efforts can now be focused on continuing to grow the value within the international business.

Now onto another very relevant ongoing topic: COVID.

Even under the ever-changing lockdown restrictions and regulations of the COVID pandemic across many geographies, our business remains resilient and is operating very efficiently. We are an increasingly data-driven organisation, and we measure KPIs on the effectiveness of remote working in great detail. I am delighted to say that these KPIs remain reassuring as we approached the 12-month anniversary of lockdown number one starting.

However, as mentioned earlier, we have been affected by supply chain issues, which have caused an increase in our claim's costs within the UK business. We have taken all actions available to us to mitigate these issues and as we progress through Q4, we are increasingly confident that this has been a temporary issue.

Customer satisfaction measures remain solid despite the current environment and demonstrate again the resilience of our business in terms of both service and operational measures. We are also confident that our brand equity has been further enhanced as a result of our great service provision when it has mattered the most to our customers. As is the case with many businesses, we are progressing well with the development of an effective, hybrid way of working model which we will implement in due course.

Moving on to slide five. I included quarterly new business and renewal growth in the Q3 results, and I've added to this analysis the Q3 data points. I feel these two slides – slides five and six – are arguably the most important in this presentation in terms of hardcore value generation.

As mentioned earlier, one measure we're looking at more closely is the lifetime value of a customer and the lifetime value of our overall book of business. Growing the lifetime value per customer and increasing the number of live subscriptions drives real value. It's this scene we will be talking about going forward in more detail.

I am delighted to confirm that the volume of subscriptions won via our new business stream was up 15% year on year in Q3. We have now grown the new business volume by 12% year to date, year on year. Let's remind ourselves that between the 1st of April and 31st of December 2020 there have been large chunks of time when some of our larger retail clients have actually been fully closed. To achieve 12% growth over this period is just another data point which shows both our resilience and the increasing diversity within our UK client base. When bricks and mortar operators were facing headwinds, our digitally led clients are outperforming.

Moving on to slide six. The second keyway of increasing the value within our subscription book is to reduce the churn of our existing customers, i.e., by increasing renewals. I'm equally delighted to confirm that the volume of renewals in Q3 increased by 6%, which means we are 11% up year to date, year on year. If we reduce churn by just one percentage point, we deliver a very attractive EBITDA profile over the periods which follow. This indicator is therefore subject to a lot of internal focus and scrutiny, as you can imagine.

There are two key takeaways from this double-digit year on year growth in renewals. Firstly, the many internal initiatives we are rolling out are proving effective. And secondly, our existing customers are really valuing our product offering and want to continue to use it.

Moving on to slide seven, which covers revenue. We are performing strongly with double digit year on year growth in the absolute number of subscriptions. Subscriptions are ultimately the key driver of future revenue. Subscription revenue grew 4.8% in the UK and over 24% in the international division. In line with our consistent strategy, our non-subscription revenue is declining as we proactively target the much more valuable subscription income. The lifetime value of a customer who takes out a subscription is greater than a corresponding customer who takes out an old-school cash product. Hence, our relentless focus on subscriptions across all geographies.

On this slide, I'm particularly pleased with our ability to really improve the quality of our revenue within the international business, where subscription revenue has now been higher than cash revenue for the third quarter in a row and the gap between UK percentage of subscription revenue and international percentage is narrowing. Our business quality transfers well across geographic boundaries. Overall, there was a 5.9% growth in Q3 total Group revenue, leading to a year-to-date growth in revenue of 4.4%.

Moving onto side eight. We have consistently reported these four KPIs over many quarters. The UK's share of renewals remains flat due to a strong recent acceleration in new business. In international, we are starting to see the share from renewals rise as the subscription base continues to grow. Underwriting costs as a percentage of revenue rose slightly in Q3 due to the temporary COVID-related supplied chain issues previously discussed. A very pleasing data point on this page is the one relating to overall subscription revenue within the Group, which continues to rise and is now 85.4% at the end of Q3.

Moving on to slide nine. Adjusted EBITDA continues to be our chosen measure of profitability. With the challenges in the UK supply chain in Q3 arising from the COVID pandemic, our year-to-date adjusted EBITDA is marginally down on last year. However, investment income falls within our adjusted EBITDA definition. We took a prudent approach to invest in risk during a period of macroeconomic uncertainty at the start of the pandemic when we liquidated our investments into cash. If we were to strip the investment income line from our adjusted EBITDA definition, our EBITDA increased by £400,000 year on year, versus a loss of £500,000 when investment income is included within the adjusted EBITDA definition.

So, the underlying business EBITDA grew year on year as a result of the outperformance of the international business, mitigating the extra costs associated with the quarter's increase in UK claims costs. I will repeat two terms I've used a few times today already with regards to our business model: resilience and increasing diversity. To ensure consistency and comparability between periods, these specific individually identifiable non-recurring costs associated with preparing our international business for Brexit and some specific, individually identifiable, non-recurring COVID costs have been disclosed separately.

Now let's turn to slide 11, to run through the cash flow. We've already talked about our EBITDA starting point. Regulated adjusted EBITDA is down £4.5 million, due primarily to the higher UK claims costs. This means that our unregulated starting point is up 7.5% year on year. Capital expenditures increased in line with our plan as we invested in our digital capability as we progressed through the delivery of our five-year value creation plan.

There continues to be a material swing in working capital between the two nine-month periods. This is for two main reasons. Firstly, a reason you're all familiar with, the unwind of the Customer First programme. Secondly, as a result of actions implemented to preserve short term liquidity, these included time-to-pay arrangements with HMRC and the COVID support measures. These short-term liquidity benefits are expected to unwind over the course of the financial year '22.

I'm looking forward to FY 22 when our working capital movements will be much more comparable between different periods as the Customer First dynamics are minimised.

There has therefore been a noticeable increase in unregulated free cash flow. However, the working capital trend is broadly reversed as a result of the change in distributable reserves within the regulated business. So, why is this? Last year saw a material one-off benefit from Customer First and a material one-off benefit from a change in the lapse risk assumption.

Compounding the variants is a Part VII impact, made up of both a deferred tax liability and an increase in capital required for DGIEU. As mentioned earlier, we are now able to apply for our USP for DGIEU, which we expect to get before the end of this calendar year, which will reduce the capital requirements within our German entity.

There is also a variance in the tax provision from last year for this year. This is due to one-off income tax rebates due to the debt restructuring exercise carried out as a result of the Project Emerald process. As a reminder, Project Emerald was when ADIA made their investment and CVC switched between funds.

On to slide 12, which shows the position on overall Group capitalisation. There is a minor fall in gross debt as a result of a slight reduction in lease liabilities going forward. However, the main point to draw out on this slide relates to the reduction in unrestricted cash reserves which have reduced from £129 million to £85 million. And there are two main reasons for this reduction.

Firstly, Group free cash flow reduction due to working capital, Capex and Part VII impacts. And secondly, an element of temporary time against differences as a result, again, of the Part VII transfer. These temporary differences total approximately £26 million, and £16 million of that difference has already unwound and sits within the unrestricted cash balance as at the end of January.

So, in summary, the business continues to trade resiliently. The benefits of our increasingly diverse client base and geographic footprint are proving beneficial and are becoming real value drivers. The ability to continually increase the overall lifetime value of the subscription book is extremely satisfying, especially during the last nine months, when retail premises have been closed for large periods of time.

Brexit is now behind us and we are also a further quarter into delivering our five-year value creation plan. The excitement of our US launch is building as the foundations are being built to launch later this calendar year. We are in a solid position to continue delivering profitable and underlying cash-generative growth from our embedded subscription model. And I look forward to further updating you on continued progress over the following quarters.

I've now finished our presentation. So, we'd like to open the call up to questions.

Q&A

Operator

Thank you. If you do wish to ask a question, please press 01 on your telephone keypad now. If you wish to withdraw your question, you may do so by pressing 02 to cancel. Once again, if you have a question for the speakers, please press 01 on your telephone keypad now. There will be a brief pause while questions are being registered. And once again, if you do have a question for the speakers, please press 01 on your telephone keypad now.

Our first question comes from the line of Irene Huete of CVC Credit. Please go ahead. Your line is now open.

Irene Huete

Hi. Good morning. Thank you so much for the presentation. I just have a couple of questions. The first one is with regards to the capital requirements related to Brexit. Do you mind remaining me what was the total capital requirement that you recorded in the current year and how much has already been unwound?

James Davies

Yes, hi. It's James here. So, yes, there was a capital inefficiency with regards to setting up the German entity by having two regulated entities: one in the UK and one in Germany. An element of the inefficiency was already in the previous quarter's numbers because we were writing new business within Germany now for over 12 months, but the additional bit as a result of the Part VII alone; the net increase is around the £3 million or £4 million mark.

But when you add in the previous inefficiencies to get there, we were in double figures. And the point I'd like to reiterate from the presentation is that we do expect capital efficiencies within Germany later this calendar year as well, because we are now able to apply for our USP application now that the Part VII has happened.

Irene Huete

Okay. Understood. I think during the Q2 call in mid-November you said that you expected total capital requirement of about £15 to £20 million, if I don't remember incorrectly. Is that still the case that you recorded as at December 2020?

James Davies

Yes, that's spot on. So, overall, the delta was about £16 million, but about £10 million of that was already built up during the prior periods with the new business strain. So, yes, the total number in there at the moment is probably about the mid-teens, and we'd expect to reduce that probably to low double digits or high single digits once USP application has been successful.

Irene Huete

Perfect, understood. And could you give us a bit more colour on the US application? I believe that it required a bit of Capex to be invested for the infrastructure to be built there. Could you give us some guidance as how cash is going to look like in the fiscal year of 2022 once you factor in the US investment?

James Davies

Yeah, the US investment programme is obviously a very exciting one, and it's really reassuring now, six months into my time at D&G, that we're starting to see real things happening. In the first year, the cash outflow; we haven't disclosed an exact number, but we're going to be in sort of single-digit millions. And then that's going to ramp up over the duration of the programme.

But in the first 12 months the number's not going to be a massively high number. But, yeah, we expect to launch later this calendar year. And so far, we are pleased with the progress.

Irene Huete

Perfect, understood. I wish you the best of luck with that one. Last question for me is on the claims cost that you have recorded with regards to the UK. Could you give a bit of colour if it's mainly driven by Brexit, or if it's COVID-related?

James Davies

Sorry, I missed the start of that question. Apologies.

Irene Huete

Yes, sorry the higher recurring claims cost that you're seeing in the UK. Can you clarify if it's mainly related to COVID - to the pandemic or is it related to Brexit?

James Davies

No, I think it's almost exclusively if not exclusively related to COVID. And we've been quite reassured as we've gone through January and February that we've not seen sort of Brexit related supply chain issues. So, the issues we experienced in Q3 were very much COVID-related.

Irene Huete

And what is it exactly? Is that because of COVID, there is supply chain disruptions and hence you cannot get the products in at the price that you used to get them and that would normalise as the economies reopen?

James Davies

Yeah, I think there's two or three reasons actually, and I guided to them at the Q2 results back in November, is that because of the sort of pattern of volume throughout the lockdowns, there is a big sort of slowdown in volume in our Q1 where everyone was trying to work out what was happening with letting people in your homes, et cetera. So, there was a lumpiness of volume issue, so that means that the network of engineers has a bit of strain. And secondly there was a supply chain issue in terms of supplying of both parts and supplying of the end product as well.

So, we kind of got hit by a bit of a double whammy and as the supplier products was getting a bit strange, we had to source products from slightly more expensive means as well. So, the good thing is that we've that we're returning to normalised trends in the last sort of four to six weeks, which is reassuring. And I'm hopeful that the sort of minor blip in Q3 – it was temporary, and it won't come back.

Irene Huete

Understood. Thank you very much. That's it for me.

James Davies

Thanks.

Operator

Thank you. Once again, I'll remind you if you do have a question for the speakers today, please press 01 on your telephone keypad now.

We currently have no further questions. I will hand back to James for any final remarks.

James Davies

Well, first of all, thanks to everyone for listening. As I mentioned in my summary earlier, it's been a very interesting first six months and we've got lots of exciting things to look forward to. So, I hope you all have a nice day.