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Q3 FY23 D&G Bondholder Call

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23 February 2023

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Domestic & General's Q3 FY23 Bondholder 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 CEO, Matthew Crummack.

Matthew Crummack

Thanks very much and good morning. Welcome. It's Matthew Crummack, CEO, here sitting alongside Joe Fitzgerald, our CFO - coming to you live from Wimbledon this morning. I wanted to welcome you to our results announcement for the quarter ending 31st of December 2022, which is our third quarter of the financial year. I'm going to kick off with a few comments on some highlights from the past quarter and then Joe will dig into some detail on the financial results as usual shortly after that.

So, let's kick into slide two, if we can, please. We continue to report ongoing growth in line with expectations, 8% year-on-year subscription revenue growth, inclusive of 20% subscription growth in our international business as we continue the transition from non-recurring cash business into more resilient subscription business. That continues and our customer retention rates remain stable at 84%. Now, this revenue growth is combined with an ongoing focus on cost efficiency and that results in continued growth to our adjusted EBITDA, which excludes the results of US start-up, and grew by 13% for the year to date to £104 million.

Now, if you include the US, that would be 11% year-on-year growth to £98 million for the nine-month period, demonstrating progress against the objectives that we set out and particularly as we navigate macroeconomic factors affecting the economy.

Now, as in earlier periods, we continue to maintain good levels of liquidity in the group and a strong solvency position in our regulated business. Group net debt was £693 million, which gives rise to a total leverage ratio of 5.7x, which was a 0.1x reduction over the quarter and a 0.4x reduction compared to the March year-end position. So good progress. Finally, our US start-up remains on track with a pleasing £4 million worth of subscription revenue generated year to date.

Now, during our last results call for the half year, I spoke in some depth about strategy, the robust business model, and our progress in the US, so I'm not planning to go over all those things again today in detail. I would say, however, that we've not had any unwelcome surprises or deviation from expectations over the past quarter and the positive response of our business to inflationary and cost of living pressures remains much as Joe and I had guided on previous calls. And based on what we're seeing and from our externally commissioned research, our products are proving to be of enduring value to the consumer.

Now, on our last call, we discussed initial routes to market for new business, including point of sale, post point of sale, and point of need – those three channels. And we did receive some follow-up questions on the proportion of our new business, which each one of these main routes represents. For our Group subscription new business plans, post point of sale, and point of need represent more than two thirds of our new business sales, which takes into account appliances at various different points in their lives with point of sale representing just under a third of new business subscription plans.

I guess the point is that, notwithstanding the well-documented downturn in appliance sales, our techniques for capturing and using customer data mean that we continue to enjoy good levels of new business. What's more, all of these initial routes to market feed into our renewals process, which accounts for the significant majority of our revenue.

Let's move on to slide three. Now, since our financial year ending 31st of March 2017, our average customer subscription retention rate has been 85%, highlighting the consistency of our model and strong retention. As you can see in the graph on the right-hand side, revenue from subscription business makes up a large and increasing proportion of our total revenue, up 11 percentage points over the period shown – 88% for Q3 year to date of the current financial year.

Our subscription business leads to long-lasting customer relationships and an increase in quality and reliability of our earnings as we grow our business further. So, our revenue benefits from new business sales, which take place at various different points in the appliance lifecycle and from a strong and healthy renewals profile. As mentioned on our last call, although new appliance sales are down, if consumers are not replacing their appliances, it means they are trying to extend the lives of their existing appliances, which means our policies continue to be as relevant as ever.

We will provide, of course, a fuller update on the business as part of our year-end results call and I'll be happy to take questions at the end of this call. But I'm now going to hand over to Joe, who'll run through more detail on the financial results. Thanks, Joe.

Joe Fitzgerald

Thanks, Matthew. Good morning for those of you listening and welcome to our quarter three results call. I'll begin with an overview of our key numbers for the nine months year to date.

So, on slide nine, you can see year-on-year revenue growth for the nine-month period of 6%, which delivers year-to-date revenue of 727 million, excluding the US, up from 687 million in the equivalent period last year. As Matthew mentioned, our year-to-date subscription revenue growth, excluding the US was 8%, which continues to be ahead of total revenue growth, taking subscription revenue to 642 million for the nine-month period. Revenue growth has supported a 13% year-on-year increase in adjusted EBITDA from 91 million a year ago to 104 million for the latest nine-month period, excluding the US, and 98 million, including the US early-stage loss.

Our net debt has increased marginally over the past three months to 693 million following the inception of our new Nottingham lease and total leverage has fallen to 5.7x in view of EBITDA growth, which is a 0.1x reduction over the quarter and 0.4x reduction compared to our March year-end position. Solvency coverage ratios remain strong in our regulated business.

So, moving on to slide six, we can take a look at our KPIs. On this first slide, we show the customer-focussed KPIs, which demonstrate a rise in the number of subscription customers from 6.1 million at the end of the comparative quarter in our last financial year to 6.2 million now, which results from the combined impact of new business and high customer retention. That customer retention rate was at 84% compared to a slightly higher retention figure of 85% a year ago, consistent with the previous quarter, which we consider to be a satisfactory result in view of the macro backdrop.

In the middle left-hand chart, you can see that average revenue per customer continues to rise, reflecting greater household penetration, and together these factors have generated growth in subscription revenues to 642 million for the nine-month period as shown in the main chart.

Our next slide, slide seven, shows our principal financial KPIs. As just mentioned, subscription revenue was 642 million, which represents 88% of total revenue. The planned fall in non-subscription revenue continues as a consequence of the transition to subscription business, where growth of 45 million significantly outweighs the 6 million fall in non-subs revenue.

The lower set of graph shows profit margins calculated on a last 12-month basis compared to the equivalent quarter last year. These show an underwriting margin of 33.6%, comparing favourably with the prior year, which was somewhat impacted by Covid-driven factors and has now normalised. This results in increased EBITDA, which has delivered a year-to-date, US exclusive, EBITDA of 103.5 million.

Turning to slide eight, we review our revenue in more detail. As you can see, on a year-on-year basis, growth in total revenue, excluding the US, was 6%, comprising 5% for the UK and 11% for international business. Total group revenue, including the US, also grew by 6% for the nine-month period. Within these total revenue figures, subscription revenue in the more mature UK market grew at 6%, where it now makes up 95% of total UK revenue, whilst non-US international subscription revenue grew at an impressive 20% to now form 61% of the division's revenue. As mentioned, non-subscription revenue continues to decline in both markets and fell by 6 million for the nine-month period, in line with our strategic focus on subscription business.

Moving on from revenue to EBITDA on slide nine, we show the adjusted nine-month EBITDA on a basis that excludes our US business has risen by 13% year on year to 103.5 million. This includes a 7 million increase in the UK business and a 5 million increase in the international business.

These are great results and testament to the robust and diversified nature of the business model. Including the US, adjusted EBITDA for the same period was a result of 97.6 million, which is an 11% year-on-year increase. As mentioned in previous results calls, the combined effect of early-stage costs and revenue-earning patterns means that the US division will weigh marginally on our results for the short to medium term, but this should be viewed as a temporary impact as the US operations are developing well and in line with our plans.

Now we'll turn to cash flow for the quarter. On slide 11, in this table, we present our group free cash flow on the basis of unrestricted cash. As explained on previous calls, unrestricted cash is a term in our bond documents, which includes the cash and liquid investment assets of our unregulated business plus the free capital of our regulated business in excess of its solvency capital needs. Following that definition, this cash flow analysis needs to be viewed as removing the IFRS-based results of the regulated business from the respective line items, to leave just the unregulated business, and then adding back the movement of distributable reserves of the regulated business following Solvency II principles.

In the opening lines of the cash flow, you can see the US-inclusive EBITDA results of the group and then we strip out regulated business EBITDA from the group results leaving just the unregulated business EBITDA of 61.1 million for the first nine months of the year. We then deduct non-US capital expenditure of 21.6 million. This remains at an elevated level as we work on finalising our new operations hub in Nottingham due to open in the spring and delivering on our tech transformation projects. However, it still represents a significant fall in Capex compared to the prior year.

On the next line, we show the working capital outflow of our unregulated business at 15.7 million year to date. As before, this includes cash outflows associated with the run-off of our Australian business with the remainder of the movement primarily one-off timing impacts and various business-as-usual timing differences on acquisition costs, receivables, claims, and other creditor payments.

Next down, Capex and working capital for US operations is also part of the unregulated business cash flow, and combined with the US EBITDA shown on the second line, this shows 8.4 million was invested in new US operations over the nine-month period.

Below the unregulated business free cash flow, we report the increase in distributable reserves of the regulated business of 22.6 million, which is derived from Solvency II actuarial principles rather than IFRS principles. This increase in distributable reserves is lower than the regulated business's EBITDA on both the quarter and year-to-date basis, which is normal and expected due to the different rules relating to the measurement of balance sheets for IFRS and solvency purposes, general growth in the insurance business and the structure of the regulated group.

Overall, we generated around 44 million of positive free cash flow over the nine-month period. This is then reduced for more than 30 million of debt interest plus tax on significant items, closing our unrestricted cash position at around 69 million as at 31st of December. This is expected to reduce next quarter following our next semi-annual bond interest payments. Overall, however, we are trading in line with plan and consistent with previous guidance. We expect unrestricted cash in total to reduce by single-digit millions over the full year to March '23, reflecting our enhanced investment expenditure in our US start-up and the facilities investments I have mentioned.

Besides our unrestricted cash, liquidity is further enhanced by our undrawn revolving credit facility of 100 million. 30 million of this facility is ringfenced as part of the regulated business's capital resources and the remaining capacity of 70 million can be combined with the unrestricted cash balance to give a fair representation of the unencumbered liquidity available to the Group.

Moving next to capitalisation. Net debt and leverage at the end of the quarter were 693.2 million and 5.7x respectively, whilst our consolidated senior-secured net leverage ratio, which is calculated with reference to our senior-secured net debt only was 4.2x. These ratios represent the continued reduction in leverage in line with our plans and we remain in a strong financial position with significant headroom.

Finally, on slide 13, to sum up, we return to our opening slide. Our business has performed well over the nine-month period, particularly so in view of the macroeconomic backdrop. Our financial results remain strong, our liquidity leverage is robust, and we are making ongoing progress with the execution of our strategic plans. Matthew and I would now like to open the call to any questions.

Q&A

Operator

Thank you. If you do wish to ask a question, please press *11 on your telephone keypad. Once again, it is *11 to register for a question. There will be a brief pause while questions are being registered.

The first question comes from the line of Karl Strecker from Guggenheim. Please go ahead.

Karl Strecker

Hi. Thanks very much. Thanks for the presentation. Just as a comment, if it’s possible to provide the quarterly detail in the presentations and some commentary around the quarter, that would be very helpful. I think that's how we would look at the business and it just makes it easier for us to follow along with the performance. The question that I would have is just around inflation. Could you talk about— You seem to have been managing inflation quite well. You haven't seen an increase in loss rates for, for example, driven by claims inflation, and EBITDA margins I think are relatively stable. Can you just talk about the impacts of inflation on the business? And have you been able to mitigate that via price increases or how have you addressed that?

Joe Fitzgerald

Yes, sure. On the first point, yes, it's a fair point on the quarterly results. We’ll have a look at whether we can incorporate something to make it easier for the reader. So, we’ll take that away.

On inflation, yeah, what we've tried to do to approach inflation is to look at it two ways. So firstly, our first approach is to limit the effect that inflation has on our Group. So, by cost discipline, looking at our repair arrangements with our various partners and just trying and be disciplined about how much cost comes through. We have mitigated well and we are by no means seeing cost inflation in line with the headline rate of inflation. But we do see elevated levels of cost inflation compared to what we would usually see, of course. And to the extent we have, we have been able to pass that on through price in what we consider to be a fair and balanced way to our customers, and we've pleasingly seen that those price increases have been accepted. We think they were fair price increases, and we haven't seen a material impact on our retention rates or on new business performance.

So, we are happy with how we are dealing with inflation. We think we can continue doing so. Our business model lends itself well to managing elevated levels of inflation, but we're by no means complacent, of course. So, we remain disciplined on costs. We're looking to manage it as well as we can, and we expect to be able to do so.

Matthew Crummack

Yeah, I think just to add, Karl, I think the work that Joe and the team have done over the last few years on managing the data sources we have, to be able to understand and unlock some of the underlying dynamics of what's happening to consumers and also supply chain has allowed the team to make some intelligent choices on which lever to pull, if you like, to respond in that environment. And we've made some investments in that space as well, in data science, and brought some new people in. So, we're hopefully getting a little sharper on that front as we go forward.

Karl Strecker

Understood. That's very helpful. And what kind of price increases have you passed through to your customers? When are you able to pass through those price increases on the subscription policies? Is that on a once-yearly basis that you have an opportunity to reset the pricing on those policies?

Joe Fitzgerald

Yeah. So, taking the second question first, yes, we typically reprice each customer contract on an annual basis in line with the annual renewal notice. So, each month, obviously, as we progress through the year, we have a large number of customers coming up for their annual renewal and we assess the price at that point for that cohort of customers and then continue throughout the year in that way. We have been asked this question on previous calls, what level of price we put through and what level of cost inflation we've put through. We've not answered because it's really commercially sensitive information. So, what we have said is that what we've put through in terms of both cost and price inflation, has preserved our margin and we expect to continue that to be the case.

Karl Strecker

Yeah. And I presume the price increases that you put through this year have been higher than in prior years, reflecting the higher inflationary environment.

Joe Fitzgerald

Yes, indeed they have. Yes.

Karl Strecker

And do you see any, because I guess, 2022, generally speaking, I think we've seen companies able to pass on price increases to customers and those price increases have stuck. But maybe there's a concern in 2023 that, say, some of the wage pressure is stickier and maybe it's a tougher demand environment. So, how are you seeing the inflationary trend at the moment? Are you continuing to see it as you saw it in 2022? Is there any abatement? Do you feel like the price increases that you put through in 2023 are similar to 2022? Or do you think they'll be lower?

Joe Fitzgerald

I think it's very difficult to say at this stage, really, because obviously it is a movable environment. I think probably we would expect to put slightly less price through and see slightly less cost inflation, would be my feeling on it. But nonetheless, what we have been pleased with is how well we have managed inflation and we really do feel the business model does allow us to do that. We have good techniques, good data, to Matthew's point, good relationships, and our customers, which is probably the most valid point really, is that our customers really value our product and, particularly in times of economic turbulence, we feel that our product is well suited to those customers. So, we're by no means complacent, but we do feel that we can continue to manage our margins well in these environments.

Karl Strecker

Yeah, understood. That's very helpful. And as you think about – last question from me – as you think about the ability for you to pass through price increases, are you thinking about what the customer sees as alternative warranty products in the market or are you more thinking about the risk that the customer just decides, well, this warranty product is more expensive and I'm just going to go without having a warranty product. What's the competitive alternative as you see it when you think about price increases?

Joe Fitzgerald

Yeah, there are obviously competitive products in the market. We have competition, of course, so we always keep an eye on what our competitors are doing. Probably, in fairness, the bigger dynamic is the customer's preference to either keep with our cover or self-insure the risk themself. That goes back to the strength of our model, I think, really. Customers taking on risk in these uncertain times is generally not an attractive thing for them to do. So that is why we believe that our product offers that peace of mind. It also offers a great service.

And that's the other thing that, if you refer to some of the customer statistics, our products, we have a 99% claims acceptance rate. Our customers know that. They know if they phone or book online, it's going to be approved. We'll do our best to help them with their problem. So, all of those factors, we think, lead to being able to manage, which is what really the business model is, as a whole, the service we provide, the basis of our cover being a subscription, the relationships we have with our partners, which are good strong relationships and fair relationships.

So, we think with all of those factors, that's why we've dealt with circumstances so well and have done in previous recessions and previous inflationary times and we think we can continue to do so.

Matthew Crummack

And just as a reminder of what we talked about, those different channels where people come in, whether they come in through having bought something in a retail store or they come in having registered the appliance afterwards, there is also point of need. And for those people who haven't got a policy or maybe have chosen previously to self-insure, we do get customers coming in because the machine's broken and they need help, and they choose to take out a policy at the same time. So, I think, we have a multiple of coverage on that on those routes, too. You're being protected and getting help.

Karl Strecker

Yeah. Understood. I'm sorry, maybe just lastly then on the US business. You mentioned that it's developing in line with your plan. Is that all on track? What is the guidance for reaching break-even and how do you see the business developing in the US?

Matthew Crummack

Yeah, I'll do a little bit of colour on what we're seeing now and then we'll try and give you some guidance on what you might expect in the next two to three years. When we launched there, Karl, we had a view that we thought that the US consumer would be similarly minded to the consumer over here, that they would convert and buy and understand the product that we had on offer. And as a reminder, the US market does not have a product right now, which is a monthly subscription protect and repair type product on appliance and white goods. The market sells a ton of fixed-term cash protection. You go to a Best Buy, and you can buy a two- or three-year product for 150-200 bucks. That's very different from what we do.

And so, we wanted to validate that the consumer would respond well to that. And also, the manufacturers and our partners would derive value from that, because the subset of this is that it's a huge market. And what we've done is we validated those points in this last year. The US consumer does understand what we're selling. They're converting very well. Even after only a year, we've been optimising the UK business for a good while now and the US business is looking pretty similar to the UK one even after just a year. And you kind of almost, you might say, we haven't even got started yet. So I think there's a lot of a reassuring points there around the dynamic around the consumer.

Our partner there, Whirlpool, that we've announced before, their business in the US, their scale of business just in the US, just with that client is probably as big as the UK as a whole. It's just a big market. Obviously, we have a pipeline of ideas going forward on what to do. So naturally, as a reminder, financially, because it's a subscription business, it's an aggregation of revenue which grows over time. So, we were never going to go out of the gates with a big number. That will build. But I think we're pretty pleased with where we are.

And just looking at Joe here in terms of the guidance we've given previously on where we expect to land.

Joe Fitzgerald

Yeah. So, I think we've said due to revenue earnings patterns and start-up costs essentially you have fixed costs and it takes time for the revenue build, to Matthew's point on subscription, takes time to soak those up. We would expect to post losses. But we do expect as well to come back into profit. And that's what the subscription model does. So, I think I've guided on earlier calls that we'd expect profitability to be reached, either at FY 25 or at FY 26. And that's what we still expect. We're trading where we thought we would be. We are investing in a territory and an opportunity that is really game changing for this business. So, we're happy to do so.

Karl Strecker

Understood. Thanks very much for all the colour.

Matthew Crummack

Thanks, Karl. Good day.

Operator

One moment, please, for the next question. The next question comes from the line of Wyatt Laikind from MAN GLG. Please go ahead.

Wyatt Laikind

Hi. Thank you for taking the questions. Just first of all, I would totally agree that if you could provide quarterly results and commentary, it would be helpful. So, thank you to the prior for mentioning that. What I wanted to ask is, I've seen the retention rate. It seems to be moving up over time, but I was wondering if you could say what it is for the LTM period rather than just an average since 2017?

Joe Fitzgerald

LTM is close to 84%.

Wyatt Laikind

Okay, good. Also, I was wondering, in thinking about the value proposition for the consumer, could you help me, or could you disclose to me, typically how many months would the consumer need to be enrolled in making monthly payments before their cumulative cost exceeds the replacement cost?

Joe Fitzgerald

Of the appliance itself?

Wyatt Laikind

Yeah.

Joe Fitzgerald

It does rather depend on the appliance in question. Obviously, there are very expensive goods, and there are cheaper goods. I wouldn't say there's particularly a rule of thumb for that, to be honest with you. What I would say is the vast majority of our claims cost goes on repairing machines. So, it's kind of a little bit of a false comparison, really, because really what we're paid to do is fix machines and extend the life of those machines.

Probably a better way to look at it is how much value does the customer get out of our products, basically. So just referring to some industry metrics, we operate in 40-50% gross loss ratio range, which is incredibly high if you refer to the FCA statistics recently published. We were right near the top of claims ratio, if you like, to premiums received.

And what I always say, is that that essentially ignores two factors. It ignores the fact that we get massive economies of scale. We do 7,000 repairs a day, 2 million repairs a year, half a million replacements. We buy and procure services in bulk that obviously the man in the street could never achieve. So, whilst we pay out X percent as a percent of our premium, the average customer would pay out significantly more due to the lack of those economies of scale.

And secondly, because we do procure such large volumes, we’re also the experts in procuring those and we’re the experts at fixing machines. So, we fix machines. So, 90% of jobs we go out to, we end up with a fix, which is way ahead of anything you would get as a customer. So again, because of that efficiency and because we fix machines, that leads to the customer getting more value. So, we've got absolutely no concerns that our product provides value to customers. And really, any way you look at it, it's a very strong value proposition compared to the rest of the insurance market and just generally as a service proposition.

Wyatt Laikind

Okay, that's noted. I was just going to ask next, I saw in the news Whirlpool had carved out a portion of its EMEA business and sold to Arcelik. I was wondering if you do business with that piece that had been carved out and if it affects your relationship with Whirlpool.

Matthew Crummack

Yeah, we do business with Arcelik in Europe, and they operate the Beko brand that you might recognise. And we also do business with Whirlpool in Europe, too. Obviously, we're very connected into that news, which is subject to regulatory clearance, I might add. So, the deal's not done yet. I think it's going initially through European Competition Commission approval processes which will probably drop it into the back half of the year in terms of timing. We have really strong relationships with both companies here. We go back a long way, and we know both teams and we'll be looking to ensure that we take the best of both relationships and work with them on that. And we're already talking to them very actively. These are day-to-day relationships; they're not things that we talk to them every quarter on.

So, I think we would just expect broadly to just keep working with them. They obviously have a lot of opportunity to go after in terms of some of the fixed costs that they have in that business, notably in terms of manufacturing and so on. But from what we give back to manufacturers, we're a channel of net goodness and value back into those organisations from which they have to deploy very little capital, frankly, and time. And so, I think we're a force for good in those manufacturers, I'd say, in terms of what we can do to help them.

Wyatt Laikind

Okay. And then just the last question from me is on working capital. Has there been any significant change in AR days?

Joe Fitzgerald

No.

Wyatt Laikind

From historical levels?

Joe Fitzgerald

No. We’re not seeing anything like that.

Wyatt Laikind

Okay. And do you guys have any factoring?

Joe Fitzgerald

No, we don't factor.

Wyatt Laikind

Okay. Thank you very much.

Matthew Crummack

You bet. Have a good day. Thanks.

Operator

Once again, ladies and gentlemen, if you do have a question, please press *11 on your telephone keypad. There will be a brief pause whilst questions are being registered Once again, it's *11 for a question. There are currently no further questions. I hand the conference back to you, speakers.

Matthew Crummack

Thanks very much and thanks for the great questions there. Lots of good detail. Look forward to seeing you, if there are no other questions here today, I look forward to seeing you for the next session. And we'll be back and noted on some of the questions there on quarterly results and so on; we will follow up on that stuff. But thank you and thanks, Operator, and have a good day, everybody.

Joe Fitzgerald

Thanks, everyone.

Operator

Thank you. This now concludes our conference call. Thank you all for attending. You may now disconnect your lines.