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A Tech Whiz Kid In An Analog Industry

- *Spy Tech Meets Auto Insurance*
- *Software Firsts Spark Outperformance*

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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A Tech Whiz Kid In An Analog Industry

Spy Tech Meets Auto Insurance

Software Firsts Spark Outperformance

This futuristic-looking device – which fits in the palm of your hand and plugs into a port under your car's steering wheel – could save you a lot of money on your car insurance.

Or it could raise your rates significantly... depending on how fast you accelerate... how often you stomp on the brake... and lots of other factors that indicate how likely it is that you'll wreck your car.

This doohickey is called Snapshot, and it's insurance provider Progressive's usage-based insurance plug-in. (There's also an app for drivers who don't want the physical gadget.) Called "the spy who paid me" by one reviewer, Snapshot tracks how safely (or unsafely) you drive and uploads that data to Progressive's central computer, GPS-style.

And your insurance rates will be adjusted accordingly.

This might sound like the Jetsons – or, unnervingly, like George Orwell's *1984* – but plenty of drivers are willing to trade a bit of privacy for lower rates. The average Snapshot user saves a whopping $156 on their annual car insurance premiums... though "risky driving behaviors" like speeding, turning corners too fast, braking too hard, and cell phone usage do lead to rate increases for about two of every ten users.

The latest, streamlined edition of Snapshot is new, but Progressive has been offering personalized insurance based on vehicle telematics (tracking driving behavior to predict risk) for over a decade – well before other insurers like Allstate and Geico hopped on the bus.

Futuristic technology isn't just an add-on for Progressive – it's part of the business's DNA.

Famous for its white "Superstore" commercials, reminiscent of an Apple outlet, Progressive is as much a tech company as an insurance company. (It was actually the *first* insurance company to launch a business website, followed by online quoting capability, back in 1995.) And the company's iconic pitchwoman, "Flo," is there to shepherd users through each new gadget and upgrade.

That high-tech focus – along with stellar financials and savvy underwriting – puts Progressive front and center as one of the top personal auto insurers in America. And one of the best insurance companies available to investors.

A Decade of Outperformance

Progressive Corporation (NYSE: PGR) provides personal and commercial automobile insurance and other specialty property/casualty insurance throughout the United States. Founded in 1937, PGR went public in 1971, and today is the second-largest insurer of personal autos in the U.S. – which represents 73% of its total business.

In this report, we'll discuss in detail the following reasons why shares of Progressive are a phenomenal long-term investment:

- Progressive is a tech innovator in a non-tech-savvy industry
- Progressive offers consistent long-term growth outperformance
- Progressive has consistent industry-leading margins

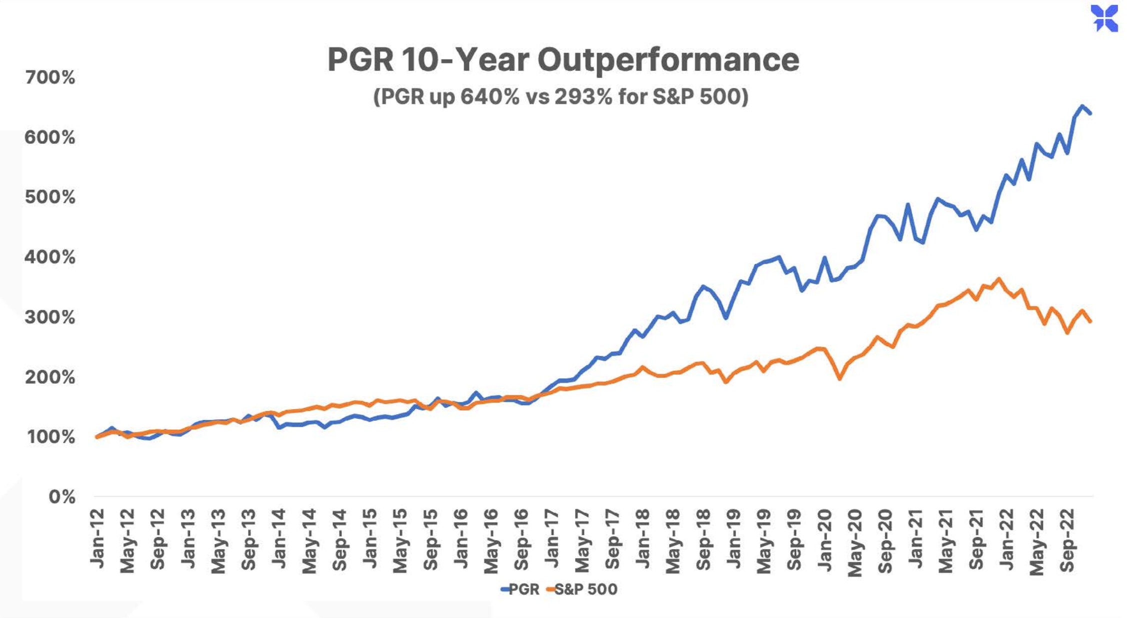
Progressive's insurance is sold through two main channels: direct to consumer (or DTC, which is online, phone app, and over the phone), and traditional insurance agents. Many readers are likely familiar with its advertising campaigns (especially those with Flo and Dr. Rick), as it spends more than $2 billion annually on ads in the highly competitive auto insurance market.

In addition to auto insurance, Progressive's other businesses include:

In *personal lines* (insurance to individuals and families), it offers homeowners' insurance as well as "specialty" insurance (recreational vehicles, snowmobiles, boats and motorcycles).

In *commercial lines* (insurance to companies and institutions), it offers commercial auto insurance (PGR is the country's largest writer of commercial auto insurance) as well as standard general business insurance and workers' compensation insurance, primarily to companies in the transportation industry.

We think shares of Progressive make for one of the best long-term investments in the property and casualty insurance industry. Over the 30 years from 1992 through 2022, shares of Progressive earned a cumulative return of 8547%, nearly ten times the return of the S&P 500 (which returned 877%). Over the past 10 years, PGR shares are up 640% vs the 293% return for the broader market (see chart below). And this track record of outperformance is likely to continue.



Let's dive into the three characteristics that make PGR an industry leader in property and casualty insurance.

A Tech Innovator in a Non-Tech-Savvy Industry

The insurance industry is widely viewed as a "people" industry, historically built more on relationships than technology. As a result, many insurance companies rely on old legacy systems for policy administration, pricing, and claims.

But technology matters, especially in personal lines. Against this metric of technology innovation, Progressive is an innovator.

Indeed, the company's history is chock-full of industry firsts:

- **1994:** introduced the industry's first 800 number for help with auto insurance rate comparisons.
- **1995:** first auto insurer to launch a company website. A year later, offered online policy access and quoting.
- **1996:** introduced credit score as a rating variable, which has since become one of the most important rating variables used by the industry.

- **1997**: first insurer to give consumers the ability to buy auto insurance in real time online
- **2000:** first insurer to receive wireless payments from customers using a PDA or cell phone.
- **2004:** introduced a usage-based insurance program.
- **2005:** first insurer to connect with consumers using a voice-over internet protocol tool.
- **2007:** first insurer to offer pet injury insurance.
- **2008:** first insurer to incorporate usage-based insurance as a rating variable (whereby how an individual consumer drives affects what they pay for insurance).
- **2010:** first insurer to offer an Android app for car insurance.
- **2017:** first insurer to give consumers ability to quote an auto policy on Facebook Messenger.

Progressive has long been at the forefront of tech innovation in the insurance industry. The company's use of data analytics and models to predict consumer behavior and the likelihood of accidents is light years ahead of its peers, making it as much of a "tech" company as it is an insurance company.

PGR's advanced analytics do more than allow it to stay ahead of a changing loss environment and more accurately predict customers' behavior. For example, it is better able to segment its customers into the appropriate pricing categories ("preferred" customers versus higher-risk customers, for example), can better predict price elasticity of demand, and has a better handle on the lifetime value of each of its customer segments.

So what is the one key thing that this advanced technology allows Progressive to do? In our opinion, the single most important benefit is ***the ability to price its products more accurately than its competitors***.

A unique feature of the insurance industry is its unknown cost of goods sold (COGS) … that is, consumers pay for their insurance policy upfront, before the insurer knows if the consumer will have an accident that the insurer will have to pay for.

This means that the insurer must rely on historical data to make predictions about the future… predictions not only about the frequency of accidents, but also about accident severity. These predictions become the insurer's best guess of its COGS, which then of course become a direct input into its pricing. So, the more accurate the "guess" of COGS, the more accurate the pricing.

In insurance, more accurate pricing means more stable pricing. Consumers love stability. What consumers don't like to see is their insurance policy premium exhibiting significant change … "sticker shock" leads to changing to a different insurance company.

With customer retention in the low 90% range, Progressive's retention rates are the highest in the industry (which averages in the mid-80% range).

High retention is an important goal in insurance. The longer a customer stays with the same insurer, the longer the insurer has to “get to know” the real risk of that customer, and is thereby better able to price for the customer’s risk. In short, retained business is more profitable than new business in insurance – and that’s where Progressive’s innovative tech truly shines.

Long-Term Growth Outperformance

Next, we’ll move onto Progressive’s genius for growth…and for growing the *right* way.

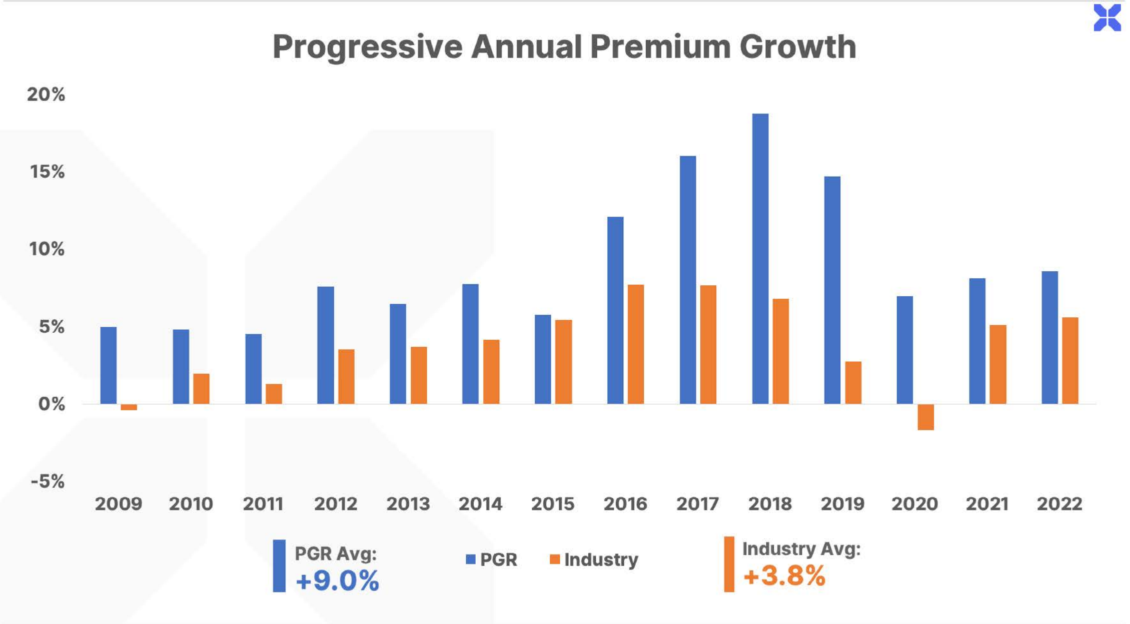
Over the past 14 years, Progressive has grown its personal auto business by a compound annual growth rate (CAGR) of +9.0%, significantly above the industry average of +3.8%. In that time, it has moved from the fourth-largest personal auto insurer, to the second-largest .

Growth in the P&C insurance industry must always be viewed with a critical eye: Did the company grow too fast because it got its COGS wrong, thereby not charging enough premium? Or did it grow too fast because it got its COGS correct but purposely charged too little premium, to gain market share?

Importantly, as we detail later in this report, PGR’s industry-leading growth came hand-in-hand with best-in-class margins, meaning that Progressive did NOT incorrectly estimate its COGS – nor did it estimate them correctly but purposely charge too little in order to grow.

Rather, it estimated its COGS correctly, and then appropriately built those costs into its pricing in order to maintain strong margins – all while it was growing.

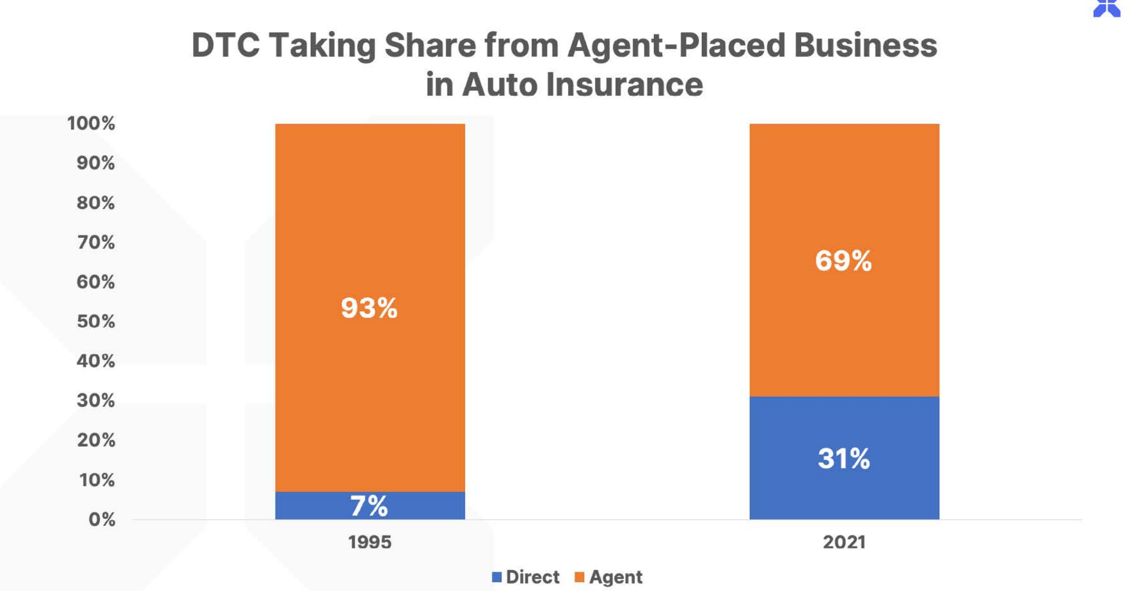
And that means its growth far outstrips the rest of the industry’s, as we see below:



Several factors account for PGR's strong growth:

The right distribution mix, with an emphasis on DTC. Progressive offers its policies through two main channels… direct to consumer (DTC) and via traditional insurance agents. Giving consumers the choice of how to buy their insurance allows Progressive to reach the entire market of insurance shoppers. In contrast, other insurers focus on just one channel.

The DTC channel has seen explosive growth over the past few decades, as consumers have increasingly decided that they don't need help from an agent when buying auto insurance. Of total auto insurance sold in 1970, only 5% was sold DTC. Today, DTC represents nearly 30% of the market, as shown below.



Importantly, growth in the DTC channel has primarily come from just two companies: PGR and Geico (a subsidiary of Warren Buffett's Berkshire Hathaway). No other company has been able to successfully penetrate this fast-growing segment of the market.

Why? The classic "channel conflict" story – where growth in one segment or channel only comes at the expense of another channel. Every other company was built on agency distribution, so trying to start a new channel in DTC would potentially cannibalize existing business from agents, thereby incentivizing agents to place business with a different insurer.

So, it just hasn't been done. The DTC channel is still dominated by Progressive and GEICO. Note from the table below that PGR's 14-year CAGR of +9.0% is the highest in the industry, beating the overall industry growth of +3.8%, and the top-10 excluding PGR and GEICO of +3.4%.

PGR Gains Market Share

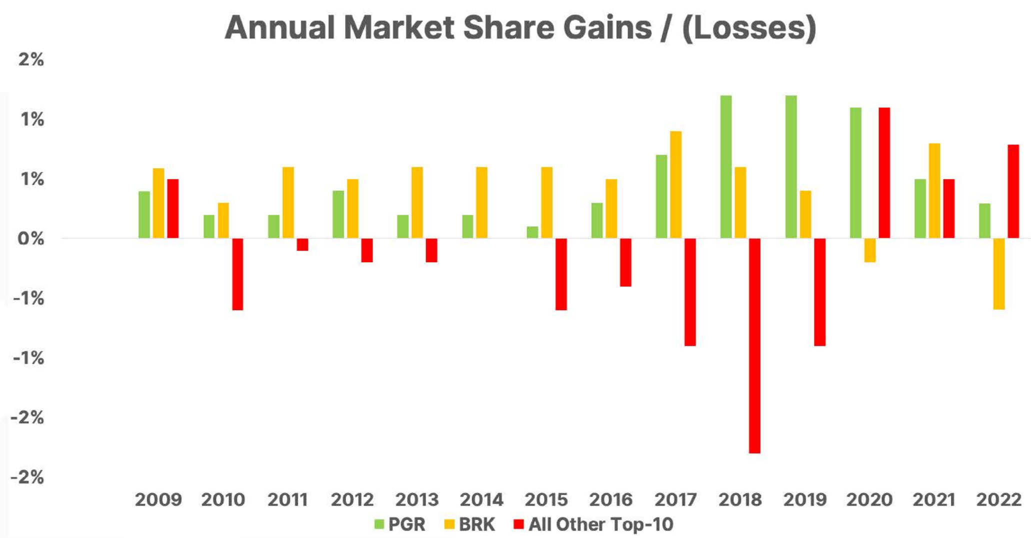
2008 Data

Rank	Company	Premium	Mkt Share
1	State Farm	30,055,729	18.3%
2	Allstate	17,691,133	10.8%
3	GEICO	12,516,814	7.6%
4	Progressive	11,678,759	7.1%
5	Zurich	8,884,495	5.4%
6	Nationwide	7,590,425	4.6%
7	Liberty Mutual	7,230,959	4.4%
8	USSA	6,251,046	3.8%
9	AIG	4,445,702	2.7%
10	American Family	3,440,816	2.1%
	Subtotal	109,785,878	66.8%
	All Other	54,625,357	33.2%
	Industry Total	164411235	100.0%
	'Top 10 ex PGR and Geico	85,590,305	

2022 Data

Rank	Company	Premium	Mkt Share	14 Yr CAGR
1	State Farm	46,660,515	16.9%	3.2%
2	Progressive	38,927,286	14.1%	9.0%
3	GEICO	38,121,466	13.8%	8.3%
4	All State	29,610,810	10.7%	3.7%
5	USSA	16,371,445	5.9%	7.1%
6	Liberty Mutual	13,704,351	5.0%	4.7%
7	Farmers	12,605,723	4.6%	2.5%
8	Travelers	5,836,018	2.1%	
9	American Family	5,834,828	2.1%	3.8%
10	Nationwide	5,505,995	2.0%	-2.3%
	Subtotal	213,178,437	77.2%	4.9%
	All Other	63,003,336	22.8%	1.0%
	Industry Total	276,181,773	100.0%	3.8%
	'Top 10 ex PGR and Geico	136,129,685		3.4%

PGR is the only company that has gained market share every year since 2009, to the detriment of the other players in the top 10 in the personal auto insurance market:



Consistent pricing leads to higher customer retention. We mentioned earlier how PGR's tech superiority allows it to price more accurately for a product whose costs are unknown. Competitors with less sophisticated pricing prowess tend to keep pricing flat for as long as they can, until the cumulative impact of prior years' cost inflation catches them off guard (and their margins have severely eroded), forcing them to abruptly increase prices. The result: customers flee.

Progressive, by contrast, prices accurately each year, and instead of keeping pricing flat for years, it typically takes annual modest increases that allow its margins to remain consistently healthy. Not getting caught off guard like its competitors means it rarely sees severe erosion in margins – thus rarely has the need for those knee-jerk price increases.

As a result, Progressive leads the industry in customer retention, which further fuels consistent long-term overall growth.

Progressive has also grown exponentially thanks to its **entry into new markets...**

For instance, it purchased ASI Corp., a **homeowners** insurance company, in April 2015, allowing it to offer a broader suite of personal lines coverages to complement its auto business. The segment is less than 10% of Progressive's overall business, but is growing rapidly – and importantly, allows it to offer "bundled" products (that is, customers that purchase auto + homeowner insurance together with one insurer), which is the most profitable segment in personal lines.

Lately, PGR has also expanded into more **commercial lines** products. Progressive recently launched a DTC offering, to write commercial auto, workers' compensation, and business property coverages to small businesses. It purchased a transportation and logistics company, expanding its commercial auto business into a broader set of companies. It has expanded its insurance offering to "transportation network companies" (that is, rideshare).

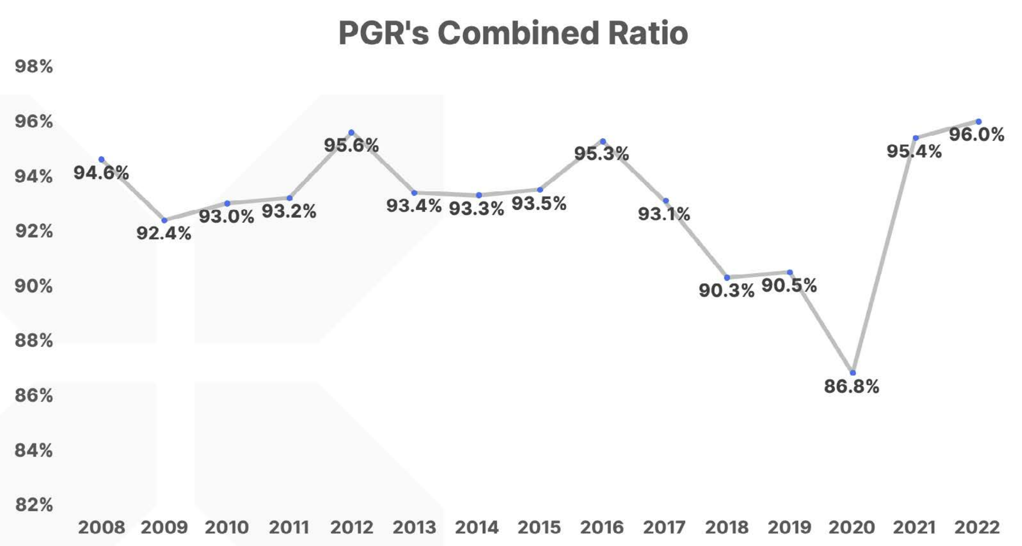
It's clear that Progressive will not rest on its strength in personal auto, and that it is always on the hunt for strategic growth opportunities in areas where it can transfer its current analytical capabilities to other insurance markets.

And finally – in addition to tech innovation and growth outperformance – PGR also brings in a significant amount of cash...

Industry-Beating Margins

Progressive's underwriting margins are the best in the business. Over the past 15 years, its overall combined ratio has averaged 93.1%, significantly better than the industry's average of about 100.0%.

Recall, the "combined ratio" in the insurance industry refers to underwriting profitability, and measures an insurer's total claim costs divided by its premium revenue. A low ratio is better; anything below 100% represents profit, above 100% is a loss, and 100% is exactly breakeven. Using PGR's 15-year average of 93.1%, PGR earned an average underwriting profit margin of 6.9% over those 15 years – significantly better than the industry, whose underwriting margin was essentially 0% over the same time period.



How is PGR able to generate such consistently-better returns? First, as discussed, PGR's analytical capabilities allow it to accurately predict changing loss trends and set accurate prices for its insurance products. This skill set is unmatched in the industry.

Second, PGR has a much lower overall expense ratio than the industry (~20% vs ~28%). Lower expenses are thanks to two elements: first, its DTC distribution means it eliminates commission expenses that are paid to agents, and second, its scale allows it to earn lower rates on repair and replacement parts from the auto parts suppliers from whom it buys the parts needed to fix damaged cars.

We'd be remiss if we didn't mention one other aspect that offers shares of PGR downside protection. Proof of insurance is required in order to drive and maintain a driver's license. This keeps demand for auto insurance steady even in any strong overall economic downturn.

Speaking of economic downturns, on the surface the current inflationary environment may be bad for auto insurers like Progressive.

PGR, though, has proved itself equal to the "inflation challenge" before...

When The Going Gets Tough, The Tough Raise Prices

Auto insurance companies are not immune to inflationary pressures. Higher new and used car prices, more expensive replacement car parts, longer repair times as supply of parts face bottlenecks (thus also requiring longer rental car periods, adding to costs), and even higher wage costs ... have all added significant pressure to auto insurer margins.

In fact, 2022 was one of the worst years for the industry from a profitability perspective, as the industry lost about $0.08 for every dollar of premium collected.

The pressure began as the economy came out of Covid. Driving levels that were significantly subdued during Covid bounced back, and with that return to more crowded highways came the return of more frequent car accidents. But unfortunately for insurers, this also came at a time when costs began to take off, and the auto insurance margin squeeze began.

Auto insurance stocks, including Progressive, initially underperformed. In fact, in 2021, shares of PGR underperformed the S&P 500 by 16 percentage points.

But the good news about this industry, and particularly good news for PGR, is that it can quickly build in higher costs into its pricing. Many auto policies have a six-month term, so at renewal, the insurer can move prices up if needed. And typically, prices can be moved up even within the policy period.

And that is exactly what the industry has done: raised its prices more than 10% since mid-2021, with continued increases into this year.

So while inflationary pressures have continued, the margin pressure has eased as insurers react with higher prices. And while most of the cost pressures have remained into this year, we note how shares of PGR have outperformed... outstripping the broader market (S&P 500) by more than 20 percentage points since mid-2021 when higher pricing began.

Therein lies the beauty of auto insurance: the ability to re-price quickly.

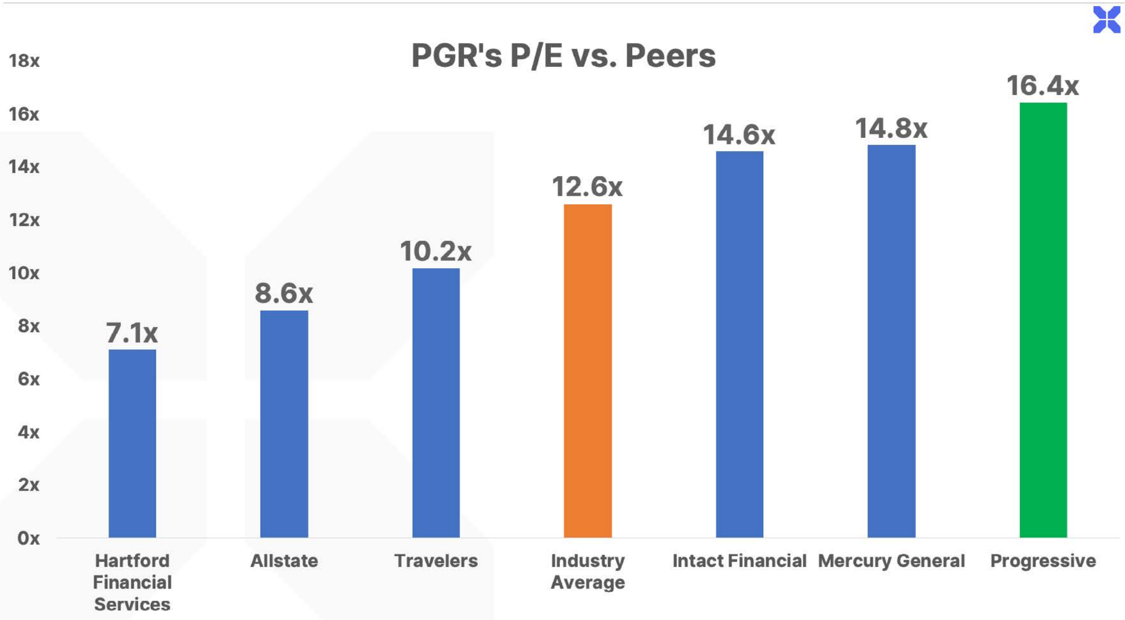
PGR is hands-down the best at seeing higher costs sooner than its competitors, and incorporating those higher costs into its pricing.

Now, a few notes on valuation.

How We Value PGR

Shares of PGR trade at a premium to its peers, which reflects the company's long track record of strong performance. Progressive's history of beating the industry on the metrics that matter, as laid out in this report, have earned it what is, in our opinion, a higher multiple.

In the end, we think the stock's significant outperformance over the long term speaks for itself.



We should note that we think it is more appropriate to value personal lines insurers – including shares of Progressive – on a price-to-earnings (P/E) basis, rather than the price-to-book (P/B) valuation metric we use for primarily commercial insurers.

Why? Personal lines companies have a *short claims payment pattern*, that is, most claims are fairly straightforward and are paid rather quickly (all as compared to commercial lines companies).

Because of this, earnings visibility is much higher for personal lines companies. Thus, Progressive shares are tightly correlated to earnings growth, so getting the trajectory of earnings correct is the key to PGR stock. Hence, the P/E multiple is more reliable as a valuation metric.

Action to Take

Progressive is one of the best-run companies in the property & casualty industry. It is a leader in the three categories that matter the most for success in this industry: technology, scale, and distribution.

In tech, its advanced algorithms give it a better ability to assess risk, forecast an ever-changing loss cost environment, and charge customers accurate pricing that largely avoids large swings..

It also offers its products in multiple channels, and its DTC channel has helped it achieve revenue CAGR well ahead of the industry, propelling it to the 2nd largest auto insurer in the US. In an industry where many risks are similar ("a car is a car is a car"), scale and the law of large numbers matter.

All of this has led to significant and consistent top-line outperformance, as well as industry-leading margins. We expect these to continue.

Auto insurance is mandatory (you must have it in order to legally drive), so the industry is somewhat resilient to significant downturns. But in this industry, Progressive shines, and its long-run stock outperformance sets it apart from all others.

With new technologies always on the horizon (tracking how drivers actually drive; autonomous vehicles), what is often viewed as a sleepy industry is far from it, and as the industry grapples with newer and newer technologies, we're confident that PGR's outperformance will continue well into the future.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**

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