

Direct Line Insurance Group: >10% motor net insurance margins will lift profits

Company:	Direct Line Insurance Group (DLG LN)	Market Cap:	£2.45bn
Industry:	Insurance	Solvency II:	197%
Country:	UK	Revenue:	£3.5bn*
Date:	29 th April 2024	Net Income:	£300mio*
Dividend:	-	Net insurance margin:	>10%
Entry:	£2.5bn	Target:	£3.25bn (+30%)

*estimated based on 6% net insurance margin in motor

Why Direct Line Insurance?

- Motor net insurance margins are back above >10% and will slowly feed through into earnings in 2024
- Strong solvency II ratio of near 200% vs. 140-180% target range
- Very strong and conservative investment portfolio with 1/3 in cash, and expected investment yield of 3.8% in 2024 vs. 3.5% in 2023

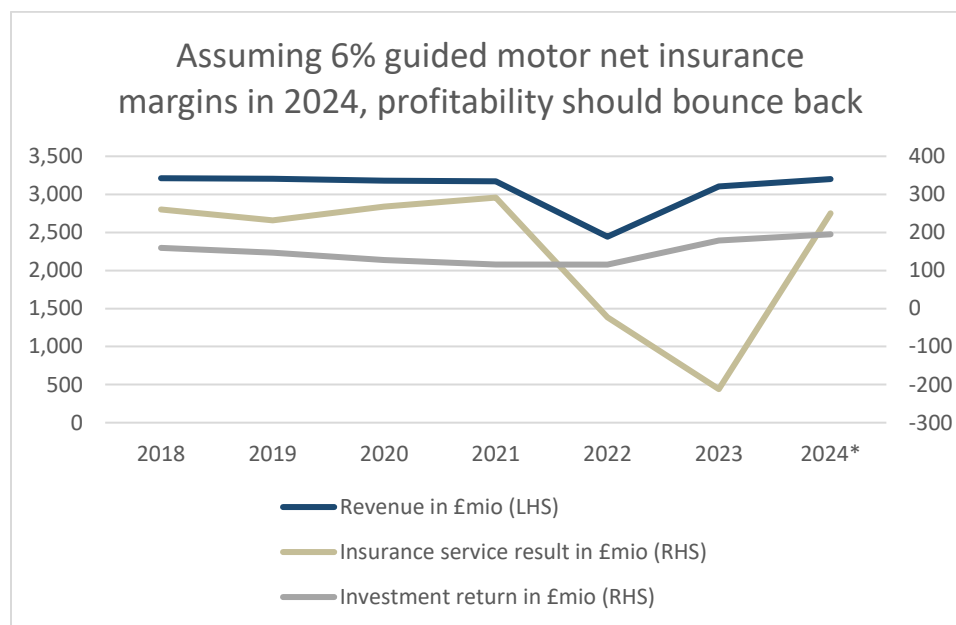
Risks

- Direct Line is one of the last insurers increasing motor pricing, which is leading to lower in-force motor count
- FCA is investigating insurance premium financing practices, which is the APR insurers charge for monthly instead of annual motor insurance payments

This note won't explain Direct Line Insurance Group's business in general, as it was done before, [here](#)

Why Direct Line Insurance Group

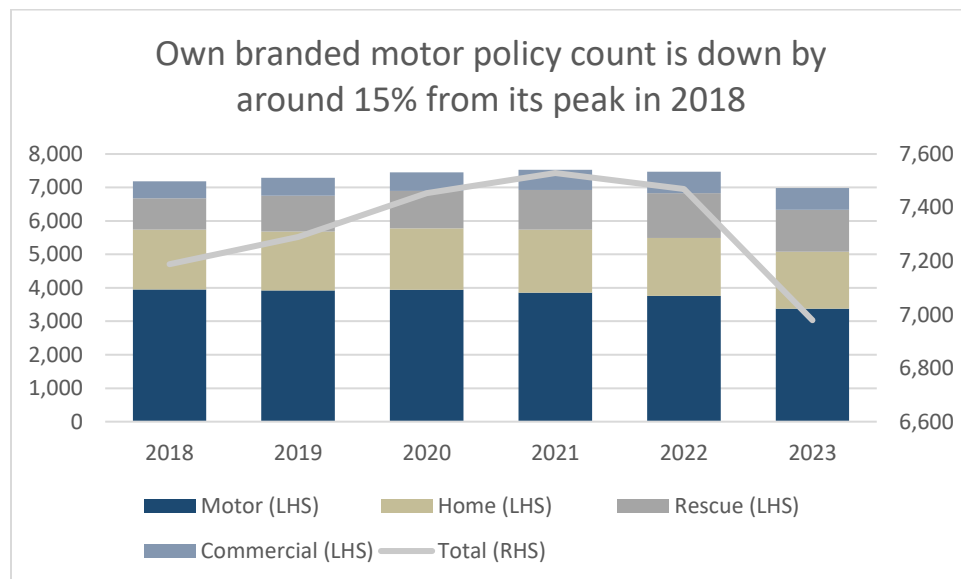
As discussed in the prior note, Direct Line Group (DLG) has begun writing motor insurance at +10% net insurance margins. This, in combination with higher interest rates and resulting higher net investment margins of 3.8% expected for 2024 vs. 3.5% in 2023, should revalue Direct Line Group. The key to understand is that while DLG has written motor net insurance margins of +10% in H2 2023, DLG still made a significant loss in motor of -£160mio in H2 2023, because of losses written in H2 2022 and H1 2023 – And this is where the opportunity lies. This lag in writing profitably over a full year can only really occur when inflation stalls. Given the guidance of 6% motor net insurance margin provided by management for 2024, and considering 3.8% investment returns while keeping home, rescue and commercial stable, the company should bounce back to strong profits.



Source: Direct Line Insurance Group, 2024* = own estimates

Is it all positive?

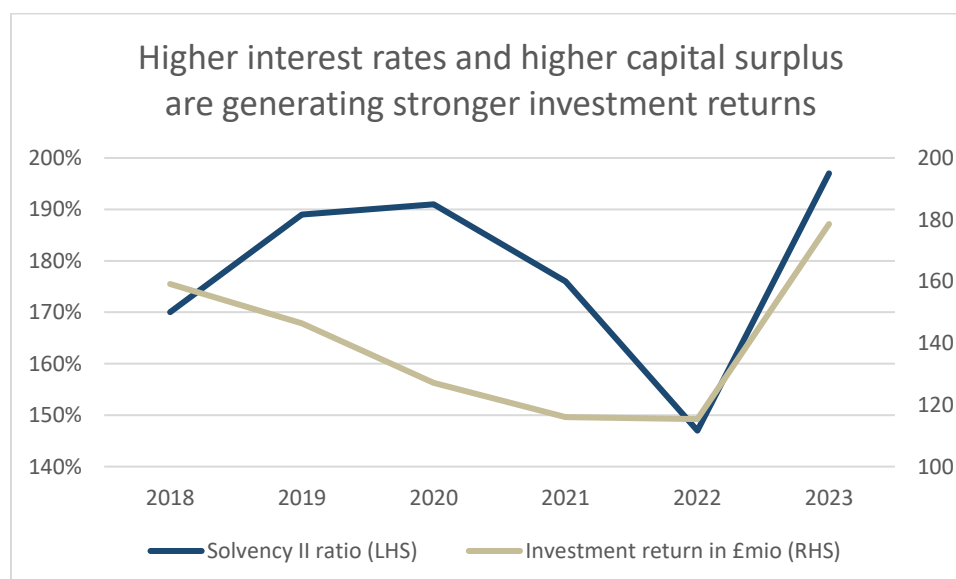
While the macro factors begin to positively align with DLG's business, the fact that DLG was last in raising their motor insurance pricing and not getting a benefit in policy count over the period is negative. As the firm began raising prices in 2023, policy count reduced rapidly, with own branded motor policy down 15% from its peak in 2018 and 10% down compared to 2022. This decline in policy count is expected to continue in 2023, but it won't show in revenues due to the higher pricing. Therefore, despite returning to profitability, it will come at the expense of market share. There might also be concerns regarding their investment portfolio, as there will likely be some kind of debt restructuring going on at Thames Water/Kemble Water and its affiliates. However, DLG's IR explained to me that they are only exposed to Thames Water by around £5mio, and only to its most senior bonds, which currently see a 5-10% write down.



Source: Direct Line Insurance Group

What about the UK regulator, FCA?

The FCA is laser focused on reducing inflation, and motor insurance inflation is in their sight¹. While this is a potential risk, it is more focused on the smaller players that charge upwards of 30% APR for monthly instalments. DLG charges around 20% APR, which is in line with their major competitors. This rate appears fair, given that insurers take credit risk by charging monthly instead of annually. Comparing monthly car insurance APR with that of credit cards, the average credit card APR in the UK amounted to 35% in Q1 2023². At the same time, the Association of British Insurers (ABI) has published new guidelines in respect to monthly instalments this week³, which will bring more transparency on charges and continuous insurance even if a customer is behind on payments. This should keep the FCA happy, while limiting any negative impact on earnings for DLG. Hence, I would not expect any fine and the high solvency II ratio could lead to attractive shareholder returns in H2 2024.



Source: Direct Line Insurance Group

¹ <https://www2.deloitte.com/uk/en/blog/financial-services/2024/the-fcas-spotlight-turns-to-premium-finance.html>

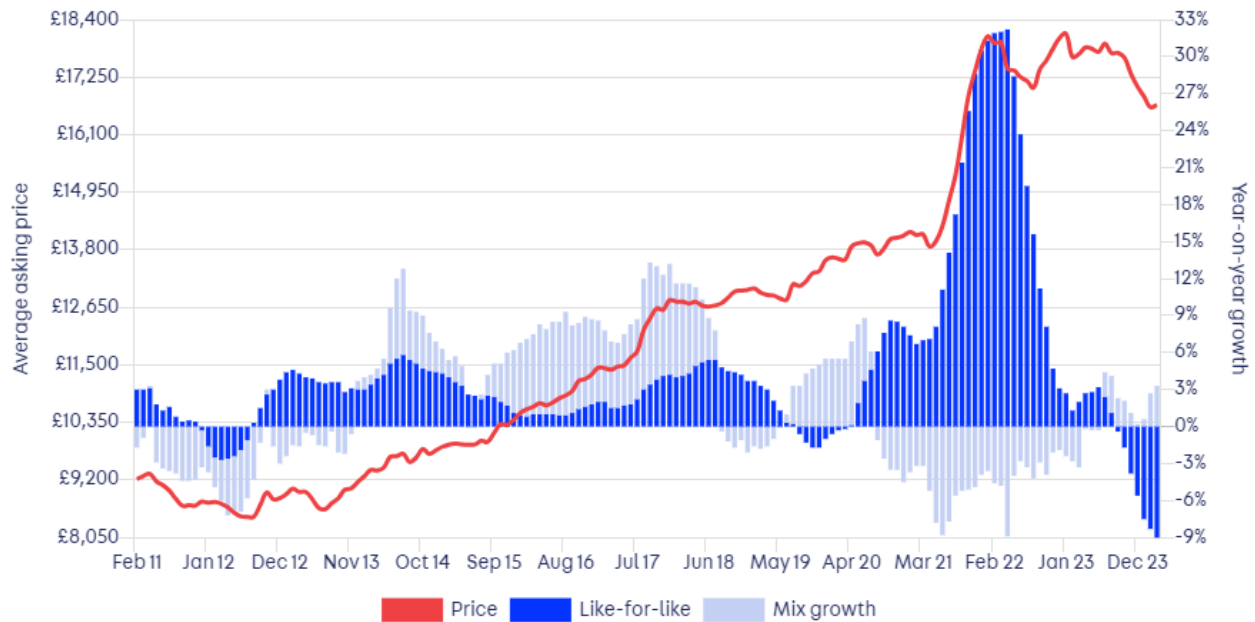
² <https://www.finder.com/uk/credit-cards/average-credit-card-interest-rate-apr-uk#:~:text=Quick%20overview,from%2032.26%25%20to%2034.58%25>.

³ https://www.insurancebusinessmag.com/uk/news/auto-motor/abi-releases-premium-finance-principles-486590.aspx?hsmemberId=12646&tu=1882787d-e869-4954-a225-0deb9dc6a0e1&utm_campaign=&utm_medium=20240425&hsenc=p2ANqtz-9RN5c2oJ1e-dBYPLIMZHA-pA5S3wtoZuEHQcBKoyvDhrsQLx1NseFE3VNrqI1144YW16rO954PRbZLg6-wFj8F98RFKN0Uy7jolPnHJyIBCJ5vfQs&hsmi=304272655&utm_content=1882787d-e869-4954-a225-0deb9dc6a0e1&utm_source=

What motor claims inflation was really about

The high claims inflation is due to three reasons: 1. The shortages of new cars during the pandemic has boosted car prices, including used cars, which in turn made it expensive to refund for accidents, 2. Cars became more and more technologically advanced, which can get very expensive to fix, & 3. Wage inflation has reduced repair profit margins. 1. Is turning around now, as car production has ramped up – to a degree that there is more supply than demand, used car prices began falling in H2 2023. The latest March 2024 new car registrations show a decline in annual private car registrations with fleet being the main growth driver⁴. Ultimately, this could mean that car prices will drop further in the coming months. Another factor is record high vehicle theft. However, auto manufacturers have worked hard in improving vulnerabilities, as 70% of all theft is keyless theft⁵. New technology and software roll-out should reduce vehicle theft going forward.

Autotrader used car prices



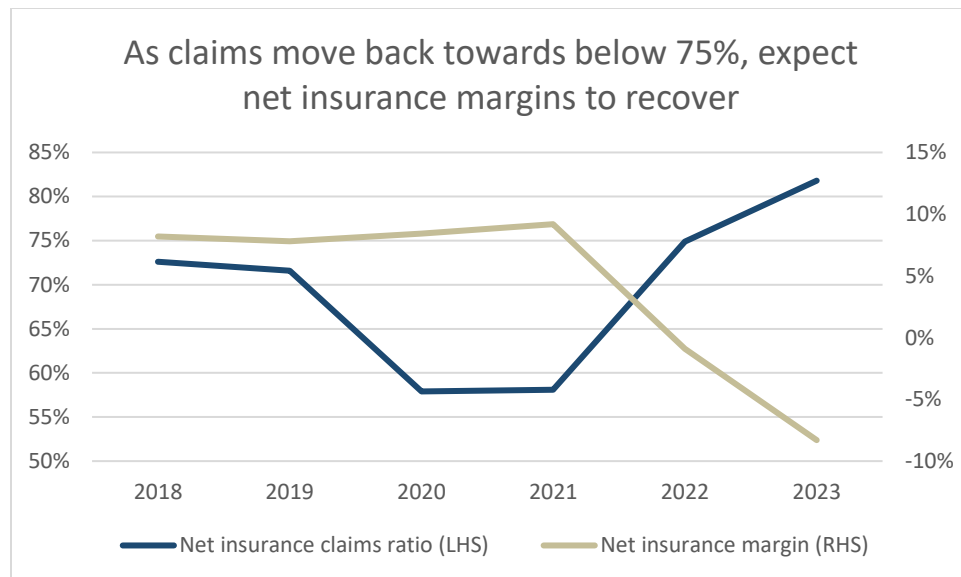
Source: Autotrader

⁴ <https://www.smm.co.uk/vehicle-data/car-registrations/>

⁵ <https://bollardsecurity.co.uk/what-you-need-to-know-about-vehicle-crime-trends-for-2024/>

Conclusion

In conclusion, the higher interest rate environment in combination with record car insurance premiums, while used car prices have begun declining, this sets some very strong tailwinds for DLG and the car insurance sector in general. While DLG is late in raising prices and as a result is losing policy count, top line revenue should remain unaffected, and with profitability back in focus, the current valuation appears attractive, especially as claims are expected to normalize again.



Source: Direct Line Insurance Group



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