MOI GLOBAL

Best Ideas 2020 Preview: Progressive Corporation

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Progressive is the third-largest auto insurance company in the US, behind State Farm and GEICO (part of our very own Berkshire Hathaway). It is an old saw that insurance is sold, not bought, and most insurance companies work with an army of independent agents who go out and find customers. The agents receive a commission (typically 12–15%) for each customer they bring in and continue to clip renewal commissions (typically 5%) for each year a customer stays with a carrier. From the insurance company's perspective, it's a low-risk way to grow a business; the company only pays for the customers who actually sign up. But it's an expensive and unwieldy tool for a sticky product like auto insurance, where customers often remain with a carrier for six to eight years. The direct companies—largely GEICO, Progressive, and USAA—pay for their own sales efforts, which requires a greater upfront investment, but then allows them to keep more of the lifetime value of the customer relationship. The direct companies have steadily, if slowly, taken share from the companies that use agents.

From a financial perspective, it is helpful to think about Progressive as two different companies: an insurance company that writes policies and pays claims and an investment company that handles the money put up by the policyholders.

On the insurance side, we expect Progressive to write about $35 billion worth of insurance next year. Roughly $25 billion will go back out the door in claims, and about $7.5 billion will go toward overhead and marketing, including almost $1 billion to bombard TV viewers with "Flo." That leaves $2.5 billion in underwriting profit, which, adjusted for taxes and the 585 million shares outstanding, is about $3 per share net.

On the investment side, Progressive's $35 billion portfolio is split between roughly $27 billion of debt and $8 billion of equity. The conservative bond portfolio should yield at least 3.5% for $950 million, and we'd expect its equity portfolio to earn at least 6% for another $480 million. All told, we expect the investment portfolio to yield about $2 per share after taxes over the medium term. However, it is important to note that accounting rules can introduce tremendous volatility in reported results: e.g., a rise in interest rates is reflected as a sudden loss in the investment portfolio, even though the company benefits from investing new funds at higher rates.

As a combined entity, we are looking for Progressive to generate slightly less than $5 per share in earnings this year. Progressive has consistently generated double-digit policy, revenue, and earnings growth, and while the top line may slow over time, we note that a slowdown in newer, more expensively acquired customers would increase profitability and earnings.