Definity Financial Corporation

Third Quarter 2022 Financial Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Definity Financial Corporation Third Quarter 2022 Financial Results Conference Call. At this time, all lines are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. If at any time during this call you require immediate assistance, please press star zero for the operator. This call is being recorded today, Friday, November 11, 2022.

I would now like to turn the conference over to Dennis Westfall, Head of Investor Relations. Please go ahead, sir.

Dennis Westfall — Investor Relations, Definity Financial Corporation

Thanks, Michelle, and good morning, everyone. Thank you for joining us on the call today. A link to our live webcast and background information for the call is posted on our website at definity.com under the Investors tab. As a reminder, the slide presentation contains a disclaimer of forward-looking statements which also applies to our discussion on the conference call.

Joining me on the call today are Rowan Saunders, President and CEO; Philip Mather, EVP and CFO; Paul MacDonald, EVP of Personal Insurance and Digital Channels; and Fabian Richenberger, EVP of Commercial Insurance and Insurance Operations. We will start with formal remarks from Rowan and Phil, followed by a Q&A session. Paul and Fabi will be available to answer your questions during the Q&A as well.

With that, I will ask Rowan to begin his remarks.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Thanks, Dennis, and good morning.

Before I begin, I'd like to acknowledge that today is Remembrance Day, a day when we take time to honour our fallen heroes, veterans, and members of the Canadian Armed Forces who have served and continue to serve at home and around the world in times of war, conflict, and peace. We will end today's call by 11:00 a.m. in time for everyone to observe their moment of thoughts.

Hurricane Fiona is one of the most recent examples of members of the Canadian Armed Forces being there for Canadians when they need it the most and one that Definity has been quite close to. We continue to work with those impacted by Fiona's devastation and are committed to delivering on our purpose to help our clients and communities adapt and thrive, which brings us to the purpose of today's call. Last night we reported results for the third quarter of 2022.

Operating net income for the quarter of $46.5 million or $0.40 per share benefitted from solid underwriting results and a 46% increase in net investment income compared to the third quarter of last year. Our combined ratio of 96.6% was delivered against a backdrop of normalizing auto claims frequency, ongoing industry-wide inflation pressures, and somewhat elevated losses from catastrophes. As expected, results in personal auto and commercial insurance normalized from last year's unusually strong performances. Claims frequency moved off pandemic-related lows and inflation impacted claims severity in auto, while commercial insurance's strong low 90s performance was in line with our expectations.

We reported a 10.9% increase in premiums in the third quarter while maintaining our disciplined approach amid firm market conditions. Our ongoing strategic expansion efforts in recent years are clearly bearing fruit as we reached two significant written premium milestones this quarter. On a trailing 12-month basis, our Commercial Insurance business now exceeds $1 billion and our company-wide premiums exceed $3.5 billion. We continue to believe we have built a business to deliver growth consistently above that of the industry. Operating results benefitted from a larger than expected increase in net investment income, reflective of our larger portfolio size but also the significant increase in fixed income yields. Our operating ROE remained robust at 9.7% over the past 12 months.

From a balance sheet perspective, our operating results were offset by investment losses from fixed income yields moving higher and equity market declines in the quarter, leading to a muted quarter-over-quarter increase in book value per share. We continue to hold a significant amount of excess capital in addition to untapped leverage capacity, resulting in financial capacity of close to $900 million as an ICA company at quarter end, before the impact of our early October acquisition of McDougall Insurance. We believe we are in a great position to continue funding our strategic growth initiatives for the coming years.

Turning to the industry outlook on slide six, we expect market conditions to remain conducive to solid industry results. We expect firm market conditions and property lines will persist over the next 12 months and we are seeing evidence in the form of rising industry rates that conditions in auto lines have begun to firm. We expect the combination of normalizing auto claims frequency and higher severity related to inflation to bring the industry's return on equity closer to its long run average.

Slide seven illustrates our key financial metrics. You can see that our year-to-date growth and combined ratios are in line with or better than our targets, as is our operating ROE. We continue to put the tools in place to enable future balance sheet optimization, which should result in a capital structure more in line with our publicly listed peers over time, enabling us to target an operating ROE in the low teens. We will be refreshing our financial targets in the year-end reporting cycle, as we finalize the estimated impact of IFRS 17 on our transition balance sheet and as part of our business planning.

Moving to slide eight, our performance remains robust and positions us well to execute on our strategy in the current environment. To reach our goals, we intend to continue diversifying and strengthening our company through acquisitions and partnerships to become one of the five largest P&C insurers in Canada, maintain our digital leadership position, consistently deliver disciplined financial management, and position Definity as a purpose-driven sustainability leader.

Going down into our acquisition strategy on slide nine, I remind you that this includes both insurance carriers and distribution partnerships. These partnerships are a key component of our strategy and offers diversification benefits as a complementary source of income. We announced in early October that we had increased our ownership in McDougall Insurance from around 25% to 75% for cash consideration of $217 million. We have been equity partners with McDougall for over five years and are excited to now expand that partnership and build on their impressive track record of success. Ross and his team have built a high-performing broker with strong EBITDA margins and one that has proven it can scale profitably. We're excited to help in this regard and believe, together, we can accelerate the growth plans and further their ambitions to double their annual premium base to $1 billion. Combining

McDougall’s operating income with our other broker investments, we expect to generate operating income before taxes and non-controlling interests in excess of $40 million annually.

And with that, I’ll turn the call over to our CFO, Phil Mather.

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Thanks, Rowan.

I’ll begin on slide 11 with our largest business line, personal auto. Strong retention in our broker business, higher average written premiums, and the growth in Sonnet combined to generate a 7.7% increase in premiums this quarter. While we did experience a lower growth rate in Sonnet due to current market conditions, including higher customer acquisition costs and lower levels of shopping, our affinity strategy continues to perform well and constitutes a higher proportion of our new business. We maintained our disciplined approach and are focused on driving profitable growth by leveraging our digital assets and deep-rooted broker relationships. Our combined ratio of 95.9% in the quarter was 4.6 points higher than the unusually strong results from a year ago. As expected, we experienced an increase in the core accident year claims ratio, driven by higher claims frequency, although still below pre-pandemic levels, combined with inflationary cost pressures. Severity was largely unchanged from the second quarter, but up from the prior year, driven by total losses, vehicle repairs, car rental costs, and car theft. We experienced favourable prior year claims development of 3.2%, in line with Q3 of last year, reflective of our prudent approach in establishing our claims reserves. We expect our personal auto combined ratio to trend into the higher end of our mid to upper 90s target range in the near term as inflationary pressures persist and claims frequencies continue to normalize ahead of our rates fully earning into results. These trends have combined to result in market rates moving higher in recent months in numerous jurisdictions.

Turning to personal property on slide 12, we reported top-line growth of 10.5% for the quarter, inclusive of our ongoing efforts to improve underwriting results. We expect a continuation of the firm pricing conditions prevalent in the industry in recent years, the organic growth potential of our digital platforms, and strong broker relationships to help maintain our growth above that of the industry. Focusing on the bottom line, the combined ratio of 100.8% was up slightly from a year ago, as the increase in the core accident year claims ratio from an unusually strong third quarter of 2021 offset a decline in cat losses. The impact of Hurricane Fiona drove catastrophes to 10.9 points in the quarter, though that was 4.6 points lower than the active cat season last year. As a reminder, we expect roughly 70% of annual cat losses to occur between Q2 and Q3. We continue to target a mid-90s combined ratio for the personal property line of business on an annual basis.

Moving on to slide 13, you'll see that our momentum in our commercial business continued, with premium growth of 16.7% in the third quarter. This growth rate benefitted from strong broker support, higher retention, rate achievement in a firm market environment, and the continued scaling of our specialty capabilities. While we expect growth to ultimately slow from the pace of recent quarters, we believe that we can sustain growth in the low- to mid-teens for the next several quarters as we continue to scale. The commercial lines combined ratio for the quarter was a solid 93.6%, but was up from the unusually strong 86.4% in the same quarter last year. The increase was largely driven by higher cat losses, which accounted for 9.1 points in the quarter versus only 0.8 points in Q3 of last year. This was somewhat offset by 3.8 points of favourable prior year development, again reflective of our prudent approach to reserving across our business. While inflationary pressures continue and the offsetting COVID frequency benefit normalizes, our rate actions have enabled us to protect our margins. We continue to expect the commercial insurance business to deliver combined ratios in the low 90s. As Rowan mentioned, at over $1 billion in premiums written in the past 12 months, we're delighted to see our strategy to grow our commercial business continue to pay off. This high-performing business now comprises almost 30% of our overall premiums.

Putting this all together on slide 14, consolidated premiums reached $944 million in the quarter, representing growth of 10.9%, while underwriting profitability at a consolidated level remained solid, despite slightly elevated catastrophe losses. The combination of underwriting and increasing net investment income enabled us to generate operating net income of $46.5 million or $0.40 per share in the quarter with operating ROE of 9.7% over the past 12 months.

Slide 15 shows our investment portfolio in greater detail. Our net investment income again increased significantly in the quarter, up $11.4 million from Q3 of 2021 driven by higher interest income from the combination of higher book yields and overall growth in the fixed income portfolio. We expect growth to continue at close to its year-to-date pace into Q4, resulting in full year net investment income of approximately $130 million.

As you can see on slide 16, our financial position remained strong, despite a volatile year for capital markets. We remain well capitalized under our current legal structure and, subject to the continuance of Definity under the CBCA, have added an additional $450 million in leverage capacity to reach over $1.3 billion in financial capacity. We remain well positioned to move to a CBCA company once the federal government finalizes its work, although we have no further updates for you at this time. Capital markets volatility tempered growth in our book value per share, which at $19.54 was up slightly from a year ago. It's clear that the conservative positioning of our portfolio helped to mitigate the market impact.

Slide 17 shows recent capital management actions and longer-term priorities. When it comes to deploying our capital, the primary focus is in support of our robust organic growth strategy by making investments in our core business, which supports our financial targets and market position. We've also been clear that we believe we can build the company into a top-five player in the industry. This would require inorganic growth, which could include both insurance carriers and distributors, as Rowan walked you through. In early October we not only announced the acquisition of McDougall, but also closed on the second broker transaction, as disclosed in our financial statements. Together, the financial outlay for these opportunities totalled nearly $230 million. I believe these are tangible examples of our ability to deploy our excess capital in an immediately accretive manner. We also intend to have a sustainable and growing dividend per common share. On this we are pleased to announce that our Board of Directors declared a dividend of $0.125 per share payable at the end of December. As for our NCIB, we've not been activeto date, and I'll remind you that we currently see buybacks at the bottom of our priority list for capital deployment actions. We believe we are well positioned to continue delivering value to shareholders as we grow profitably and deploy our capital in a manner that enhances earnings while maintaining significant capacity for future opportunities.

With that, I'll turn the call back over to Rowan for some final thoughts.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Thank you, Phil.

In summary, I believe the company has done a great job of navigating the volatile environment over the past few years, successfully emerging as a strong Canadian public company. Our prudent approach during these uncertain times has served us well. I'm also proud of some recent progress on our strategic priorities. A key focus area for us is to ensure that we maintain our pace of innovation. We announced in September that we were the first Canadian P&C insurer to transition our core insurance platform to Guidewire Cloud. This better positions us to continue to scale our business, enhance the quality of service to broker partners and customers, and continue to innovate with agility. Attracting and retaining top talent and delivering on our inclusion, diversity, equity, and accessibility targets are two other focus areas of our strategy. I'm thrilled that Definity was named among the best workplaces in financial services and insurance and, more recently, among the best workplaces for inclusion. Every employee helps shape our culture and workplace experience, so I thank them all for living Definity's values and helping to make a difference every day.

And with that, I'm going to ask Dennis to start the Q&A session.

Dennis Westfall — Investor Relations, Definity Financial Corporation

Thanks, Rowan. Michelle, we are now ready to take questions.

Q & A

Operator

Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. If you would like to ask a question, please press star followed by the number one on your telephone keypad. If your question has been answered and you would like to withdraw it, please press star followed by the number two. If you are using a speakerphone, please lift your handset before pressing any keys. One moment please for your first question.

Your first question will come from Tom MacKinnon of BMO Capital Markets. Please go ahead.

Tom MacKinnon — Analyst, BMO Capital Markets

Thanks and good morning. Just two questions here, the first one with respect to Sonnet. You noted the growth seems to be slowing here a little bit and it’s due to lower levels of shopping. Given the slower growth, are you still kind of on track for Sonnet to have a combined ratio under 100% by the end of 2023? I mean isn’t the story with respect to Sonnet really just one of building up scale or are there other means to improve that profitability with respect to Sonnet other than just by being able to have substantially high growth in gross premiums written for Sonnet?

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Thanks, Tom. Let me take that. Look, I think, as we have kind of signalled, Sonnet has slowed a little bit in its growth and, as you correctly point out, I mean this is really about us adapting to the market. What we’re seeing is a number of things. And so firstly, there is less shopping in the market and I think that’s driven by a couple of items. One would be, if you look at the inventory of new cars and you look at new car sales, there’s just less demand, and so that has an impact. And then I think that, as we’ve signalled, the market will start reflecting better pricing changes with some of the inflationary trends that are out there. That's really just started and it's still fairly benign or low-rate environment. So there isn't as much shopping that we've seen. So, one of the implications of that is that there's more people chasing fewer customers in the marketplace and that does drive up the cost of acquisition to chase fewer customers. And we're not seeing as many high-quality customers in the marketplace. So being a bit disciplined on that makes sense.

I think the other area for us is that getting Sonnet to profitability is not just purely about the expense ratio. It is about the quality of the portfolio, allowing it to mature, as well as the mathematics of scaling up on the expense ratio, and so those are the two items. And with that area, we are seeing inflation and frequency normalizing. That does mean that, in our Sonnet portfolio, we are also focusing on putting price changes through and segmentation, underwriting changes, all of which addresses both of those things too. So I think when you step back it's actually, in our perspective, reasonable to be disciplined through this phase of the insurance cycle and that's why we're comfortable with Sonnet slowing a bit.

There's also another element of that. That policy count keeps growing, but as we focus more on the affinity market, which is now over 20% of our total business, it's a higher-quality segment, it has better risk characteristics and retention, but it does come with a lower average premium. And so that also puts a little bit of a slower impact on this growth. So that's kind of what's happening and we're doing that.

I think the other part that we feel is that there's a natural hedge in a multichannel strategy. So, as there's less shopping, and that means less flow for Sonnet, we're getting a benefit on the broker side. And so in our intermediated business we're seeing retention at higher and elevated levels. And so it's a natural hedge for us. I think if you go forward and say, well, what does this environment look like going forward? Firstly, Sonnet is still a decent growth rate at around 10%. It's just not at the high teens that we've had in more recent quarters. If this environment stays stable, then Sonnet will be more like a 10% growth in the near term than the higher teens, but we get the benefit on the broker business for that. As we are actually expecting more price changes in the marketplace, we do expect that there will be more consumer shopping and then this will be more of a near-term issue.

With respect to your comment about the path to profitability, we're still very focused on that. And it is both. It's about maturing the portfolio, getting the loss ratio coming down, but also the mathematics of the scale. And so clearly, just the mathematics of growing at more like a 10%-ish than a high-teens percent is likely going to push out by a couple of quarters that path to our breakeven target. So we'll really have to see on how the market evolves over the next few quarters. But our current expectation is that, at least for a few quarters, the Sonnet growth rate will be a little bit slower and, quite frankly, that's just our discipline, we're putting into the business at this stage of the cycle. We've done such a great job of building it and getting the technology to work and now broadening the path, we don't want to pollute the business at the wrong stage of the cycle. So we're comfortable with what that is. And as I said, if you look at the overall auto performance, we still grew about 8% in the quarter, and that's because we get the benefits of multichannel.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. So the takeaway there is could be pushed out in terms of the breakeven on Sonnet, but you're getting that natural hedge in terms of better retention in the broker business, so maybe, net-net, not net-net neutral. Is that a good way of summarizing what you said there?

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Yeah, yeah. Thanks for being articulate about that, Tom. That's exactly right. And so I think that we were expecting that could very easily go out a couple of quarters, but there's a natural hedge, and in no way does this impact any of our macro targets that we've communicated to the marketplace. So you have it right.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. That's great. And then the follow up is just on the tax rate. It was 24% in 2020. In 2021 it's been lower of rate. I'm talking about the operating tax rate. How should we be looking at that operating tax rate going forward?

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Hi, Tom. It's Phil. Thanks for that question. We did see the tax rate come down a little bit this year. I'd point to some one-time items that are in there in the other components. So, from an operating perspective, we'd say that a few points below the statutory rate is a better range for go-forward expectations, so somewhere in that low to mid-20s range is a longer-term pick.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. So that sounds like you're talking, low to mid-20s kind of sound like 22 to 23 as opposed to the 24 that you were running at in 2020 and 2021.

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Yeah. The way I'd look at it is, if you look at the statutory rate, we'd normally get a few points benefit from the dividend income. It can move up and down on the quarter just the proportional mix between that Canadian dividend impact and the underwriting performance in the quarter, but around that range is around the right level.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. Thank you.

Operator

Your next question comes from Geoff Kwan of RBC Capital Markets. Please go ahead.

Geoff Kwan — Analyst, RBC Capital Markets

Hi. Good morning. Just wanted to also follow up on Sonnet. With respect to the growth in the affinity side, kind of what's that percentage of gross written premiums coming from that segment, what was it may be like a year ago, and do you have a goal of what you want that in terms of the business mix going forward?

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Hi there, Geoff. So, what we have been doing is broadening out, really over the last year and a bit, on affinity. So that was really kind of a new extension of the strategy. So if you go back 18 months, it was very little affinity in the total portfolio. If you look at the combined portfolio at the end of Q3, we're now into the low 20s of the total portfolio is what we defined as affinity and, as a percentage of the new business, it's in or around the 40% kind of range. And so you clearly see us focusing on that segment and it's going remarkably well. We like it for a number of reasons, better quality customer, better retention, longer lifetime value, et cetera. So we're going to keep working on that.

I think it's difficult to know exactly what that trend what the ultimate target would look like, but I think it's fair to say that we would like it to be in excess of a third of the target state. And really that depends on a number of things, partly how successful we continue to be gaining affinity, but also what's the end goal of the size of Sonnet and how much other retail business is in there. So I think what we found at this stage of the cycle, that's a very good segment for us to be in. We're really a disruptive player there. We've found a lot of interest. And so it's very likely that, for the foreseeable future, that's going to occupy a significant proportion of our new business, so that should move us too. If you think about, let's say, the near term, a couple of years, thinking about that as exceeding a third of our premium seems very likely.

Geoff Kwan — Analyst, RBC Capital Markets

Okay. And just my second question was just on broker distribution M&A. It seems like, in many industries in general, deal flow is kind of lower, just disconnect between what sellers want and what buyers are willing to pay, but it does seem like it's still relatively active in the P&C broker distribution market. So I'm just wondering, has it been transaction multiples that have come down or have buyers just been willing to pay at or close to what the sellers are looking for because of competition and maybe they can still generate some sufficient level of deal accretion?

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Yeah, look, I think that, you know, and I've been in this space for a long time, decades, and I do think that it's fair to say that the valuations and the multiples that you see in distribution are certainly elevated to what they used to be. I think that there is a significant pipeline of opportunities for brokers looking to either partner with somebody else or potentially exit. And I think what you're seeing is the size really matters. And when you think about our recent opportunity where we made a big investment in McDougall, those type of businesses, when they have the scale, really have a lot of synergies available to them. So I think, to your question, multiples are elevated, but there is still good returns for buyers in the marketplace, particularly if you really can bring revenue and cost synergies to be acquired by targets. And so I think that's what's happening. There is kind of a meeting of the minds and I think that there's a significant amount of activity, quite frankly, that we expect to happen. If you go back for the last three or four years, it's really been quite active, and we don't see anything that's really going to change that trajectory in the next couple of years.

Geoff Kwan — Analyst, RBC Capital Markets

Okay. That's helpful. Thank you.

Operator

Your next question comes from Doug Young of Desjardins Capital Markets.

Doug Young — Analyst, Desjardins Capital Markets

Thank you and good morning. Maybe Phil, can you talk a bit about your expectations on prior year reserve developments? They were definitely higher than we were expecting, running closer to 3% of earned premium, and I guess my question is, and I do get that it's definitely more advantageous and we'd rather see this than the other way around, but my question really is around sustainability. And I think you've talked historically, you can correct me if I'm wrong, historical levels of 1% to 2% of earned premium. Is that what we should be anticipating this to go back to or is this likely, giving your prudence, to remain elevated over the near term?

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Thanks, Doug, and I agree with you. We prefer to see it favourable than adverse as well, you know, in terms of the way we manage the overall reserving. So if I just step back a bit, I think what you're seeing is the consistency of that behaviour, particularly as we've gone through the period of the pandemic, making sure that we maintaining the prudent kind of philosophy and approach to how we've set our reserves. So the favourable development you've seen running off is really, for me, an evidentiary point of that practice. And that practice continues as we look forward in terms of how we look at the macro environment and particularly some of the trends from an inflationary cost perspective. 3% year to date is a little high opposite our longer-term kind of 1% to 2% range. I think over the medium to longer term 1% to 2% holds. That's what we'd expect to see. In terms of the nearer term, we're monitoring what's happening with that kind of macro risk environment. We've seen that our reserves are holding up well and we're continuing to see that defend the balance sheet. But over the longer term I don't see any reason why we will continue to see that 1% to 2% range. How it emerges over the next period we'll really just have to monitor opposite the kind of inflationary trends and if there's any late emergence, but right now I think we feel pretty comfortable overall.

At 3%, it's only marginally outside of the normal range and I think for auto it's actually pretty close. That's where most of our prior year development has historically come from. But you are seeing a little bit more emerge out of the property and commercial lines. And again, that's really just reflective of that approach we've taken throughout the pandemic. So overall I'd say very confident in balance sheet. What you're seeing released now is very reflective of that proven strategy and that 1% to 2% range still holds in our view over the medium to longer term.

Doug Young — Analyst, Desjardins Capital Markets

So if I could just kind of paraphrase, it looks like 1% to 2% long term but you could be at the top end or a little bit above that over the near term based upon what you're seeing and feeling right now. Is that a fair statement?

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Yeah, we'll see how things emerge. The macro risk environment remains elevated, but we're pretty comfortable with our overall position.

Doug Young — Analyst, Desjardins Capital Markets

Okay. Just second on commercial. Obviously, good top-line growth. That's been an area of focus since demutualization and even before that. Can you talk a bit about where you're seeing the growth coming from? Is it the small case? The mid case? The specialty lines? You were quite clear we need to demutualized the focus into each of those particular segments. I'd be curious to get more of a sense of where that growth is coming from. Or is it equally across all of it?

Fabian Richenberger — Executive Vice-President, Commercial Insurance & Insurance Operations, Definity Financial Corporation

Thank you, Doug, for your question. This is Fabian Richenberger answering the question. So, overall, we are really pleased with the support that we're getting from our broker partners. We have a market-leading value proposition in terms of our product range and service standards and we are very pleased to see that the investments that we made into small business and specialties are creating desired traction. So, these two are the segments that would have been growing over 20% year over year in small business and in specialties as well.

And then the other point to share with you is that we've been benefitting from our relationship with Uber. Uber is normalizing to pre-pandemic premium volumes and Uber has been adding a couple of points of growth overall. But, as I mentioned, even if we exclude Uber from our growth rates, we are growing the core business in that low double-digit range, which is very much in line with our guidance. And as I mentioned to you, based on the value proposition that we have, based on the service standards that we have, we are quite confident that we will be able to continue to grow commercial insurance in that low double-digit range going forward.

Doug Young — Analyst, Desjardins Capital Markets

Thank you.

Operator

Your next question comes from Jaeme Gloyn at National Bank. Please go ahead.

Jaeme Gloyn — Analyst, National Bank Financial

Yeah, thanks. I just wanted to dig on personal lines growth and seeing a little bit of deceleration across both auto and property on a policy in force unit growth basis as well as overall. Is it the same trends you're seeing in Sonnet that are driving some of that deceleration? How are you thinking that's going to progress over the next couple of quarters? And if you're comparing it to Sonnet, would you look at unit growth, so policies in force, being slower or faster than Sonnet in the broker channel?

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

I'll let Paul give you his insights into that, but I think one of the just overarching comments that I would make is that, when you think about the shopping environment, and that's back to the hedge, so on the one hand it's tougher for Sonnet, which needs more new business to scale, but we get the benefit in the broker side of things.

On the personal property side, I think the other thing that we are doing is looking to optimize margin in that area, because when we sit back and you look over the last couple of years, we do know that the personal auto contribution will have some margin compression. I mean that's pretty obvious given the normalization coming out of the pandemic. And so therefore it's important for our teams to get more margin out of other parts of the business. You've seen that being delivered in the commercial business and we're working on the personal property business. So, in a way, there's a little bit of slow, slower, but still very healthy growth in personal property that is completely by design as we're taking more rate and tightening underwriting appetite in that area.

But Paul, do you want to handle the rest of the question?

Paul MacDonald — Executive Vice-President, Personal Insurance & Digital Channels, Definity Financial Corporation

Absolutely. Thank you. And you may recall me previously saying that last year, due to the low rate environment, the majority of our growth in both auto and property was coming from unit growth. And I have called out in each quarter of this year that we are looking to right size that by proportionately growing the premium component of it, which has benefits in loss ratio, and we have successfully done that. So, to give you some data points, on the auto side last quarter, about 54% of our growth was premium-related and only 46% was unit. That's now moved up to 60/40, so 60% in favour of unit growth. And that reflects the unwinding of our COVID relief measures and it reflects rates starting to flow through the portfolio and our higher retention component. So that's up quite favourable.

On the property side, last quarter we were about 50/50 between premium and unit growth and that moved up to about two-thirds premium and one-third unit. This has been very deliberate. As Rowan said, we are looking to optimize our property portfolio to help mitigate some of the effects of the inflationary impacts on the automobile side, but we've also been able to keep pace with the rate environment, the hardening rate environment in Canada. And so we have previously increased the indexation rate to 5%. Now we've got to 7%. We've got 7% to 8% of premium flowing through the portfolio on the property side. And we continue to have faith that we can more than cover any inflationary trends that we're seeing on the property side.

So, our overall auto premium growth is almost 8%. We're very pleased with that given the context of the current environment. Yes, the broker side had slightly less new business, also impacted, as is Sonnet, by less new business circulating in the marketplace, but of course it has a much larger retained portfolio. And so that impact is quite muted on the broker portfolio and we gain the benefit of the retention. On the property side we have healthy double-digit 10.6% growth and, again, that's a reflection of the rate environment and of our underwriting actions. So we are quite pleased. We think this is a good outcome and we intend to keep managing the portfolio in this manner to make sure that the results come in as expected.

Jaeme Gloyn — Analyst, National Bank Financial

Okay, great. And just so I'm clear, are you able to disclose what kind of rate increases you are pushing through on both sides of the personal lines business if we think about like earned rate and then momentum coming through on recent approvals?

Paul MacDonald — Executive Vice-President, Personal Insurance & Digital Channels, Definity Financial Corporation

Yes, absolutely. And as I just mentioned on the property side, so let's start there, we've got about 7% to 8% of written rate, but we've had that consistently pushing through the portfolio in the last few quarters, so the earned rate is very close to that and we continue to expect that in the near to medium term.

On the automobile side, just a little bit of detail required here, and so you may recall that we had 5% of COVID relief flowing out of the portfolio. We reversed that beginning the midpoint of this year and that will continue to go through the portfolio until the midpoint of next year, sometime in Q2 of next year. Actually, at the end of this year is the crossover point, so we'll have a net inflow from that expected to hit our portfolio. In addition to that, we filed and got an approval for additional rate. So our written rate on the automobile side will be close to seven points by Q4 of this year. And we have confidence, we intend to file and secure additional rate on the automobile side for next year, we have confidence that we'll be able to do so based upon what we're seeing in the marketplace. Some market players are getting approvals from regulators in high single digit rates. So that, I think, is a reflection that the regulatory environment is being quite prudent and pragmatic and responding to the inflationary trends that we're all seeing.

Jaeme Gloyn — Analyst, National Bank Financial

Great. Thank you very much.

Operator

Your next question comes from Brian Meredith of UBS. Please go ahead.

Brian Meredith — Analyst, UBS

Good morning, everybody. A couple questions here for you. First, I'm just curious, Rowan, the McDougall acquisition, how much of their premium does Definity already have and is that part of the acquisition here that you expect that to increase and how much could it potentially be? It's a pretty big sized premium base there.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

Hi, Brian. Thanks for the question. We don't actually disclose revenues of any of the markets that McDougall's deal with. That's kind of important information for them and some sensitivity around that. I would say that we are clearly, given our long successful history with McDougall, one of their leading insurance markets and, as they build and grow their business, naturally, you know, we'll be a beneficiary of that. But I think the important part of that model is that the McDougall business continues to operate as an independent broker market. That's how they could best serve their customers and best make EBITDA margins. And I think, from our perspective, there are two sources of value creation. One is going to be from the underwriting income we get from being a supplier, ah, relationship with McDougall, and the other one is going to be this complementary distribution income as they continue to build an already profitable EBITDA contribution. So I think that's the outlook for them. And we're very excited, of course, about that acquisition. It's a phenomenal business. They've had a great kind of track record of growing organically very strongly in addition to doing some acquisitions. And so we clearly expect they'll participate in M&A, but also comfortable with just their organic capabilities going forward. So look forward to supporting them. And as I said, all of that, both on the revenues to us, premiums to us, but on the EBITDA should be favourable in the years ahead.

Brian Meredith — Analyst, UBS

Makes sense. Thanks. And then just a second question, in personal auto, frequency and severity that you're seeing, is it pretty consistent between Sonnet and the broker channel? Or are there differences?

Paul MacDonald — Executive Vice-President, Personal Insurance & Digital Channels, Definity Financial Corporation

Yes. Because these are macroeconomic trends, these are quite consistent between the two portfolios. As we've said, as we said last quarter, we were starting to see that the inflationary rate of inflation has started to flatten out. We've seen that again in Q3. These are positive signals because, if they remain consistent, that allows the rate actions to take hold and catch that rate. And so there's no material differences between the two portfolios on that regard.

In terms of frequency, we are seeing rising mileage essentially at pre-pandemic levels. Despite that, there's still a bit of a persistent frequency benefit in the portfolio and, intuitively, that makes sense when you consider the hybrid work environment. So still people are not coming fully back to the office five days a week and we expect that to remain fairly persistent for the near term.

In terms of what we're doing about it, we've got, as I mentioned just moments ago, quite a few rate actions covering that inflationary trend, so we're quite pleased with our ability to cover that. But in addition to that maybe it's important to call out that we have quite a few underwriting actions as well in terms of segmenting the portfolio, both of the Sonnet and the broker portfolio. I'll remind you that we have a centralized pricing and underwriting function that supports both the channels and so we are segmenting the business, removing substandard business, increasing affinity portfolios and group portfolios, as Rowan mentioned. And then on the claims side, we have previously moved to moving everything in customer billing into the Guidewire platform and now Guidewire Cloud. We are now on the third component of the three-legged stool and we are partway through transforming our claims operation onto the Guidewire Cloud platform and expect that to pay dividends in the future in terms of efficiency and productivity.

Lastly, I will also mention that there is a bit of a seasonality component, so I do expect in Q1 of next year, with a little bit of weather, that there'll be some additional frequency, so there may be potential upside in people choosing not to drive to work if there is inclement weather.

Brian Meredith — Analyst, UBS

Yeah. Can I squeeze another other quick one in here? Reinsurance costs, ceded reinsurance, I mean it's a hot topic right now, big price increases in property cat coming through, obviously you had some cat losses here. What are your kind of expectations do you think for the ceded reinsurance program and can you remind us when your program renews?

Philip Mather — Executive Vice-President & Chief Financial Officer, Definity Financial Corporation

Yeah, I'll take that. Thanks, Brian. I mean it's fair to say that we're expecting a hard market this year and that likely makes for a bit more of a challenging renewal than we've seen in recent years. Although I'd say what we expect that to do is contribute to sustaining the hard market conditions we've seen on our side for both personal property and commercial lines. And that's where we buy the vast majority of the reinsurance coverage that we have and it's also in lines with more ability to flow through the implications from a pricing perspective. We renewed the program, the vast majority of it, effective January 1st, so we're coming up to our renewal cycle right now. We're going to look at that structure, look at our needs, and look at the profile as we go through that process, as we do every year, but we're still very confident that the capacity we require is out there and we'll be in line with our kind of risk appetite perspective.

Overall, we're reasonably modest in the overall use of reinsurance on the program, so it's only about 5% to 6% from a ceded perspective, and over the past few years I would say that we've had a very strong track record on our overall reinsuranceprograms. We've got very good reinsurance relationships that we've built and fostered over time and we have got a continually improving book of business and a good growth story. So, not diminishing the fact that we expect it to be a more engaging and challenging renewal cycle than we've seen in recent years, but we do think we're pretty well positioned to go through that and we'll obviously reflect the outcome of that process as we go through and establish our targets in the year-end cycle next time around.

Brian Meredith — Analyst, UBS

Great. Thanks for your answers.

Operator

Your next question comes from Stephen Boland of Raymond James. Please go ahead.

Stephen Boland — Analyst, Raymond James

Yeah, just a follow up on the personal auto. You touched on some of the initiatives that you're dealing with on the claims side. Maybe you could just touch on a few more in terms of how you're dealing with severity, how you're dealing with inflation. Is it preferred vendors and parts and labour, things like that? Maybe you could just, you know, what other initiatives you're trying to get to lower that combined ratio.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

And I'll have Paul give you a bit of an insight there. I think, again, one of the things that's useful for us here, obviously the context is, as we know that when you think about the auto claims, in our portfolio, about 50% is injury claims and the other 50% being the auto physical damage, and so we're really focused on the auto physical damage, mitigating that inflation trend, because really we're not seeing anything unusual or unexpected in the accident benefits or the bodily injury. It's exactly as we price for it, it's exactly as we kind of anticipated, and not really subject to this higher inflation trend. So really what we're talking about is the auto physical damage areas and you know the story there with thefts going up, some labour rates and parts and delays and things like that. So that's the kind of area that we've had and there's a number of factors and, Paul, maybe you could talk about a couple of the initiatives to mitigate what we can.

Paul MacDonald — Executive Vice-President, Personal Insurance & Digital Channels, Definity Financial Corporation

Yeah, and maybe I'll start with a couple of data points that I previously shared. And so, if you think about, as Rowan said, the auto physical damage category is just under 50% of our portfolio. Previously, one of the major drivers of that was cost of new and used vehicles. We've previously called out that we have started to see the flattening of that and we continue to see that trend in Q3, particularly in the US, which is a bit of a leading indicator. We're seeing used car prices come down and so we expect to have that to be a positive impact on our severity on the total loss and non-driveable categories.

I previously mentioned theft and, interestingly, theft severity is coming down quite significantly quarter over quarter. A bit of an interesting data point is that frequency in theft remains fairly elevated, but the nature of the theft has decreased, and so with the combined activities, I think, of police and the industry as a whole, thieves are stealing less valuable vehicles and focusing on the least expensive vehicles.

Where we are seeing slight variation in terms of costs are on parts and labour. Rowan mentioned them. Labour is going up a bit, that's just in terms of availability of individuals working in things like auto body shops, and then parts is a curious one. Parts availability is actually freeing up a little bit compared to prior term, but the average cost per part is increasing slightly. And so you pointed out earlier that we have vendor contracts, absolutely we find we have preferred vendor networks. There's a material difference, a positive difference between the costs that we pay in our vendor networks versus our non-preferred networks. And so we're grateful that most of our clients are selecting the preferred vendor networks and we do have a significant ability, improved ability to control some of those costs, including, for example, the cost of rental days. So rental days are flat, if not slightly improving, on our preferred vendor networks, slightly longer on a non-preferred. So clearly there's an interest in here and working together with our vendors to make sure that we provide the best possible service at the best possible price for our customers.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

So I think there's actions we can take, both on the underwriting and on the claims, and Paul's talked to just a couple of the claims ones, and if you think about something, an easy example is if you look at the types of cars that have been targeted for a theft, their underwriting rates, rules, and the use of industry pools, tactics like that that we've been deploying to actually mitigate as well. So, as you watch this trend, there's a lot of, let's call them, tactical actions, both on the underwriting pricing and claims initiatives that we can do to mitigate that trend, and that's what the team has been doing.

Stephen Boland — Analyst, Raymond James

Okay. That's great. My second question is just on the commercial cat losses. Just want to confirm that the vast majority of those cat losses were, I guess, small medium business, like property portfolio, or was there other segments that were impacted or that are buried in the cat losses?

Fabian Richenberger — Executive Vice-President, Commercial Insurance & Insurance Operations, Definity Financial Corporation

Thank you for your question. So, about two thirds of the cat contribution in Q3 were weather-related cat losses and then one third was on part commercial loss that we will expect to happen at any quarter as well. So the 9% provision overall is very much in line with what you will be seeing as loss margins for Q3. And then if you think about the way we construct our plan, just the Q3 plan ratio was 93.6%, and again that is very much in line with what we will expect Q3 to look like as well as from a combined ratio point of view, and on a year-to-date basis we are at 90.7%, which, again in line with what we expect from the portfolio in that low 90s combined ratio going forward

Stephen Boland — Analyst, Raymond James

Okay. Thanks, guys.

Operator

Your last question comes from Lemar Persaud of Cormark. Please go ahead.

Lemar Persaud — Analyst, Cormark Securities

Thanks for taking my questions. So, you mentioned growth in Sonnet was a bit more muted this quarter. Nothing unusual in the comment for rate shopping being down, it was down across the industry, but what I am curious about is the comment that growth was impacted by elevated customer acquisition costs. Just given that it's an online platform, I'd expect costs to be relatively static or maybe I just don't have a good appreciation for the variable costs, so things like marketing costs. Maybe you could help me understand the mix of fixed versus variable costs in Sonnet.

Paul MacDonald — Executive Vice-President, Personal Insurance & Digital Channels, Definity Financial Corporation

It’s Paul here. So, in terms of those costs that you’re referencing, many of those costs are marketing-related costs. And so we have a wealth of marketing activities, of course, on the broker side. We pay a commission to outsource that activity to our broker partners. On the Sonnet side we take on that responsibility and that can involve digital marketing, that could involve general awareness marketing, and typically what happens is that you bid on certain search terms. I’m oversimplifying it grossly here to give the example, but when there are periods like this where there’s less activity in the marketplace, the competitive pressure increases. Not unlike when you’re bidding for a new vehicle, prices go when demand goes up or house prices go up when demand goes up, the same thing happens with digital and search marketing. And so it does vary quite a bit actually and we’ve gotten it successfully reduced from our initial period of launch by bringing in house a lot of our capability. And so we’re quite effective relative to initial launch, but what we have seen over the last quarter or two, particularly as retention has gone up countrywide, mostly due to COVID relief measures, what we are seeing is that the smaller amounts of new business circulating are increasing the costs. And so we look at that carefully. At a certain point, we think there’s no point bidding on it. If the cost of acquisition exceeds a target level for us, we will back off paying for those search terms and we’ll redirect the marketing to other jurisdictions or other lines of business. So we’ll dynamically adjust this expenditure and, as Rowan mentioned earlier, we’re in a peak period of cost and it doesn’t make sense to chase this business if it ends up being too costly.

Rowan Saunders — President & Chief Executive Officer, Definity Financial Corporation

And I think that’s one of the benefits of scale. So, if you have a largely fixed marketing budget and you divide that back into $350 million of revenue, clearly it’s going to be a higher percentage than when we divide that back into $500 million of revenue, and so that’s where there is importance of scale. But as

Paul said, quite simply, because you’ve got less people shopping, you’ve got less customers in the market, and therefore your cost per bind is going to be higher with all the competition in the market. And so, as you’re bidding on auction terms, the cost per bid increases. And so it could be like that for a little while until there’s more customers moving in the marketplace and so we’re just going to be disciplined on that. I mean we have another option. The other option is to just increase our marketing budget and keep the revenue higher than the kind of roughly 10% that it is but, for the reasons we mentioned earlier, we don’t think that’s appropriate, at least for the next couple of quarters.

Operator

There are no further questions, gentlemen. Please proceed with any closing remarks.

Dennis Westfall — Investor Relations, Definity Financial Corporation

Thank you, everyone, for participating today. The webcast will be archived on our website for one year. The telephone replay will be available at 1:00 p.m. today until November 18th and a transcript will be made available on our website. Please note that our fourth quarter and year-end results for 2022 will be released on Thursday, February 9th. That concludes our conference call for today. Thank you and have a great one.

Operator

Ladies and gentlemen, this does conclude your conference call for this morning. We would like to thank everybody for participating and we ask that you please disconnect your lines.