Definity Financial Corporation

Fourth Quarter 2022 Financial Results Conference Call

February 10, 2023 — 11:00 a.m. E.T.

Length: 59 minutes

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CORPORATE PARTICIPANTS

Dennis Westfall
Definity Financial Corporation — Head, Investor Relations

Rowan Saunders
Definity Financial Corporation — President & Chief Executive Officer

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

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

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

CONFERENCE CALL PARTICIPANTS

Geoff Kwan
RBC Capital Markets — Analyst

Jaeme Gloyn
National Bank Financial — Analyst

Lemar Persaud
Cormark Securities — Analyst

Paul Holden
CIBC World Markets — Analyst

Mario Mendonca
TD Securities — Analyst

Tom MacKinnon
BMO Capital Markets — Analyst

Brian Meredith
UBS Securities — Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Definity Financial Corporation Fourth 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 on Friday, February 10, 2023.

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, Julie, 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 on 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'll start with formal remarks from Rowan and Phil, followed by a Q&A session. Paul and Fabian will be available to answer your questions during the Q&A.

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

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

Thanks, Dennis, and good morning, everyone.

We reported fourth quarter and year-end results last night that capped off a successful first full year as a public company for Definity. Strong underwriting, robust net investment income, and an increasing contribution from our recent investment, McDougall Insurance, combined to generate fourth quarter operating net income of $79 million or $0.67 per share. I believe our performance in 2022 is a testament to our team's ability to successfully manage volatility in the insurance and capital markets.

From an underwriting perspective, our fourth quarter combined ratio of 91.7% benefitted from strong performances in our commercial P&C and personal property lines. Though weather was active in the quarter, the net impact from catastrophe losses was benefitted by recoveries under our multiyear catastrophe aggregate reinsurance treaty. The solid underwriting performance was delivered in conjunction with continued strong top-line growth, strategic investments in our digital platforms, and our expansion efforts in personal property and commercial insurance amid firm market conditions combined to deliver an 11.3% increase in premiums for the quarter. For the full year, premiums increased 11.8% while our core of 94.1% marked the third consecutive year below 95%. Operating results benefitted from a greater than expected increase in net investment income, which reflected the significant increase in fixed income yields. Overall, our financial performance led to an operating ROE of 10%. I'm confident in our ability to continue to deliver on our key financial targets.

Our operating results combined with a revaluation gain on McDougall to drive a substantial 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. In aggregate, our financial capacity remains above $650 million as an ICA company at quarter end. We have also increased our quarterly dividend by 10%, consistent with our objective to sustainably grow our dividend over time. 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.

Turning to the industry outlook on slide six, we expect firm market conditions in property and commercial lines to persist over the next 12 months, particularly in higher catastrophe risk regions following the recent CAT events. The impact from the challenging reinsurance renewal for 2023 is also expected to prolong firm market conditions and underwriting discipline. In auto lines, industry rates began to firm in 2022 following a period of pandemic-related customer relief. We expect this trend to continue in 2023 outside of Alberta. Rate actions were deemed necessary due to the combination of normalizing auto claims frequency and higher severity related to inflation. These factors, in addition to continued elevated levels of severe weather events, are likely to lead carriers to focus on ensuring long-term profitability and sustainable availability of capacity. Overall, we expect the industry's return on equity to trend closer to its long run average of 10%.

Slide seven illustrates our key financial metrics. Growth and combined ratio were in line with or better than our targets, as was our operating ROE. Recognizing the macro headwinds arising from the recessionary risk outlook leading to reduced customer shopping for new auto and home purchases, combined with an ongoing disciplined approach to underwriting, we have refined our growth target range for 2023 to upper single digits to approximately 10%. As we've stated before, we believe we have the

growth platforms to outpace the market, but we'll continue to defend company profitability along the way. We have maintained our mid-90s combined ratio and operating ROE targets.

You'll notice that all three of our insurance businesses now exceed $1 billion in premium on an annual basis. This was the result of a concerted effort to grow beyond our regulated auto rates into personal property and commercial lines. As recently as 2019, in fact, personal auto comprised 50% of our business. This is down to 42% in 2022 and only 40% in the fourth quarter. We believe this focus on diversification of our portfolio will improve our underwriting profitability and reduce its inherent volatility over the long run. We've also made strides to diversify the earnings profile of the business. Our expanded partnership with McDougall now positions us to benefit from a complementary source of income. We like the repeatable nature of distribution income and believe we have now built another platform that can reach an annual premium base of $1 billion.

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 nine with personal auto. Strong retention in our broker business, higher average written premiums, and the growth in Sonnet combined to generate a 6.1% increase in premiums this quarter. Sonnet growth continued at a pace slightly above 10% despite current market conditions, including higher customer acquisition costs and lower levels of shopping. While we expect the recently announced rate freeze in Alberta auto will be more impactful to Sonnet growth, the affinity strategy

continues to perform well and constitutes a higher proportion of our new business. We will maintain our disciplined approach and focus our efforts on driving profitable growth by leveraging our digital assets and deep-rooted broker relationships. For the full year, top-line growth was solid at 7.3%. We reported a combined ratio of 94.2% in the fourth quarter, an improvement from the comparable quarter a year ago, which included 7 points attributable to reserve strengthening related to inflationary trends in physical damage. Severity continued to be a factor in Q4 of 2022 but was essentially unchanged from the third quarter driven by total losses, vehicle repairs, rental costs, and car theft. Favourable prior year claims development was strong at 5.5 points, reflective of our prudent approach to reserving taken throughout the pandemic. Full year 2022 personal auto reported a 94.7% combined ratio, up as expected from 2021, which benefitted from lower claims frequency due to reduced driving levels. We continue to 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.

Turning to personal property on slide 10, I'm pleased to report robust top-line growth of 13% for the quarter and 13.2% for the full year, 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 stronger broker relationships to help maintain our growth above that of the industry. Focusing on the bottom line, we reported a combined ratio of 90.4% compared to 93.2% in the same quarter a year ago. A decline in CAT losses reflecting the benefit of our CAT aggregate treaty was partly offset by an increase in the core accident year claims ratio and the expense ratio, which was unusually low last year, largely due to the timing of contingent profit accruals.

For the full year, the 96.7% combined ratio was an improvement over 98.6% in 2021. We continue to target a mid-90s combined ratio for the personal property line of business on an annual basis.

Slide 11 outlines the highlights in the quarter for our commercial business, with premium growth of 17% in the fourth quarter and 17.6% for the year. This growth rate benefitted from continued broker support, rates achievements in a firm market environment, further scaling of specialty capabilities, and a continued focus on strong underwriting execution. 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 and benefit from firm market conditions. Our fourth quarter combined ratio of 89.2% was much improved from the 95.5% a year ago, primarily driven by a decline in catastrophe losses. We reported a net recovery of CAT losses in Q4 of 2022, including favourable development on events from earlier in the year. We continue to expect the commercial insurance business to sustainably deliver annual combined ratios in the low 90s.

Putting this all together on slide 12, consolidated premiums reached $943 million for the quarter and over $3.6 billion for the full year, representing growth of 11.3% and 11.8%, respectively. The disciplined nature of our growth through our underwriting expertise, pricing strategies, and prudent reserving resulted in a fourth quarter combined ratio of 91.7%, nearly three points better than Q4 of last year.

Slide 13 shows our investment portfolio in greater detail. Our net investment income again increased significantly in the quarter, up $14.4 million from Q4 of 2021, driven by higher interest income from the combination of higher book yields and overall growth in the fixed income portfolio. We expect

double digit growth to continue in 2023, resulting in expected full year net investment income of approximately $130 million.

As you can see on slide 14, our financial position remains strong despite a volatile year for capital markets. Our operating performance and a non-taxable $67 million revaluation gain on our previous ownership interest in McDougall offset capital markets volatility in 2022, resulting in ending book value per share of $20.74, largely unchanged from a year ago. We currently anticipate the adoption of IFRS 17 will bring a further 5% to 6% increase to our equity attributable to common shareholders as at January 1, 2022, providing a boost to book value per share. We remain well capitalized under our current legal structure and, subject to the continuance of Definity under the CBCA, we could add an additional $500 million in leverage capacity to reach nearly $1.2 billion financial capacity. To that end, we submitted our application earlier this week to continue as a CBCA, the final step in our process.

Slide 15 shows recent capital management actions and longer-term priorities. When it comes to deploying our capital, our primary focus remains in support of our robust organic growth strategy. 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. McDougall Investments is a tangible example of our ability to deploy our excess capital in an immediately accretive manner. We also intend to have a sustainable and growing dividend for common share and I'm pleased to announce that our Board of Directors declared a dividend increase of 10%, resulting in a dividend of $0.1375 per share payable at the end of March.

Before I turn things back to Rowan, I'll take you to slide 16, where we illustrate the changes in our CAT reinsurance program for 2023. Our net retention increased for the first time in over a decade, now beginning at $40 million, up from $30 million previously. The other change in the lower portion of our tower is that we're now retaining 42.5% on average of amounts between $40 million and $100 million. We're comfortable with this structure given our increased size, improved profitability, and proven risk selection capabilities. In response, we are taking additional rates in our property and commercial books, managing risk accumulation, and have continued the placements of the catastrophe aggregate reinsurance treaty in 2023 on the same terms.

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

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

Thanks, Phil.

Our robust performance 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. We also strive to maintain our digital leadership position through our pace of innovation. Consistently delivering disciplined financial management is another objective and one that we focused today's discussion around. Lastly, we are working to position Definity as a purpose-driven sustainability leader by delivering on our inclusion, diversity, equity, and accessibility targets and the climate goals and ESG priorities.

We have an excellent team in place and supportive broker partners to continue building on our track record of success. I'm extremely proud of the milestones we achieved together in our first year as a public company and excited by the opportunities that lie ahead for Definity. And with that, I'll turn the call back over to Dennis to begin the Q&A section.

Dennis Westfall — Investor Relations, Definity Financial Corporation

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

Q & A

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the star followed by the one on your touchtone phone. If you would like to withdraw your question, please press the star followed by the two. If you are using a speakerphone, please lift the handset before pressing any keys. One moment please for your first question.

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

Geoff Kwan — Analyst, RBC Capital Markets

Good morning. My first question was just on reinsurance. So, the benefit that you had realized in Q4, the way I understand your CAT agg reinsurance coverage is that, because you had a number of CAT losses earlier in 2022, this is what triggered the higher reinsurance coverage for the CAT activity in Q4, that you essentially have the same level of reinsurance coverage for both 2023 and 2024. Is that correct?

As I'm just trying to see it, like it doesn't seem like any of the reinsurance benefit you realized in Q4 needed to be normalized.

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

Hey, Geoff. It's Phil Mather here. Thanks for the question. Your synopsis is correct. I think just a quick reminder of what the aggregate treaty is, so while our catastrophe treaty provides protection against individual large events, the aggregate treaty is, as you say, designed to protect against volatility and when you have multiple mid-or large-sized events happening in the year. And the purchase of that treaty really was a deliberate part of our catastrophe management and volatility management planning, particularly as we focused on the first few years of our life as a public company and as we knew we're deliberately seeking to shift the mix to personal property and commercial lines over time. We also knew that we'd be moving up our attachment points on the core treaty over time, so we did put a three-year cover in place in 2022, so you're right, the aggregate treaty remains in place and active for 2023 and 2024.

And I think really what you saw in 2022 was a great example of the use of that treaty. You're quite correct that we saw a number of events building up to the fourth quarter and, as they accumulated, it effectively turned the aggregate treaty on. And so, what we saw in the fourth quarter, it would have been, absent that treaty, a pretty normal fourth quarter, around the two-point CAT quarter for the company as whole overall, that fell down to about half a point because of the impacts of that tool. And we really do see it as an effective risk management tool that's in place. It helps us manage that volatility, helps us transition as that CAT treaty develops overall, and we can also plan for that premium cost upfront and put

that into our product. So, in a nutshell, we were very pleased to have it. It did what it's expected to do in 2022 and we're glad we've retained it for the next couple of years.

Geoff Kwan — Analyst, RBC Capital Markets

Okay, thanks. And just my second question, just on M&A. I know you can't provide specifics on anything, but just wondering, are you able to say whether not there's any active processes that you're involved with on the insurer side? And then separately, on distribution, kind of how, ah, do you think about a certain level of amount of capital you'd like to deploy this year into distribution, either like investments or acquisitions?

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

Yeah, I mean I think on that point, we're anticipating that there will be more opportunities coming ahead, and I think that is both on the insurer side of things as well as the distribution. So obviously we can't comment on specifics, but we definitely have a belief that there'll be more activity over the next year or two.

With respect to the distribution side of things, since our acquisition of McDougall there has been a lot of activity. I think that there's a very healthy pipeline, a lot of brokers like that model, and so the McDougall's team has been quite active and so it's likely that we will continue to keep deploying capital there. And I think that, you know, we don't quantify exactly what we're moving in terms of capital into that area, other than to say, you know, you know we have a significant amount of excess capital, we like that opportunity. Within the broker itself, there's strong profitability, free cash flows, it's largely

unleveraged, so there's a lot of opportunity before adding further capital, but that being said, we're totally supportive of deploying more capital to support those opportunities that we do expect to unfold through the course of 2023.

Geoff Kwan — Analyst, RBC Capital Markets

Okay, great. Thank you.

Operator

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

Jaeme Gloyn — Analyst, National Bank Financial

Thanks. First question is on the McDougall acquisition and the performance within the quarter. It looks like $19 million of revenue, $15 million of expenses, and a $4 million income in the quarter. Is that reflective of a typical quarter or are there maybe some additional expenses loaded in this quarter, some other moving parts? What can you say about the performance of that business this quarter and the outlook for the next several quarters?

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

Thanks for that. So, just in terms of the distribution income that flows from McDougall, so when you actually look to the total contribution to operating income, you don't quite see the full picture when you look at that distribution revenues and distribution expenses. We also have the revenue that comes from the commissions associated with the business that Definity underwrites, and for the consolidation

purposes that actually gets netted off the commission expenses. So, there's actually a few million dollars of additional benefits coming through to the organization overall. That's actually up in a reduction of commission expense. So, when you kind of take that together, you're in the kind of upper single million-dollar kind of range for the quarter as an overall. And when we look at that combined with some seasonality that you normally have and some timing about when you have a stronger line of sight on CPCs, we're still very comfortable with the $40 million contribution towards operating income that we've included in the guidance and essentially what we saw in the fourth quarter is very in line with our expectations going into the transaction.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. So, if I understand right, we should see a little bit lower expense ratio as a result of the increased share in McDougall, and I guess that would be typical of any distribution acquisitions going forward, that you'd have a reduction in commissions based on how much DFY writes, but McDougall maybe is a bit heavier than a normal transaction. Or how does that…? Did I sort of characterize that correctly?

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

You characterized it bang on. I think, in terms of our interaction with McDougall, that's great strategic partner of ours, but we have that kind of level of relationship with a number of parties. But you're absolutely right that, as we acquire distribution and as we participate with our partner, it comes through in those couple of areas. So, you should expect to see that continue over time as we continue to strengthen that distribution channel.

Jaeme Gloyn — Analyst, National Bank Financial

Great. And I'll frame my personal auto question in this way in the sense that Q4 2021 was a pretty high current year loss ratio as you seemed to take a prudent stance or conservative stance towards inflation. The PYD number this quarter also looks a little bit higher as well. How much of that PYD would be reflecting some outperformance versus your inflation expectations this time last year and then how do you feel about that going forward?

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

Yeah, just a couple of comments on that. So, there's about 1.5 points in that 5.5 that relates to the facility association, so that actually is contributing a little bit more that true-ups to the FA reporting, you know, comes along as and when they manage their own reserves. So, there's a little bit of elevation there. And I think just stepping back, what you've seen in auto over the last couple of years throughout pandemic is the pretty prudent response that we've taken kind of throughout and those levels of PYD are a little higher than you would normally expect of the long run. So, at a total company level, we would historically have normally been in that one-to-two-point range. You see we're a little higher than that over the last couple of years. But from a longer-term perspective, think that one to two is pretty reflective of our longer-term approach to reserving. I think what we've seen on the actions that we took in respect to 2020 and 2021, as we leaned into inflation and made sure we were comfortable there, we've seen that be robust and was a good decision and quite prescient over the last couple of years. So, we had good, solid reserves that have been unwound naturally over the last couple of years.

Jaeme Gloyn — Analyst, National Bank Financial

Thank you.

Operator

Your next question comes from Lemar Persaud from Cormark. Please go ahead.

Lemar Persaud — Analyst, Cormark Securities

Thanks. I just want to come back to the application for continuance. Should we kind of think about this as a done deal or is there a real risk that this doesn't get approved? And then any indication on timing would be helpful given that it is the final step. And then what sorts of things would the Minister of Finance be looking at to improve your application? Thanks.

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

Thanks, Lemar. So, I'm happy to be able to report that we've made some good progress there since the last call. So, as you remember, last time around, the regulations were finalized and enacted into legislation. We moved very quickly after that. So, we went through a four-week notice period in January, as required, and then we submitted our application to OSFI to continue under the CBCA this week. So, from our perspective, we're now in the final stages of that process. Obviously, we don't control the outcome, but we'd say it's pretty low risk from our perspective as we've been engaging quite meaningfully with OSFI and with the Ministry of Finance department over a period of time. So, we don't control the outcome, but we'd put it in a low risk that it wouldn't complete.

And in terms of timing, we still think there's probably several more months from here before the actual CBCA approval comes. We wouldn't anticipate it coming before the AGM, as an example. So, a few moments ago, but from here we'd consider it as low risk in terms of the outcome.

Lemar Persaud — Analyst, Cormark Securities

Okay. And then any thoughts on what kind of things they're going to be looking at?

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

I think there's been a good engagement throughout. So, we've signalled the strength of the company, the position of the company, you know where our capital positions are, our intent to go through the CBCA. I think, for us, there's been good, robust engagement through that process throughout. And in terms of the company's strategy and its financial strength and positioning, I think we'd arguably look pretty robust.

Lemar Persaud — Analyst, Cormark Securities

Okay, great. Thanks. And then maybe just a quick modelling question for Phil. Is an operating tax rate in the low to mid-20s still appropriate for 2023?

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

Yeah, so, I think on the tax rate, obviously the effective tax rate at net income level is distorted this time around when you see the McDougall flow, but from an operating income perspective we usually run

with a couple of points below the statutory rate. So that kind of low to mid-20s tax rate is a good one for operating income. What you saw this year is pretty representative of what we'd expect.

Lemar Persaud — Analyst, Cormark Securities

Great. Thanks for that.

Operator

Your next question comes from Paul Holden from CIBC. Please go ahead.

Paul Holden — Analyst, CIBC World Markets

Thank you. Good morning. A few questions for you. I guess the first one is with respect to risk retention considering January reinsurance renewals. Just wondering how you approach that. My assumption is probably you retain more risk and reinsure a little bit less, but just want clarity on that.

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

Thanks, Paul. I'll take you through that. I think going in we anticipated the renewal cycle was going to be pretty challenging, you know, there were signals for that, and we'd been positioning ourselves, I think, pretty strongly going into that cycle. And we had in our favour a pretty good performing program overall and a deep focus on relationships with our reinsurance partners. We fully expected the program would move over time. So, we fully anticipated the level of retention at the bottom of the program, so moving up from $30 million to $40 million would increase, and actually we've been up $30 million for over 10 years. It was actually long overdue and it wasn't the most optimized use of our capital. And we also

expected to participate somewhat in the program through that level of retention of risk. So, nothing unexpected, per se, in terms of the level of participation. The program as structured is well within our risk appetite and expectations coming out of that. And we have incorporated that program structure into our kind of guidance of around a four-point impact on the loss ratio per year. In response to that environment, we've done a couple of things already. We've already been active from price, because as some of that risk gets retained by the organization, obviously, we want to be paid for it in terms of product structure. We look at the risk accumulations and also the product turns and, as I mentioned earlier on, we still have that aggregate treaty in place. We're very pleased we have that in advance of the cycle given how challenging we expected it to be and that just helps us with some kind of risk around the expected outcomes. So, it helps just mute that in more volatile years.

Paul Holden — Analyst, CIBC World Markets

Got it. Okay.

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

The only thing to add there would be that we have strong relationships with our reinsurers and I think that was reflected in our renewal. The fact that our business has changed quite a bit over the last number of years, the quality of the portfolio has been reflected, where we consciously underweight, like the Alberta CAT zones, have helped our business. And reinsurers, as you know, underwrite us, they've seen a massive change in our technical and underwriting capabilities. And so I think, at the end of the day, as Phil said, we're very comfortable with where we landed. We absolutely have the program and the capacity in place to continue executing our strategy and, as you see us building out personal property and

building out the various segments in commercial, we're able to continue exactly along the lines that we had anticipated.

Paul Holden — Analyst, CIBC World Markets

Okay. And then second question, I guess, goes to everyone's favourite topic, personal auto claims inflation. I think your underlying current year loss ratio surprised to the upside for pretty much everyone, I think. So maybe you can talk a little bit about sort of trends you're seeing in claims inflation, how it might impact your outlook for 2023, and then, related topic but a little bit different, just wondering how you view weather-related impacts in auto claims in Q4. Thank you.

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

Yeah, I'll get Paul to kind of give you a bit more of a detailed answer on this one, but I think it's also useful reflecting that we believe that we were early here in terms of picking up the inflation trends, and if you think back as far as the Q2 of 2021 when we took a provision on personal property and then, as you point out, Q4 of 2021 on the auto line, and so when you look at the year-on-year shift 2024 Q4 versus 2022, you do have to take into consideration the provision we put in last year. I think the fact that we've been early and our teams have been very focusing on mitigating that has helped us and we have done a good job of mitigating some of that trend that is still kind of ongoing. So, the big picture on automobile ability is pretty well back to where it was pre-pandemic, but the patterns are different. So, we are still seeing some favourable frequency impacts on that one. Paul will give you the data, but the headline story is it's elevated from where it was a year ago but it has been flattening for a couple of quarters. So that's important to us, as all the underwriting actions and pricing changes that Paul and team

have been putting will start to kind of earn in over the next number of quarters. And so I think we think about this as the accident year is really still increasing a bit, and you see that more on the year-to-date numbers than in the quarter numbers, and that's what in the guidance and the reason for why we have been guiding auto up a bit higher in the range until we get all those rates kind of coming in.

But in terms of some of the detail of the actual inflation trends, do you want to add some light to that, Paul?

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

Yes. Thank you, Rowan. So, I'll give some examples, as I've done in previous quarters, around actual severity trends. And what we're seeing in the quarter is, on a consolidated auto basis, 10.5 points of year-over-year severity increase. That represents only a slight improvement over Q3, and so what we've seen is fairly consistent, though slightly diminishing, year-over-year severity trends in the last few quarters. And when you look quarter over quarter, what you'll see in Q2 is almost an eight point increase from Q1. Q3 was only a five point over Q2. Q4 was only 1.1 over Q3. And so what we're seeing is a nice steady trajectory down to a flattening of those trends. So, while still elevated, as I said, about 10.5 points year over year, what we've seen is a flattening and our expectation is it will remain relatively flat, which is positive, because it allows us to earn the rate. It allows the rate to catch up to that particular trend.

A little bit more colour on the underlying elements. Theft is still elevated. It's still one of the large ones year over year, particularly in Quebec. But when you look at it Q4 over Q3 it's actually a slightly negative. So that's starting to improve as well. Some of the other categories are not particularly

meaningful to call out, other than non-drivable. So this is just repair of the vehicles. What we are seeing is that parts availability is improving, availability of new and used vehicles is improving, and what we're seeing is a bit of a stack up of work at the auto body shops and a little bit of wage inflation. So it's really about the auto body shops working through some of the backlog of the repairs. So we have some level of confidence that it should remain fairly static at this point and, as I said, that will allow our rate trend to catch up.

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

I just think, Paul, just to your question on outlook, I think we still think mid to upper 90s is the range of expectation with us moving into the upper end of that range in the nearer term, also as you get some of this timing of inflation staying up there.

And I think you also asked about weather. We'd normally see Q1 for sure as the most seasonally impacted of the quarters. Q4 can have some weather, and certainly Q4 was the winter, coming into the winter period, but the most distortion you would always see would be in the first quarter.

Paul Holden — Analyst, CIBC World Markets

Okay. And last one: Why introduce a DRIP? Obviously, you have excess capital, zero leverage. Why the need to build additional capital through a DRIP?

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

Yeah, so thanks, Paul. We don't see it as a capital build facility. Really at this point we just see it as another example of us maturing as a public company and having that facility in place for those shareholders to have an appetite to participate in that kind of facility. And we certainly expect to see any take-up of that be settled through market purchases. So, we don't expect to do any treasury issuance in the near term through that. As you say, we've got a very strong capital position. So, it's more about maturation as a public company.

Paul Holden — Analyst, CIBC World Markets

Got it. Okay. Thanks for your time.

Operator

Your next question comes from Mario Mendonca from TD Securities. Please go ahead.

Mario Mendonca — Analyst, TD Securities

Good morning. Phil, could you first clarify something for me? Did you say that you would expect, in a normal year, CAT to be about four points of net earned premium?

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

That's right, yeah, about four points of the loss ratio.

Mario Mendonca — Analyst, TD Securities

Yeah, that would amount, like just assuming normal growth in net earned premium, like high single digit, which would be lower than what it was in 2022. That would imply CAT losses of something like $140 million. Now, obviously, that's a big increase from what we saw in 2022. So, in offering the four points, are you taking into account any recovery, ah, analogous to the recovery we had this quarter?

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

Yeah, so what we're doing in terms of the modelling there, the key drivers really is the mix shift that we've got going on between the move away from auto as a proportion of the book as a whole and then the higher level of growth that we've seen in personal property and commercial lines. So, if you look at what we've done historically, we've been around 3.5 points over the last several years, but really it's the dollar impact growing on that higher proportion and outsized growth that we've seen in personal property and commercial lines.

The second point I'd make is that, within commercial lines itself also we've seen good growth in specialty lines. And included in that estimate of the loss ratio points are estimates or modelling impacts of individual large losses. So, under our definition, you'll know that we include individual large losses above $3 million in that estimate and, as we built more specialty, what you tend to get is a slightly better attritional but you'll get a slightly higher, lumpier large loss load, if you like. So that's also reflected in the program. As is the reinsurance coverage that we get.

In terms of the aggregate itself, where that really helps you is like in 2022 where we've had this combination of a few large events and quite a number of midsized events. So, that really helped you be

more insulated around your target fleet or your model outcome. So, it really helps you when you have those wilder years like we had in 2022.

Mario Mendonca — Analyst, TD Securities

So, can I interpret that to mean that the $140 million or so does contemplate some type of recovery on the aggregate cover?

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

Not really. It models more some expectation around how our reinsurance, as a holistic basket, responds. But what it does do, it gives us comfort. And if we have an elevated CAT year, we're going to land closer to our budget. That's the way we think about it. So, this year is a great example. At the end of Q3, we were pretty much there in terms of our annual run rate for CAT loss expectations, but we knew the aggregate was in place and we knew it was ready to respond. I could sleep more peacefully at night in the fourth quarter because I knew if we had a big storm event, and we had one in late December, I knew that treaty was going to respond.

Mario Mendonca — Analyst, TD Securities

Okay. So, we should look at that four points, we have to give some consideration that it may trigger a recovery as well, depending on how the claims unfold.

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

I would. I think we look at it holistically, all those different moving parts when we model out, and I think it helps us with volatility. It's really helping us manage the mean around that midpoint.

Mario Mendonca — Analyst, TD Securities

Okay. Let me go to a different type of question. This might be best for Paul. I'm just tracking how the earned premium relative to your policies in force. It's my best sort of way of trying to keep track of how earned premium grows over time. And in personal auto, we've seen a really nice trend there as the earned premium relative to the policies in force continues to grow. But I suspect a portion of that relates to the relief that there was in 2021. So, what would be helpful for me to understand is how do you see that earned premium relative to the policies in force evolving in 2023?

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

Thanks for your question. And that's right. So, we're pleased with that trend as well. And just to remind everyone, in Q4 of 2021 we actually had negative rate flowing through the portfolio, in large part due to that premium relief measure that you've just mentioned. We've been unwinding that premium relief measure as of Q2 of 2022. We reached a point at which the net inflow matched the net outflow of the relief measures and therefore, for the next four to five months we would expect to see a positive impact that premium unwinding and it should be completely unwound by the end of May. So that's one component. At the same time, we've been increasing rate and continue to be working effectively at increasing the rate to cover the trend. There is a bit of a lag, as you indicated, in terms of when it's earned versus when it's written, but just to give you a data point, at Q4 we had about seven points of written rate

but just under three points of earned rate. That will continue into next year. And to answer your other question, that's expected to be in the 6% to 7% range in terms of earned premium next year. And one more data point to give you some comfort around why we believe this to be true. Our largest trading territory, Ontario, just last month we got an additional 3.5 points approved, and that will be earning through the portfolio in 2023.

Mario Mendonca — Analyst, TD Securities

Okay. So, when you say 6% to 7% earned in 2023, would it be appropriate to say that a good chunk of that happens in the first half because of the timing of the relief and then it moderates in the second half?

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

Actually, it's fairly consistent throughout, partially because, as I mentioned, that premium, the net outflow of the remainder of that relief is in the first quarter and a half, so it should be a fairly steady 6% to 7% earned rate. Now of course we'll continue to be vigilant on this and if we're seeing trends move the other way we'll continue to promote additional rate as necessary.

Mario Mendonca — Analyst, TD Securities

And again, all of these comments were about personal auto, right? That's what you're referring to there?

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

Yes, they were all about personal auto.

Mario Mendonca — Analyst, TD Securities

And then just moving to property, the trend has sort of gone the other way, still very strong growth in earned premium, but it's been tapering up as the year progresses. Can you offer a similar commentary for 2023 in personal prop?

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

Yeah, absolutely. Actually, as a data point for Q4 of 2022, we had about 7.6% written rate in the property and about 5.7% of earned rate. So still a slight lag that is anticipated to catch up in the early part of this year. And as you point out, we would expect at the front end of this year to have a slightly higher earned rate, in the 7% to 8% range, and that tapers off a little bit down to about 6%. But we will continue to monitor this very closely. We have, of course, incorporated additional rate as a result of the reinsurance renewal and we'll continue to monitor the weather trends to make sure that that's appropriate. What I can tell you is that we feel comfortable that the earned rate will be matching the inflationary trends. And in addition to that, we continue to take other action to improve the portfolio, underwriting actions and mix of business.

Mario Mendonca — Analyst, TD Securities

Thank you very much.

Operator

Ladies and gentlemen, as a reminder, should you have a question, please press star one.

Your next question comes from Tom MacKinnon from BMO Capital. Please go ahead.

Tom MacKinnon — Analyst, BMO Capital Markets

Yeah, thanks very much and good morning. A question, Rowan, with respect to your refined outlook for top line for 2023, modestly lower than the previous guide. And that refinement, what was driving that refinement? What segment? Is it a personal auto more? And what's the Sonnet outlook as a result of this revised guide as well? And are you still thinking about Sonnet breaking even? I think you said it was going to be in 2023, but then you pushed it out to 2024. With this lower top line right now, does that have any bearing on that breakeven for Sonnet? Thanks.

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

Sure, Tom, and good morning. That kind of, let's call it, a tweak in the guidance. I think the way we think about that is that's really just kind of part of cycle management and the way we think about the aggregate portfolio. So, commercial lines has really been growing very impressively, as you saw, like in the really upper teens, and as we think about the market and potentially some recessionary impacts later on in the year, we're reflecting the potential of that happening. So, I think in the commercial business, very

comfortable with the strong growth that we have, lots of opportunity, but it is off a bigger base and we want to be disciplined in that marketplace, and so we'll see where that goes.

In terms of the auto, that's really the area that I think makes sense for us to prioritize rate over unit count growth at this stage of the cycle. As Paul was just talking, there are a number of actions. We've been pleased to get some rate increases. There's a lag between as that comes in relative to the lost cost and so it makes sense for us to be a little tighter on growing share in the auto lines at this stage. And I think we're thinking about a few quarters here until that kind of moves forward. So I think what you would expect is really slowing the growth in auto a little bit, let's call it mid single digits given we've been upper single digits, and we think that's a few quarters before you resume back up to our normal upper single digits auto growth rate.

Where you do see a bit of that impacting is consistent with, I think, with what we guided last time around with Sonnet. Sonnet is still kind of growing. We don't think anything dramatically is going to change there. It looks more like 10%-ish growth for Sonnet, but very careful there not to sacrifice discipline for achieving our growth targets. And a lot of what we're doing in Sonnet is really focusing more and more on the higher-quality business in the territories we like. And so, the affinity story is one that continues to be very impressive. It actually grew 50% year on year for us last year. It's now a little over 20% of the total portfolio. We like it because it's got better credit and better retention, so we're going to continue working on that. But even with that, Tom, as we slow the Sonnet story, it doesn't change our overall guidance of what we're expecting from a breakeven. You're correct, we did say that it would be not a 2023 but a 2024 breakeven target, and we're still packing and targeting for that.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. And the second question is with respect to the $150 million net investment income guide for 2023. I mean if I annualized what you had in the fourth quarter, I'm above that. Was there anything unique in the fourth quarter or what can you add about that little arithmetic I did with respect to your guide?

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

Thanks, Tom. I think overall you're right, we're guiding towards $150 million for next year. That's assuming the rates don't shoot up as they did through 2022 or shoot down again as they did in prior years to that. So, whatever happens with the overall rate environment can obviously have a bearing on where we end up and land.

I think when you look at the year-on-year increases, we were still, you know, comparing to the low base there, and we have seen it start to slow quarter on quarter through this year. So, you know, Q2 versus Q1 we were up 17%. Q4 versus Q3 we're about 10% higher. The one thing I'd comment on that has a little bit of impact on the flow is on cash flows. So, what we've seen in the last couple of years with the low claims frequency, we've seen cash run up in the portfolio. What you normally see happen in the first part of a year is that you're a bit cash consumptive. So, we'd actually normally expect that we'd utilize some of the cash in the first half, because you get the weather frequency, the short tail claims, you don't really get the seasonality of the premiums coming up until the kind of mid part of the year, and then you pay off some big lumpy amounts of like CPCs, reinsurance, tax deposits. So, you usually get a bit of a cash drain in the first part of the year and with the high rates that you've been getting on cash holdings you

wouldn't necessarily see that come through. That's not really happened the last couple of years because we've seen that low level of claims frequency. So, I think that just distorts it a little bit as well, but overall we're still comfortable that that's a pretty reasonable expectation.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. And then the last question is with respect to, I mean the disclosure you have in the supplement, you basically flow everything into a reported income number and then you back out a bunch of things to give us operating, and so it's tough sometimes to get to other expenses that are associated with on an operating basis. But you can get them out of the financial statements and that shows $26.5 million in 2022, it only shows it on an annual basis, in public company expenses, which are operating. And these aren't really in the operating expenses associated with, or these are non-operating expense or, pardon me, they're in the operating income but they're not in the expenses in the combined ratio. So, what are these expenses, this $26.5 million in 2022, and how should we be looking at them kind of growing going forward? They are part of your operating income but, as I said, they reside in another thing called other expenses. So, yeah, maybe give us a little bit of guide there.

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

Sure. No problem. So, you're right, they're outside of underwriting income, but they are included in operating income overall. So really there are a number of things in there. Part of it is the corporate capabilities that we've been building up, so functions that are more corporate in nature, things like corporate development, strategy. There are associated costs of being a public company, so listing fees or some of the structures that we put in place. And then obviously allocations of time. So, certainly at an

executive level, both allocations of the cost base associated with the efforts we put into support public company. We didn't obviously have that in the past as a mutual. So, as we transitioned over, it's that kind of capture and allocation of that proportion of time cost and some of those new fees that are associated with running a public company. We also have in there some of the donations associated with the foundation. So, post the demutualization, you know, we are committed to supporting the foundation and we make donations annually based on profitability. Obviously, we didn't do that before when we were in the mutual form. So that's the nature of them.

In terms of how they're moving going forward, I think 2022 is a good kind of proxy to look at that. There'll be normal inflationary pressures on the cost base like they would be anywhere, but obviously the 2021 versus 2022 is distorted by the timing of the IPO and how we've then allocated and proportioned some of that cost and effort into that public company support.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. Thanks for that. I mean it'd be helpful to have this number disclosed not just annually and not on page 63 of a financial statement, but somewhere actually in the supplement, and if we can sort of work the supplement to work towards everything on an operating basis and then back things out of that into a net income basis, that would be helpful, at least in terms of trying to model operating earnings going forward. Thanks.

Operator

And your next question comes from Brian Meredith from UBS. Please go ahead.

Brian Meredith — Analyst, UBS Securities

Hey, thanks. Most of my questions were asked, but a couple of quick ones here for you. Just curious, back on the investment portfolio, what's your new money yield look like versus your current book yield on the portfolio?

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

Thanks, Brian. Yeah, so our book yield moved up quite a lot through last year, so we're at about, I think it's about 2.8, and we're achieving more than that on the new money. So, we're probably achieving somewhere between 50 and 100 basis points better than that. Now we'll see what happens going forward. As I mentioned earlier on, first part of next year, or this year I should say now, we probably expect it's a little bit consumptive, so the new money impact will be out further off in the second half of the year. That's what we anticipate, and we'll all see where yields are at that point. But there's probably still a 50 to 100 basis point spread between what's available there in the current book yields in the portfolio.

Brian Meredith — Analyst, UBS Securities

And what's the current duration on your investment portfolio, fixed income?

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

It's about four.

Brian Meredith — Analyst, UBS Securities

Four years? Okay. That's helpful. And then I guess my second question, I'm just curious, looking at your severity outlook that you gave, what is your assumption with respect to used car prices? And I'm just curious, what percentage of your claims would you say are kind of tied to what's going on with used car prices?

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

Okay. So, in terms of used car prices, what we've been seeing is a steady decrease in the price of used vehicles, which is a positive sign. That being said, we're still prudent in our forecast for what that might look, so we're not assuming a massive reduction in the short term and, as I said previously, we're pricing for that.

In terms of the percentage of the impact, it really impacts a number of categories. So obviously theft is a significant one and total loss is the other category. These are the two categories where your vehicle is no longer available to you and we, as an organization, then have to replace that vehicle with either a new or a used vehicle. It's a bit challenging to determine the exact amount of used versus new, because it really depends at the spot price of both the vehicle at the time and how much it might cost to repair. So we use a calculator to determine is it worth repairing or is it worth replacing, and that's quite variable over time. But to give you a sense of those two categories, the theft category represents 7% of our total auto portfolio and the non-drive or the total loss is 17%. So that together is about 24%, about one quarter of the entire auto portfolio in terms of that could be impacted. But again, that quarter is both new and used.

Brian Meredith — Analyst, UBS Securities

Gotcha. Is that a dollar figure or is that a number of claims? When you said that in 7% and 17%.

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

The percent of loss is a dollar figure in terms of the loss cost.

Brian Meredith — Analyst, UBS Securities

Okay. Gotcha. Makes sense. Okay. Awesome. That's really helpful. I appreciate it. Thank you.

Operator

And there are no further questions at this time. Mr. Westfall, please proceed.

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 two o'clock today until February 17th and a transcript will be made available on our website. Please note that our first quarter results for 2023 will be released on May 11th. That concludes our conference call for today. Thank you and have a great one.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for joining and ask that you please disconnect your lines.