



Definity Financial Corporation

Second Quarter 2023 Financial Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Definity Financial Corporation Second Quarter 2023 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, August 4, 2023. I would now like to turn the conference over to Dennis Westfall, Head of Investor Relations. Please go ahead.

Dennis Westfall — Head, Investor Relations, Definity Financial Corporation

Thanks you 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, where Paul and Fabian will be available to answer your questions. With that, I will hand it over to Rowan to please begin his remarks.

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

Thanks, Dennis, and good morning.

Before I get into the specifics of the quarter, I wanted to recognize the progress we have made on a few fronts. It's been an active year in advancing our operational and strategic objectives. We were early and deliberate on the rate increases taken in personal auto. This has intentionally slowed growth somewhat in the short term but sets us up very well from a profitability perspective. We've also responded to government intervention in Alberta auto with our intent to protect profitability. Our teams, from corporate development to commercial insurance to claims, have delivered on an array of initiatives from strategic to the day-to-day essentials. Since early in the quarter it has been our CAT response teams that have stepped up to the plate. Severe storms and wildfires have impacted communities across the country in recent months and I'm proud of our team's ability to be there for our affected customers during their time of need. Being there for those who count on us is why we're here.

Last night we reported results for the second quarter that continued our solid performance in 2023. Operating net income of \$64.8 million, or \$0.56 per share, benefitted from strong underwriting results, robust net investment income, and an increasing contribution from our recently strengthened distribution capabilities. Our 95.3% combined ratio was in line with our financial target, reflecting the benefits of our diversified business mix. Our commercial insurance business led the way with \$38 million of underwriting income while personal property results were resilient despite experiencing 17 points of losses from catastrophes. As expected, personal auto improved from the seasonally higher first quarter of the year to report a COR of 97.6%. This was driven by increases in frequency, continued elevated levels of claim severity from persistent but stabilizing inflation, and heightened levels of theft. We maintain our view that we can deliver an upper 90s COR in this line in 2023 as our rate actions begin to be reflected in

the results in the second half of the year. As our actions demonstrate, our top priority is defending our profitability in personal auto during this phase of the market.

Turning to the top line, I'll point out that this was the first time Definity has generated over \$1 billion of premium in a single quarter. That's quite an accomplishment. Strong growth of 9% was driven by commercial insurance and personal property, as our strategy to diversify our mix of business away from regulated auto demonstrates strong momentum. We continue to expect top line to reflect our disciplined approach to managing growth.

On a per-share basis, book value was 12.7% higher than a year ago, including the estimated impacts of the conversion to IFRS 17, and up 2.2 points from Q1. Continued strong operating results drove an operating ROE of 9.8% over the past 12 months. Although we've been actively deploying capital in our broker distribution business, we have a significant amount of financial capacity, putting us in a strong position to continue funding our strategic growth initiatives for the coming years.

Turning to the industry outlook on slide six, we expect firm market conditions in both personal property and commercial lines to persist over the next 12 months, particularly following another active period of severe weather events and the dynamics of the reinsurance market. We believe conditions in auto lines will continue to firm as insurers aim to keep pace with underlying cost trends.

Slide seven illustrates our key financial metrics. Growth, combined ratio, and operating ROE were in line with or better than our targets, which are unchanged from the prior quarter. We are confident that we have the growth platforms to outpace the market and we'll continue to protect company profitability

along the way. This was evidenced in the quarter by our actions to slow growth in our direct auto business until conditions return in Alberta that enable us to achieve a reasonable level of profitability.

You'll see on slide eight that we continue to diversify and strengthen the earnings profile of the business. Recall that we acquired a controlling interest in McDougall in October, thereby launching our efforts to build a broker distribution platform. We followed that up with the acquisition of McFarlan Rowlands in May, establishing a leading broker platform in Ontario. This also provided a solid foundation for geographic expansion. In June we announced our intention to expand our platform into Alberta with the acquisition of Drayden Insurance. The addition of Drayden will provide immediate scale and market-leading presence outside of Ontario. Each of these brokers has experienced management teams, highly valued brands, and generates excellent operating margins.

These acquisitions advance our ambition to build this platform into another \$1 billion business for Definity. We like the repeatable nature of distribution income, as they can serve as a hedge against volatility that sometimes occurs in underwriting. We also built this insurance broker platform to improve our access to high-quality portfolios, which come from delivering high service levels and fostering strong relationships with the brokers in our network. I'm confident the additional distribution income from this platform will support growth in our operating ROE in the coming years.

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 10 with personal auto. Premiums were up 2.6% in the second quarter of 2023, driven by an increase in average written premiums. This is particularly evident in Ontario, our largest single portfolio, and we were successful earlier this year in obtaining multiple rate increases in both our broker business and in Sonnet. We are proactively managing our business in Alberta with the ongoing regulatory constraints, which has led to a deliberate drop in new business volumes at Sonnet. We're committed to taking a disciplined approach to growth and have paused all Sonnet marketing activities in Alberta until market conditions improve. We are redeploying marketing efforts to other areas of the business where we see an opportunity for more profitable growth in the interim. We continue to be focused on our affinity and group segments, which continue to grow at a faster pace than retail.

In the quarter, Sonnet partnered with Tangerine to become the digital insurance provider for their digital bank customers. Tangerine's high-quality customer base aligns very well with our focus on affinity. In addition to continued strategic commitments to our affinity group and partnership growth strategies, we have recently launched our new usage-based insurance auto product in Ontario, exclusively to Sonnet customers, which has seen solid results in take-up since its pilot launch. The recent Tangerine partnership and UBI launch are expected to support Sonnet's longer-term growth strategy and offset some of the in-year impact from the Alberta rate pause.

Our reported combined ratio of 97.6% in the second quarter was 4.8 points higher than the results from a year ago and in line with our expectations. Rowan mentioned the primary drivers of profitability. I'll note that, although severity was up from a year ago, inflationary cost pressures have been stabilizing

and were down slightly from the first quarter of the year. As we discussed in our last call, theft continues to be a challenging issue for us and the industry, accounting for approximately 10% of our total auto loss costs and six points of loss ratio points over the last four quarters. In response, we are implementing both underwriting and claims initiatives aimed at addressing theft and also recovery. We continue to expect this line of business to operate in the upper 90s for the remainder of the year. We've taken meaningful rate actions across much of our auto book, which we expect will result in earned rate improvements that will more fully benefit results in 2024.

Turning to personal property on slide 11, we reported strong top-line growth of 12.3% for the quarter amid continued firm industry pricing conditions. We expect to maintain our growth outperformance versus the industry, supported by strong broker relationships and scalable platforms. Focusing on the bottom line, we reported a combined ratio of 102.5% inclusive of 17 points of CAT losses. Although the overall level of CATs for the company was largely in line with our expectations, personal property bore the burdens of these losses in the quarter. Despite the CAT events, actions to improve the underlying results are paying off, as core accident year results improved 5 points from the second quarter of 2022. We continue to target the mid-90s combined ratio for the personal property line of business on an annual basis, but I will remind you that Q2 and Q3 tend to be our most active CAT quarters, accounting for about 70% of our annual CAT losses.

Moving on to slide 12, you will see that strong growth in commercial lines continued in the quarter with gross written premiums up 15% versus the prior year as we continued to benefit from broad support from our broker partners across Canada. Growth was driven by strong retention and rate achievement in a firm market environment and further scaling of our small business and specialty capabilities. Commercial

lines combined ratio was very strong at 84.3% in the second quarter compared to 91.6% in the same quarter a year ago. The current quarter benefitted from a low level of CAT losses and elevated favourable prior year claims development. We continue to view this line as a key growth area for the Company and expect the commercial insurance business to sustainably deliver annual combined ratios in the low 90s.

Putting this all together on slide 13, premium growth was a strong 9% in the quarter while profitability at a consolidated level remained consistent with last quarter in the year ago at 95.3%, bolstered by the strong performance in commercial lines. The chart on the right illustrates the balanced nature of our earnings between underwriting income and net investment income as well as the growing contribution from distribution income. The diversified earnings profile gives us confidence that we can more sustainably generate operating ROEs that are inherently less volatile and with the potential to grow over time.

Slide 14 shows our investment portfolio in greater detail. Net investment income again increased substantially in the quarter, up nearly 35% from Q2 of 2022. This was driven by higher interest income from the combination of our proactive actions to capture yield in an increasing rate environment together with higher reinvestment rates. We expect double-digit growth to continue in 2023, resulting in an expected full year net investment income exceeding the \$160 million. This recognizes the solid start to the year while also taking into account the impact of our anticipated cash outflow for our investment Drayden Insurance.

As you can see on slide 15, our financial position remains strong. We are well capitalized with over \$660 million in financial capacity under our current legal structure and, subject to the continuance of

Definity under the CBCA, we could add another \$600 million in leverage capacity. These figures include our acquisition of McFarlan Rowlands, but not our announced acquisition of Drayden, which is expected to close in Q3.

Slide 16 shows recent capital management actions and longer-term priorities. While our capital management priorities remain unchanged, you will see we continued to make strong progress in our execution. As we continue on our journey to the optimization of our capital structure, our recent broker acquisitions represent concrete examples of our ability to deploy our financial capacity in a strategic and accretive manner. In July, DBRS recognized the progress we've made in diversifying our business and the steady improvement in our overall performance by upgrading the issuer rating of Definity Insurance Company to A from A (low). As we prepare for our transition to a CBCA, which we continue to plan for late summer, remember that we successfully renewed our debt facility and upsized its capacity to \$700 million immediately upon conversion.

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.

We've been clear that we believe we can build the Company into a top-five player in the industry. This requires continued inorganic growth, which will include both insurance carriers and distributors. The acquisition of McFarlan Rowlands and pending purchase of Drayden Insurance are expected to result in our annual insurance broker platform premiums of approximately \$900 million. Once Drayden is closed,

our insurance broker platform should generate over \$75 million in annual operating income before finance costs, taxes, and minority interests. This level of earnings contribution is possible as each run with excellent operating margins while benefitting from access to more than 50 insurance markets. McDougall will continue pursuing organic growth in addition to their successful track record of bolt-on acquisitions.

While we've been successful in quickly building a leading insurance distribution platform, we remain focused on our top-five objectives. Carrier acquisitions are very much part of the strategy, and our team continues to work to identify actionable opportunities. In terms of focus areas, we are interested in expanding our commercial insurance expertise and capabilities, particularly as it relates to specialty. That said, given our investments in technology, our platform is also well positioned to take advantage of any scale opportunities in personal insurance.

In closing, I'm pleased with our performance in the quarter and the excellent continued momentum in the business. We delivered strong revenue growth. Despite an active CAT quarter, we delivered on our target mid-90s combined ratio. Distribution income is building nicely and provides a new and stable income stream. Net investment income again benefitted from our actions to capture yield. And putting this all together, we move forward with a strong and growing balance sheet, which enables us to continue executing on our strategic vision.

With that, I'll ask Dennis to start the Q&A session.

Dennis Westfall — Head, Investor Relations, Definity Financial Corporation

Thanks, Rowan. We're 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 telephone keypad. You will hear a three-tone prompt acknowledging your request. Questions will be taken in the order received. Should you wish to cancel your request, please press the star followed by the two. One moment please for your first question.

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

Geoff Kwan — Analyst, RBC Capital Markets

Hi. Good morning. Just my first question was just on the capital you've been deploying on the distribution side, the relatively sizable acquisitions on the distribution side, and obviously it's to diversify your earnings. Normally when you've announced these your share price doesn't normally move off of this type of news. And my question is this, is how does the ROE on the distribution side compare to the insurance business? And the reason I ask it is just if the distribution has a higher ROE, then growing that part of your business should have positive implications for your consolidated ROE and, therefore, I think, would have positive implications for your valuation multiple.

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

Hi, Geoff. Thanks for that question. Yeah, I'd agree with that synopsis. If you look at the operating margins of the broker business in comparison to the carrier side, they are better and sustainably higher.

And I think the other thing that's important to us when we look at it, it's not just the contribution, which I agree is generally speaking at a high level, it's also stability. So the degree of volatility that you may experience on the underwriting side, there's a more sustainable base when you look at the broker platforms. They have very high retention levels, generally speaking, higher than the insurance side, and a pretty diverse portfolio with a good base commission level. So I'd agree with your synopsis in terms of the contribution, but also we're pretty keen on that stability aspect and the diversification it gives us in the overall profile.

Geoff Kwan — Analyst, RBC Capital Markets

Okay. And just the other question I wanted to ask is just on the auto theft side. Are there certain measures that you're taking right now or you plan to be taking to try and mitigate that impact? I know there's stuff like vehicle tracking technology that some insurers may be using, just wondering if that's, like I said, if you're using that or, just in general, how you're trying to tackle the impact of auto theft.

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

Thanks, Geoff. Actually, just to level set, what we're experiencing is quarter-over-quarter frequency in severity and theft is slightly decreasing, which is positive, but it still remains elevated, as you've indicated. As Phil mentioned earlier, the loss ratio impact of this is about six points, and to give you a sense of comparison, it's about two points pre-pandemic. So we're experiencing about a 4% unusual drag on our results. So that's why we are taking corrective actions to address this.

So, there are a number of things that we're doing. First and foremost, of course, there's an underwriting and pricing component and we're particularly targeting high-theft vehicles. So, depending on what our models suggest around the types and models of vehicles, we have ensured that we've increased premiums related to them. And we're encouraging customers also to take proactive steps and actions to avoid that in those classes of vehicles. In addition, we have implemented a variety of different initiatives around vehicle tracking, which will help us track and recover stolen vehicles and, as we've said before, theft is a very expensive component on our portfolio because often you don't get the recovery. So, wherever you can recover something, that's very beneficial to our performance.

And of course, we continue to make improvements to our enhanced predictive modelling scenarios. So, this both allows us to identify types and locations of potential stolen vehicles. It also allows us to connect up with our fraud initiatives. So, we've helped to identify a number of fraud rings and we've worked with local authorities to both break up those rings and recover any vehicles in that area. So, we're confident that the industry as a whole, and Definity particularly, is focused on this issue. As I said before, we're starting to see a slight decrease, and too early maybe to call a trend, but we're cautiously optimistic that we will continue to focus and remediate this part of the business.

Geoff Kwan — Analyst, RBC Capital Markets

Okay. Thank you.

Operator

Thank you. And your next question comes from the line of Jaeme Gloyn from National Bank Financial. Please go ahead.

Jaeme Gloyn — Analyst, National Bank Financial

Hi. Good morning. First question just on the commercial lines portfolio. Obviously, a good headline, combined ratio beat, but seeing some core accident year uptick year over year. Wondering if you can kind of dig into perhaps what was driving that uptick and anything structural or persistent in those trends.

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

Thank you, Jaeme, for your question. This is Fabian Richenberger answering your question. So overall I would say that we are very pleased, as you said, with the results that we achieved in Q2 and we believe that the combined ratio that we have in our portfolio is now solidly in that 90% range. I think what is important to recognize is that if you have a commercial portfolio of our size, any given quarter you will have different loss patterns based on seasonality, based on weather, based on large losses, and based on CAT activity. And as you said and as you pointed out, the impact that we had in the second quarter from the weather on our CAT loss ratio was very low. It was only 1.2%. But as you would expect, based on all the weather that we have had to go through in Canada, the impact on the attritional loss ratio was a bit elevated, but we are really not concerned about that.

If you look at what you're doing on the underwriting side, what we're doing on the rate side, we are very comfortable that we are mitigating the impact of inflation, that we're mitigating the impact of

higher reinsurance costs quite effectively. We're getting about 8 or 9 points of rate if you add the impact of inflation adjustments, the premium change from that is in the lower double-digit range, and that gives us confidence that we are, as I said, that we are mitigating the impacts of inflation and reinsurance very effectively and, again, that gives us confidence that we'll continue to run the portfolio in that lower 90% range and we'll be able to continue to drive growth rates in that mid-teen level as well.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. So if I understand correctly, weather, which maybe normally would have driven higher CAT losses, just ended up driving higher attritional losses. It's as if some losses didn't reach the CAT threshold. Is that kind of the right way to think about it for this quarter?

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

That's exactly, yes. If you normalize our combined ratio, we posted an 84.3%, and Phil will give you more details on the impact of a COVID-related release, so that gives you a normalized combined ratio in the second quarter in the high 80s range, again, that's in line with our guidance, and based on the rate and underlying actions that we are taking, we are confident that we'll be able to continue to run portfolio in that 90% range.

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

Jaeme, I think the big picture for us there is, as you know, we're trying to shift the overall portfolio by growing personal lines, property, and commercial lines at a rate faster than the regulated auto, so we

continue to be very pleased with that impact of growing commercial on the overall company. And then even within commercial insurance there is a mix change as well where we're getting above average portfolio growth in specialty and in small business, which further improves the margins on that commercial business. And Fabian and the team have done a tremendous job of leaning into the market and ensuring that we consistently are achieving earned rate at higher than the lost cost trend and so that's where we come back to. Each quarter is going to be a little bit different, but with a very strong level of confidence of continuing to run this business in the low 90s for quite some time ahead.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. Great. And following up, Fabi, on that COVID release, my understanding or my assumption is that that's, I guess, somewhat one time and the reserve development we saw this quarter should return back to, let's say, a low single-digit reserve development in the upcoming quarters and into future years. Is that a fair assessment?

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

Yes. Thank you for that. That is a fair assessment. So, you've certainly seen a higher-than-normal level of favourable developments in the quarter and it was triggered by successful progress in the outcome of the class action on the COVID BI claims. It's a good example, though, I'd say, of the prudent approach to reserving. So, while we were confident throughout the class action process of our position, we were prudent in establishing those initial reserves, which ultimately supported the drawdown. So yes, you're right, we wouldn't normally see this level of elevated PYD in the quarter on commercial lines, but it is indicative of the kind of prudent approach that we take in establishing reserves for these kinds of issues.

Jaeme Gloyn — Analyst, National Bank Financial

Very good. Okay. Shifting to the broker acquisitions, obviously it's flowing through distribution income nicely and you're getting some benefit there, but it's also coming through the expense side. I was just wondering if you'd be able to quantify that benefit from the broker side and eliminating commission fees on consolidation. So, when I think about like the expense ratio or commissions coming down, let's say, 40 basis points, sorry, 60 basis points year over year, how much of that would be driven by the broker, the owned broker commissions being eliminated? Is there a little bit more colour you can provide on that benefit?

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

Sure. It can move around quarter on quarter, because it obviously would be dependent on the flows of the business that gets pushed through the brokers, but it is the primary cause for the reduction that you're seeing the commission ratio there. So, I'd say probably two thirds to three quarters of the 0.5 or 0.6 you're seeing come down in the quarter was attributable to the consolidation. It can move up and down a little bit depending on the quarter, but it is giving that beneficial run rate in the expense ratio, as you say.

Jaeme Gloyn — Analyst, National Bank Financial

Okay, great. I'll re-queue.

Operator

Thank you. And your next question comes from the line of Paul Holden from CIBC. Please go ahead.

Paul Holden — Analyst, CIBC Capital Markets

Thank you. Good morning. So, clearly making some good progress on personal auto and it seems to be trending in line with your expectations. Maybe you can just do a quick drill down for us on what earned premiums look like in Q2, i.e., what's the rate of change on earned premiums, what do you expect for Q3, and then Q4 also just so we can get some sense in the building momentum there.

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

Thanks for the question, Paul. Let me just going to start that off and then I'll ask Paul to add some flavour and specifics to your earned rate question. Look, I think that, when we sit back and look at the overall environment, we know that it's been normalizing in the post-COVID period and we're seeing sort of increased evidence of now the environment stabilizing. So that's really positive for us. When you look at the big picture, we know that year-on-year frequency is up, but we see that kind of flattening now and it's going to remain, likely remain below the pre-COVID levels. So that's a good point.

On the severity of inflation point that you talk about, we have to remember it's still elevated when you compare to year on year, but absolutely stabilizing. So, I think those are pretty good forward-looking impacts. And then not only are our prices moving up, but the industry is moving up as well, and that's also very relevant because it will maintain our competitive position. We might have been a little earlier than the market and, as the market starts to follow with price increases, and we are actually seeing rate increases being approved by the regulator right across the industry, that is going to mean we're going to

keep high levels of our retention and earn the rate, so that earned rate is obviously very important for us. And the main message here, and don't forget the big picture, is this is still about cycle management for us. We are absolutely prioritizing margin over rate through the portfolio and that has led to the actions that Paul and his team have taken on rates.

Paul, why don't you get into a little bit more detail on what we're seeing on written and earned rate?

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

Yeah. Thank you, Rowan. And so, as we previously disclosed, we leaned hard into asking for additional rate on our auto portfolios in the first half of the year. So, as of Q2, the written rate was just over 7%. But as we've also previously disclosed, the earned rate takes a while to come through the portfolio and we expect that to increase dramatically in the back half of the year. So, to give you a point of reference, in Q2 our earned rate was just under 5.5 points of earned rate. Toward the end of this year, that's going to increase by 3 points to 8.5 points rate, which is a material improvement to the overall portfolio. And it doesn't stop there. Into next year we go up into the double-digit earned rate increases throughout the portfolio. And as Rowan says, given the double-digit rate increases that are flowing through the industry as a whole, we have a high degree of confidence that we will retain that rate.

Paul Holden — Analyst, CIBC Capital Markets

That's helpful. Thank you. Thank you for that. And given that you're expecting to trend to 8.5 by the end of 2023 and that severity remains high on a year-over-year basis, your expectation for sort of that crossover somewhere around the middle of this year is unchanged, i.e., the pace of earned is good enough to exceed the increase in severity?

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

Paul, just as a reminder, there's really two crossover periods. One is the written rate exceeding the severity trends and that's happening essentially right now at the midpoint of the year, as we've previously discussed. The crossover point at which the earned rate is covering the trend is going to occur toward the end of this year. And so, we are encouraged to see the path, as you indicated, and as Rowan indicates, frequency remains consistent quarter over quarter, which is positive and, as Phil indicated earlier, severity has turned it come down a little bit, so if that pattern continues that should bode well for our trajectory.

Paul Holden — Analyst, CIBC Capital Markets

Okay. Got it. The next question for me is regarding climate risk. Now you were less impacted by CAT events than your major public comp this quarter, but still climate risk seems like it's an increasing question from investors. Like is there anything you're rethinking in terms of reinsurance, product structure, claims management in respect to climate risk? Like has anything really changed in your mind or is this really a continuation of trend that we've seen for the last 10, 15 years?

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

Yeah, I think the short version of this is it's a continuation. So, climate change is increasing as expected, and it makes it quite difficult to predict where and when it will occur. While we're proactively managing concentration of risk to ensure we aren't exposed in areas like Alberta hail zones, it's very difficult to predict exactly where other things like tornadoes and severe rains are going to occur. But despite this, we do actively manage our CAT volatility in our portfolio through a number of different mechanisms.

So, first and foremost, we use sophisticated CAT modelling tools for key perils like quake, wildfire, flooding and hail, and we continue to enhance those models. Our Sonnet and Vyne automation allows us to dynamically suspend binding activity in the face of impending CAT exposure, so we can reduce CAT exposure from that angle. We continue to improve our claims handling processes and enhance our vendor relationships to minimize exposure post a CAT event. And we really have a multiyear view of CAT volatility. So, back to your point, this is why, for us, the expectation doesn't really change, because we look at this in long year cycles, which inform our pricing strategy and our choice of reinsurance structure. So, of course we continue to remain focused on continued improvements underneath our property portfolio and, as was indicated previously, we're delighted to see a 5% year-over-year improvement in this quarter, which also helps manage the overall CAT volatility of the portfolio. So, when you take all of this together and when we adjust for the elevated CAT this quarter, our expected core is in the mid-90s, which is in line with our run rate expectations. So, despite the elevated levels of CAT, this is something that we expect and we price and action for and therefore we end up with the results that we guide to.

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

And Paul, maybe just to comment on reinsurance, in terms of philosophy, it's pretty consistent as well. So, when we look at reinsurance, we look at it in the context of protecting the company from large events. So obviously we have the catastrophe treaty that we structure in place there. We also look at individual large events, so our purchases of risk coverage on individual events or facultative, depending on the complication of the risk. But we also do have an eye to volatility management. So, Paul has talked a lot about the actions we take there. Consistently we've tended to perform below market share, when we've looked at annual levels of CAT losses, and a large part of that is being well distributed across the country and being cautious of the key CAT areas.

And the last comment I'd make is I'd just remind you of the aggregate cover that we have in place for this year and also through 2024. For us, that was an important tool, because as we grow property and commercial lines and take on some more climate exposure, we're leveraging the balance sheet to support that, but we knew as the attachment points move on the CAT treaty, we wanted some coverage from the aggregates, and that, at the end of the second quarter, was about halfway to being switched on. I always talk about it in the context of, you know, it's to protect you from multiple kinds of mid-sized events. It gets to a point where it's switched on and then it's available for recovery against what comes next. We were probably about halfway to that coverage being switched on by the time we got to the second quarter. That helps give us some comfort around management to expectations in the second half of the year.

Paul Holden — Analyst, CIBC Capital Markets

Okay. That's helpful context. Thanks for that. Last one for me, and I want to go back to one of the questions that Geoff asked regarding the broker acquisitions and impact on ROE, also a question I'm hearing a lot from investors. And so just to sort of fine-tune the question, based on the multiples you're paying for these acquisitions, are they immediately accretive to ROE? Does it take time for the ROE accretion to come through? I think that's kind of the answers people are searching for, so any help there would be appreciated.

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

The first kind of comment I'd make is, yes, they are immediately accretive to ROE, so we're pleased with that. I think the other points that I would kind of add to this is, if you go back, we really like distribution and, as we've said before, like the stable margin earnings, and also we like the access to a pool of high-quality distribution income. So don't forget, when we think about the contribution, as per the earlier question, there is the distribution impact, there's an elimination of commissions, but also we write a significant amount of high-quality business, which we generate underwriting profits on. So there are really two streams of income from that for us here, underwriting income in addition to distribution income. So that's why this is immediately accretive and favourable to our ROE targets.

The other point I would make is that, when you think about what we've done, we wanted to build a platform, and we've really leaned in, firstly, in Ontario with McDougall, then with McFarlan to build out a solid platform, and now we've taken that outside of Ontario. We've been very fortunate that we've been able to attract what I would say is top-notch assets. I mean these are scarce opportunities in the marketplace given their size and their expertise and track record. And so that gives us a lot of confidence.

What we've bought is a very high-quality asset here that generates above-market returns and growth outlook. So that's going to be very helpful to us.

And I think the next phase of this really is, as we start shifting from these anchor brokers to more programmatic bolt-on M&As, which they currently do and, you know, they're not large enough for us to report or announce those, but those are happening, and what we see in those areas is they are really quite synergistic. And so there are obviously revenue synergies they bring, they have more influence over the mark of their insurance companies and yield management, and of course back-office synergies. So not only is it very strategic to us, but to answer your point, it is immediately accretive and very helpful to our operating ROEs going forward.

Paul Holden — Analyst, CIBC Capital Markets

Great. That's all I had. Thanks for your time.

Operator

Thank you. Once again, should you have a question, please press star then the number one on your telephone keypad.

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

Brian Meredith — Analyst, UBS Securities

Thanks. Good morning. A couple of questions here for you. Just focusing in on the brokers a little bit here, I just want to clarify, the \$75 million includes McFarlan and Drayden in it, correct?

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

That's correct. Yes.

Brian Meredith — Analyst, UBS Securities

Okay, great. Just wondering. And then how do I think about just the breakout of where the earnings is coming from those brokers? I know you've got some commission benefit as well as just the distribution income. Is that \$75 million inclusive of both the commission benefit and the distribution income or is that just simply distribution of income?

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

No, that's fully inclusive. What it would exclude is a high-quality underwriting opportunity. So, to Rowan's point that he's just made, if we're able to grow more and attract high-quality customer opportunities, that would benefit the loss ratio and premiums, but the \$75 million is fully inclusive of the expense benefit as well as the distribution income.

Brian Meredith — Analyst, UBS Securities

Gotcha. Okay. That's helpful. And is it possible, I know that's kind of like a 2024 run rate, to give us kind of what the current run rate is so I can kind of think about it for the remainder of this year?

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

For the current year, just including the McFarland transaction, we have about \$50 million expectations fully loaded for the current year. If Drayden closes, it would go up a little bit further after that. And we're confident Drayden is going to close, but obviously it's just subject to an approval process. That's for 2023.

Brian Meredith — Analyst, UBS Securities

Gotcha. And then last question, just on personal auto insurance, taking a look at here, we've seen PIF decline versus the second quarter because of some of the initiatives and what you're doing in your discipline. When do you think, now that written rate is exceeding trend, do you think we'll start to see that reverse at all here soon?

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

I mean I think, Brian, on that particular point, we're not anticipating a significant change in the next couple of quarters from a unit count perspective. What we're really focusing on this time, as we've mentioned, it's really margin over growth. I think there are a couple of different stories in the portfolio. The broker business, which is more rate adequate and higher quality and more of a mature portfolio, continues to grow and we're quite comfortable about that. Really it's the Sonnet area and particularly with respect, you know, essentially exclusively driven by Alberta that we've really tapped the brakes on that issue. We're not expecting any change on that portfolio until the end of the year. The freeze is in place until the end of the year. So that's why I think when you ask about the growth in auto, it's the kind of low single digits for the next couple of quarters. That's all rate. And really, I don't think we're expecting to see much of a change to unit count until we get into 2024. I think then that will start to normalize.

Brian Meredith — Analyst, UBS Securities

Makes sense. Very helpful. Thank you.

Operator

Thank you. And your next question comes from the line of Tom MacKinnon from BMO Capital.

Please go ahead.

Tom MacKinnon — Analyst, BMO Capital Markets

Thanks and good morning. Just a follow up on the PIF question here. If I look at the gross premium, if I look at gross premiums written per policy, that's kind of only up about 2% year over year, despite the rate hikes. Is this strictly just a mix change?

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

Yeah. It is a combination, of course, of the Alberta freeze, which freezes rate, but it's also very much a mix change. So, as we continue to take actions to improve the profitability of the auto portfolio, that results in lower AWP, because it's a higher-quality client.

I'll remind you also that we're focusing very hard on growing our affinity portfolio in Sonnet. That typically comes in at a 10% to 15% discount relative to retail rates. So that clearly drives the AWP down, but it's a much higher-value client in the long term with far lower experience on the loss side. And just to give you a couple of data points around how successful we are being with that, affinity has grown 20%

year over year and it's now representing 25% of Sonnet, which is up from 19% last year. Another proof point: it now represents 32% of our new business counts.

So, we're pushing very hard in that space. As Phil mentioned in his opening remarks, we're delighted to have partnered with Tangerine, which is the leading digital bank. They've got over two million high-quality customers that are very focused on digital transactions and we've had great success so far with that partnership. Those customers come to us and have a much higher conversion rate, much higher retention rate, and essentially on every risk characteristic they're a higher-quality customer, which is a proof point for us of why we continue to make the strategic investment. But in the short term, that will result in lower AWP, and in the longer term, obviously, will make up for it in growth.

Tom MacKinnon — Analyst, BMO Capital Markets

Maybe just a question on Sonnet. We don't hear much conversation on Sonnet anymore. It seemed to be a big part of the IPO, we tracked all the great growth you were getting in Sonnet, and now it's hard to find any mention of Sonnet at all in anything that you guys would produce and it doesn't seem to come up much in terms of the conference. What is the future of Sonnet? It seems to have stalled a bit now. I guess getting insurance in seven questions may not necessarily bring in the right kind of client you want in this environment, but maybe you can elaborate a little bit on that for us. Thanks.

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

Yeah, Tom, on that one, look, I think it's still a strategic part of our platform. When we think about auto, we think about it as a total portfolio, but of course there are two parts to the market. There's an

intermediated path and then there is the Sonnet path. I think what we've guided, if you kind of step back, is that we think that Sonnet is a great tool to have for changing customer demographics over time.

What we've also said is that we had a path to profitability and what we were trying to do is scale this business to a reasonable level and ensure that we could get to a breakeven. At the IPO we were talking about at the end of 2023 and then, given the post-COVID hyperinflationary environment, we've moved that out to the end of 2024. And we still believe that is in line. So, the focus for us has been, at this stage of responding to the market cycle, a little less about rapidly scaling Sonnet, but staying disciplined, putting the underwriting quality in to ensure that we are on path to profitability, and that's really been the priority that we've got.

So back to, I think one of the earlier questions, Sonnet is, you know, we've tapped the brakes, let's put it that way, on Sonnet, particularly on the auto lines, for the next few quarters. It's been magnified by the fact that a third of the automobile portfolio of Sonnet happens to be in Alberta. So that's, again, responding to a bit of a unique and temporary position. So, I think once we roll out of this year, with all the favourable trends we're starting to see and our confidence overall with the auto segment picking up, we expect that to kind of, let's call it, normalize, we'll go back to previous trends, but in 2024. That's the way we think about that.

Tom MacKinnon — Analyst, BMO Capital Markets

The decision to tap the brakes with respect to Sonnet, like pulling ads and that, does that have an impact on that operating expense ratio? It seems to be a little bit lower than what it's been in the past. When you kind of decide to ramp up on Sonnet again, would that increase?

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

Yeah. So, a couple of points on that. So, as Rowan has indicated, our desire to tap the brakes has been mostly supported by us dramatically reducing our marketing expenditure in Alberta, so that has a temporary impact of slightly reducing the expense. It does take a little while for us to reset. When we reallocate those marketing dollars to other jurisdictions, the algorithms have to reset and it takes a while for those efforts to begin to take hold, but we expect that to occur. And while we are tapping the brakes on Alberta auto, we are certainly not tapping the brakes on our investments in Sonnet as a whole.

So, as I just mentioned, we are very pleased with our continued efforts in growing Sonnet, particularly in the affinity space. And as Phil mentioned in his opening remarks, we've also just recently completed a pilot in UBI, which is focused solely for Sonnet. So this is an exciting new product that has completed its pilot phase. We are now going to be rolling it out to all of Ontario and thinking about future expansion. And this is a Sonnet investment to help Sonnet customers and Sonnet affinity customers come up with another product to help improve conversion rates and improve long-term profitability. So, we are very committed to this space, and we feel that, with the earned rates coming through in the back half of the year and into next year, which are even higher than the broker portfolio, we're quite excited about this.

Tom MacKinnon — Analyst, BMO Capital Markets

Thanks for the colour.

Operator

Thank you. And we have a follow-up question that comes from the line of Jaeme Gloyn from National Bank Financial. Please go ahead.

Jaeme Gloyn — Analyst, National Bank Financial

Yeah, thanks. Two follow ups. First one is, sorry if I missed this, but what's the latest on the CBCA conversion?

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

Thanks, Jaeme. So, no specific update at this point in time. I will say we're continuing to actively pursue what we think now are the final stages of the approval process. And as we said last time around, we're continuing to plan for late summer kind of timing for an approval outcome. We don't control the outcome or the timing, but we do continue to believe that any risk of non-approval is very low at this point in time. So, as you've seen from the balance sheet, we're well positioned, our financial capacity is strong, but late summer would be our kind of planning expectation at the moment.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. And the second one is, Rowan, you talked about or you just reaffirmed your desire to execute carrier acquisitions. I'm curious what you're seeing in terms of the M&A market on that front. Are you seeing any more, let's say, I don't know, liquidity, if that's the right word, in terms of the acquisition opportunities there?

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

Yeah, it's a hard one to kind of answer there other than to say we are active in the marketplace. We think this is an important part of our strategy. And I think the macro trends are favourable for increased M&A activity, right? And I think that when you think about some of the comments we made earlier in the call about some of the pressures on certain lines of businesses like automobile on the need for technology, on commercial lines, when you think about the larger impact of reinsurance and natural CAT kind of events, this favours, I think, companies with bigger balance sheets and larger scale and particularly those that have already made a lot of technology investments. So, our thesis is that there will be more opportunities over time. And I think I'll remind everyone, you know, we've made massive investments to be able to participate in that. And some of those outsized investments we made leading up to our life as a public company really mean we've got a platform that's built for a bigger business than we are today. And as we grow organically, as we do with our growth engines at a rate ahead of the market, but as we supplement in organic activity, that's really going to be, I think, a favourable impact to our operational leverage and future ability to get synergies. So, we're still very confident in that thesis but, as you know, these are opportunistic things and it's hard to be specific about timing.

Jaeme Gloyn — Analyst, National Bank Financial

Yep. Understood. Thank you.

Operator

Thank you. Mr. Westfall, there are no further questions at this time. Please proceed.

Dennis Westfall — Head, 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 2:00 p.m. today until August 11th and a transcript will be made available on our website. Please note that our third quarter results for 2023 will be released on November 9th. That concludes our conference call for today. Thank you and have a great weekend.

Operator

Thank you. Ladies and gentlemen, that does conclude our conference for today. Thank you all for participating. You may all disconnect.