Definity Financial Corporation

Fourth Quarter 2023 Financial Results Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Definity Financial Corporation Fourth Quarter 2023 Financial Results Conference Call. At this time, all lines are in 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 16, 2024.

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, Sergio, 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; Paul MacDonald, EVP of Personal Insurance and Digital Channels; Fabian Richenberger, EVP of Commercial Insurance and Insurance Operations; and Bryan Lillycrop, VP of Financial Reporting. We'll start with formal remarks from Rowan, followed by a Q&A session. Paul, Fabian, and Bryan will also be available to answer your questions during the Q&A.

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

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

Thank you and good morning, everyone. As Dennis mentioned, Bryan is joining us in place of Phil, who is unable to participate today as he is recovering from a minor procedure. I'm happy to say that he's doing well and will be back at full strength with us soon.

We reported strong fourth quarter results last night that enabled us to deliver a full-year performance in line with our financial targets despite an elevated level of catastrophe losses this year. In the quarter, strong underwriting income, robust net investment income, and growing contributions from our insurance broker platform resulted in record operating net income of $100.7 million or $0.86 per share. From an underwriting perspective, our fourth quarter combined ratio of 90.6% reflected solid performance across our portfolio with particularly strong results in personal property, the benefit of higher earned rates flowing through the business combined with milder weather to generate improved core accident year loss ratios in all three lines. Lower CPC accruals and operating expenses further improved our results. We continue to leverage our strong broker proposition and digital platforms to drive solid overall premium growth of 9.4% in 2023, ending the year with gross written premiums exceeding $4 billion for the first time. For the full year, we delivered a 95.9% core, which included a trough period for personal auto results early in the year and approximately 2 points of CAT losses above our 2023 expectations. I want to thank our CAT response teams who were there for our customers in a challenging year. Operating results benefited from growth in net investment income, driven primarily by higher interest income that was enhanced by our active management of the portfolio in the rising interest rate

environment. Overall, our financial performance led to an Operating ROE of 9.2%. I'm confident in our ability to continue to deliver on our key financial targets and I'll expand on that in just a moment.

Our operating results, combined with significant mark-to-market gains on investments, drove a substantial quarter-over-quarter increase in book value per share. With our successful CBCA continuance now in place, our pro forma financial capacity at year end exceeded $1.2 billion. This provides significant flexibility to support the ongoing growth of our business. The confidence in our operational outlook is demonstrated by the more than 16% increase in our quarterly dividend, which delivers on our objective to consistently grow our dividend over time. While still early in our life as a public company, we've now increased the dividend by a cumulative 28% from its starting point at IPO.

Turning to the industry outlook on slide six, we believe the operating environment is one that remains conducive to sustaining favourable market conditions. We expect conditions in auto lines to continue to firm as insurers aim to keep pace with the combined impact of elevated theft, lingering cost pressures, and ongoing regulatory uncertainty in Alberta. We also expect firm market conditions in personal property will persist, particularly following a second consecutive year of industry CAT losses north of $3 billion, ongoing cost pressures on building materials and labour, and the dynamics of recent reinsurance renewals. In commercial insurance, we expect the market to remain firm as carriers focus on ensuring long-term profitability and sustainable availability of capacity. Overall, we expect the industry's return on equity to be close to its long run average of 10% in 2024.

Slide seven illustrates our key financial metrics. I've already touched on our ability to deliver on our growth and combined ratio targets. We view this combination of mid-90s core with above-industry

growth as an effective way to create shareholder value. We're confident that we've got the growth platforms to outpace the market over time and we'll continue to protect and improve Company profitability along the way. The strength in underlying profitability, combined with expansions in investment and distribution income, are expected to increase operating ROE to 10% or more in 2024 and beyond. As such, we've increased the low end of our operating ROE guidance range, recognizing that the challenging weather events from the third quarter of 2023 will weigh on this metric until the second half of 2024.

You'll see on slide eight that we made great strides last year to diversify and strengthen the earnings profile of the business with repeatable distribution income that complements our underwriting operations. We closed the acquisition of the Drayden brokerage early in the fourth quarter. McDougall and McFarlan Rowlands have well-established operations in Ontario while our addition of Drayden provided immediate scale in Alberta. Within months of joining McDougall, Drayden has already completed two additional acquisitions in Alberta, furthering its market presence. These additions bring the platform to our initial $1 billion ambition. Looking ahead, we expect continued M&A activity and the organic growth potential of the business to result in $1.5 billion of managed premiums in the next three to five years. In 2024, we expect our national broker platform to generate operating income before finance costs, taxes, and minority interest of approximately $75 million through a combination of distribution income and lower consolidated commission expenses.

Let's now turn to our line of business results, starting with personal auto on slide nine. For the full year, top-line growth was 4.9%, as our early-mover approach to rate increases impacted growth for much of the year. Stronger top-line results in the fourth quarter are an indication that our competitive position

has improved as the market firmed. Strong retention in our broker business and higher average written premiums combined to generate a 7.6% increase in premiums this quarter. We're committed to taking a disciplined approach to growth and expect to maintain our pause on all Sonnet marketing activities in Alberta for the foreseeable future. For now, we're focusing on other areas of the business where we see opportunity for more profitable growth.

Personal auto reported a solid combined ratio of 95.9% in the quarter, up slightly from a year ago. Our overall claims ratio was up 4.1 points, despite improved core accident year results, as unusually high prior year favourable development from industry pools aided results in the comparable period of 2022. Frequency has stabilized now that driving patterns have normalized while the rate of inflation for auto physical damage has continued to stabilize current loss severity trends normalizing to pre-pandemic levels. For the full year, personal auto reported a 98.3% combined ratio, inclusive of two additional loss ratio points from theft compared to the prior year. Theft continues to be a major challenge for us and the industry, accounting for approximately seven points of loss ratio over the last four quarters. In response, we are continuing to implement both underwriting and claims initiatives aimed at addressing theft and auto recovery. We have taken meaningful rate actions across much of our order book, which is resulting in earned rate levels that now exceed loss cost trends. They are expected to more fully benefit both top and bottom line results in 2024. For the full year, we expect to run personal auto at a mid to upper 90s combined ratio, but likely at the higher end for the first quarter of the year, reflecting typical levels of winter seasonality.

Turning to personal property on slide 10, growth of 3.7% slowed, as expected, from recent levels. The slowdown was the result of lower levels of portfolio transfers than the same period in 2022 and our

actions to address risk concentration in CAT-exposed regions. Though the timing impact from portfolio transfers will continue into 2024, we expect this line to grow at a mid to upper single digit pace for the full year given the firm pricing conditions prevalent in the industry. Focusing on the bottom line, we reported a combined ratio of 80.1% compared to 90.1% in the same quarter a year ago. All components moved in the right direction, aided by benign weather. Our focus on disciplined underwriting and proactive rate actions enable us to earn an underwriting profit in 2023 despite 15.6 points of CAT losses. We've increased our expectation for Company-wide CAT losses to 4.5 points in 2024, up from 4 points last year, and have taken rate actions to offset this change. As such, we continue to target mid-90s combined ratio for the personal property line of business on an annual basis.

Slide 11 outlines the highlights in the quarter of our commercial business, as double-digit growth in commercial lines continued with gross written premiums up 14% versus prior year. Our strong results in commercial insurance reflect firm market conditions, our underwriting capabilities, and a comprehensive value proposition that's well supported by our broker partners across Canada. In small business, our SME Pathway capability is doing very well and allows our broker partners to quote and bind over 50% of their business in an automated and digital manner. In specialty, our D&O, E&O, surety, and large account capabilities are also benefiting from strong momentum, the result of the comprehensive underwriting and risk management capabilities we now have in place. We expect commercial insurance to maintain growth at a double-digit to low-teen pace in 2024. Our fourth quarter combined ratio of 93.3% was above Q4 of 2022, primarily driven by CATs. At close to 8 points of core, CATs in the quarter were the result of individual large losses. The timing and occurrence of these types of losses vary by quarter. Overall, we look at CAT losses on a 12-month basis and they were within our expectations for the year as the business delivered an 88.8% combined ratio in 2023. We continue to expect the commercial insurance

business to sustainably deliver annual combined ratios in the low 90s. With a banner year performance that includes 15% growth and high 80s combined ratio, I think it's fair to say that the business is in great shape as we continue to build towards becoming a top-five player in the market.

Putting this all together on slide 12, consolidated premiums reached $1 billion in the quarter and slightly over $4 billion for the full year, representing growth of 8.5% and 9.4%, respectively. The disciplined nature of our growth through our underwriting expertise, pricing strategies, and prudent reserving resulted in a fourth quarter combined ratio of 90.6%, 1.6 points better than the solid Q4 of last year. Our full-year expense ratio of 30.8% was 1.7 points improved from the prior year, benefiting from ongoing disciplined expense management and reduced CPC accruals due to the higher CAT activity in 2023. While some of the improvement is sustainable, we expect 2024's expense ratio to come in about a point higher. Focusing on distribution income for a moment, you'll see we generated $39 million in 2023. Keep in mind that the full impact of our national broker platform also includes a benefit to consolidated expenses in the form of a commission offset. This contributed an additional $16 million in 2023. We expect 2024's target of $75 million to have a similar 70/30 split between distribution income and commission offset.

Slide 13 shows our investment portfolio in greater detail. Our net investment income again increased meaningfully in the quarter, up roughly $10 million from Q4 of 2022 due to higher interest income from increased book yields driven by active management of the fixed income portfolio. Growth is expected to slow from double digits to mid single digits in 2024, resulting in an expected full-year net investment income exceeding $190 million.

As you can see on slide 14, our financial position remains robust, with over $1.2 billion of financial capacity now that we continued through the CBCA. Market movements bolstered our capital in the fourth quarter and combined with operating income to generate a sequential growth in book value of 8.4%.

Slide 15 shows recent capital management actions and longer-term priorities. When it comes to deploying our capital, the primary focus remains in support of our robust organic growth strategy. I already discussed our 16% dividend increase, which delivers on our objective to grow the dividend over time. We have also been clear that we believe we can build the Company into a top-five player in the industry. This requires inorganic growth, including both insurance carriers and distributors. As we continue 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. We have an excellent team in place and support our broker partners to continue building on our track record of success. I'm extremely proud of the milestones we've achieved together in our early years as a public company and I'm excited by the opportunities that lie ahead for Definity.

So with that, I'll turn the call back over to Dennis to begin the Q&A session.

Dennis Westfall — Head, Investor Relations, Definity Financial Corporation

Thanks, Rowan. Sergio, 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 star one. If you want to withdraw your question, please press star two. Your questions will be polled in the order they are received. If you are using a speakerphone, please lift the handset before pressing any keys. Your first question comes from Geoff Kwan from RBC Capital Markets. Please go ahead.

Geoff Kwan — Analyst, RBC Capital Markets

Hi. Good morning. First question was on the property side. The year-over-year growth rate in gross written premium in Q4 had come down from the levels that we saw in Q1 to Q3. Just was wondering if there was anything specific around that, particularly given where it seems like the rates are probably or the premium growth will be in 2024.

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

Yeah, why don't you take that, Paul?

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

Thank you. Thank you, Geoff, for your question. So, a couple of things it's important to understand. It's really reflective of two elements. First, as Rowan mentioned earlier, a number of large property portfolio transfers began in Q4 of 2022 were completed in Q3 of 2023. While portfolio transfers are a feature of our growth, their timing quarter to quarter tends to be lumpy, so we look at our annual growth and for the full year that was 9.9%.

Secondly, we've been actively managing our portfolios to strengthen diversification and profitability. So let me remind you, a few years ago our portfolio was heavily weighted towards auto with a 70/30 split. We took material actions to rebalance our portfolio and bring it back to a target of 60/40, a weighting more consistent with the market average. As I mentioned last quarter, having achieved our 60/40 weighting, we'd be focusing on a more balanced growth rate between the two lines while also prioritizing rate growth to strengthen profitability.

We'll continue to refine our property appetite to further reduce volatility and address concentration risk from elevated weather events in CATs like wildfire, but moving forward we're quite comfortable that firm market conditions and our pricing and underwriting sophistication will support our expected growth and profitability in our personal property line and, as Rowan said earlier, that's in the mid to high single digit range.

Geoff Kwan — Analyst, RBC Capital Markets

Okay, thanks. And just my other question, I apologize if I missed this, but on the investment income guidance for 2024, it seemed quite a bit lower versus kind of where the current run rate is. Just wanted to get some colour around that.

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

Yeah, Geoff, on that one, a couple of things are happening there. So I think, when we look at 2023, I mean the team has done a very good job of being more active and trading tactically than we had initially

kind of planned. They're taking advantage of tactical trading opportunities and I think what that's done is a couple of things. There's always been a significant spread between new money yield and book yield. That yield, the gap has narrowed for us. There is still one, but it's certainly much more narrow than we've got.

I think the two things when we look forward would be, one would be we're deploying capital, and so even in the fourth quarter of 2023, later on into the quarter we acquired Drayden Insurance for a couple of hundred million dollars. We've made another acquisition in the first quarter of this year and we plan for further broker transactions through the year. So there's a capital deployment story there. And then the second one is about the estimating of the forward yield curve. I think, generally, we're expecting interest rates to come down and so that's kind of reflected in our assumptions. I mean this is fairly dynamic, as you see, just in the last kind of week or so, so in the event that it takes longer for interest rates to come down, then obviously that's favourable to our net investment income projections, and so I think that's why we say we're very comfortable with looking at the $190 million as an absolute floor.

Geoff Kwan — Analyst, RBC Capital Markets

Okay. Thank you.

Operator

Thank you. Next question comes from Paul Holden from CIBC. Please go ahead.

Paul Holden — Analyst, CIBC Capital Markets

Thanks. Good morning. I'm not sure if I missed this one, but I guess I want to ask on personal auto, if you can provide an update on earned rates, written rates, and claims inflation please.

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

Thanks for the question, Paul. A couple of points there and I'll maybe ask Paul to get into a bit more detail.

I think the big message on this line of business for us is that we've been guiding to a quarter where we would cross over the earned rate than the loss cost trend, and that's happened, and so you start to see that favourably impacting the core accident year loss ratio. If you recall, what we had said is we were in the range of double digit written rates and then that was going to move from about 6.5% earned last quarter to about 8.5% earned this quarter. So that definitely is happening. So that's a very encouraging kind of sign for us and obviously there's more that to come.

And in my comments I did refer to some of the other trends on frequency and inflation, things normalizing, but perhaps, Paul, you can add a bit of colour to that.

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

Yes. Thank you, Rowan. So, a couple of things in terms of the written and earned, as Rowan described what happened in Q4. Moving forward, we expect written and earned rate to be in the low double digit range. So that's positive for the trajectory of the book.

In terms of those frequency and severity statistics, we've actually seen a flattening and really a return to pre-pandemic levels in terms of these trends. Reminder that even in pre-pandemic levels, on the physical damage side, we were in the mid single digits, mostly reflective of vehicle technology getting more expensive and more sophisticated. The one exception to that, as Rowan mentioned earlier, is still the theft element. That remains quite elevated and represents about 7% of the auto loss ratio relative to about 2% pre-pandemic.

Now on that note, I would like to highlight that we're quite pleased with the response that the government has had in terms of reacting to these trends. There was a recent summit in Ottawa that was introduced by the Prime Minister and it was represented by individuals from across government, industry, insurance companies, auto manufacturers, and there's a real focus and desire to address this. So, moving forward, it gives us a bit of confidence that, collectively, we can address this trend, and obviously that would help the overall performance of the portfolio.

And lastly, I would also add that, as we indicated in Q4, we believed we were earlier than the market average in terms of seeking additional rate, which impacted our competitiveness a little bit in Q4, and moving forward it looks like the market is taking double digit rate and that's given us that benefit of increased count.

Paul Holden — Analyst, CIBC Capital Markets

Great. A couple follow-up questions on that, I guess the first one is just regarding the combined ratio outlook for 2024. If you're getting earned rate, call it, somewhere around 10%, claims inflation somewhere around mid single digits, so a 5-point gap give or take like. What are the potential offsetting factors other than theft that would prohibit the combined ratio coming down somewhere around 5 points next year.

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

Really, there's probably two elements that are the most material to that, other than the uncertainty around weather and catastrophes, but the primary one is the one that I just mentioned around theft rates. So, depending on how long the theft rates and severity remains elevated and we want to make sure that we're appropriately covering that.

And the other element, of course, is the situation in the flattening rate expectation of Alberta. While the government in Alberta has approved rate, it's essentially a rate cap and the cap is below the severity trends and the inflationary trends in the auto environment, so that provides a bit of a headwind for profitability.

Paul Holden — Analyst, CIBC Capital Markets

Thanks. And then the other follow-up question I had was on theft. So you've given some colour around where it stands today versus pre-pandemic, but maybe give us a sense of sort of sequentially. Is it

getting worse? Better? You referenced the government taking more action, police taking more action, we can see it in the news headlines, so is there any kind of rate of change that's notable?

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

Really sort of two offsetting factors. We've noticed a small decrease in frequency and a small increase in severity and this is really likely reflective of the types of vehicles being stolen. As I mentioned in previous quarters, that stat is quite dynamic, because the thieves will target certain types of vehicles. As they become less available, they'll focus on other types of vehicles. So we're constantly monitoring that, but the idea is, if every aspect of the value chain can work together to effectively reduce this, that gives us the best chance of reducing it over time. But it is still quite early days in that. I mean the summit was just two weeks ago and some of these actions take a little while. So, in the meantime, we're ensuring that we cover it with rate.

Paul Holden — Analyst, CIBC Capital Markets

Okay. Got it. Thanks for that. And I'll sneak in one more. In terms of the $11 million of cost restructuring, what should we assume the impact is on the expense ratio in 2024?

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Hey, Paul, it's Bryan Lillycrop here. So, the restructuring charge you talk about, there's about $11 million in there. A large portion of it is tied to costs associated with realigning our occupancy footprint with our hybrid way of working and real estate management rigour. So this is going to earn out over several years. The balance is modest headcount impacts as we focus on leveraging our digital assets and our operating efficiencies. The savings associated with those are already built into our earnings guidance. So, as Rowan said, if you look at your expense ratio for the year at currently 30.8%, so it will be about a point higher overall as the commissions come through, but you can expect our OpEx to be kind of in line with the 13 points that you see currently.

Paul Holden — Analyst, CIBC Capital Markets

Thank you for that.

Operator

Thank you. Your next question comes from Doug Young from Desjardins Capital. Please go ahead.

Doug Young— Analyst, Desjardins Capital Markets

Hi. Good morning. Just on the commercial side, obviously a tougher quarter from a CAT perspective, not weather related. Just wanted to get a better sense of under the hood in terms of what really drove that. I know you talked about large losses, just looking for a little bit of colour. And then I know the growth is, on the top line, the growth written premium is quite strong, but there's been a bit of a de-acceleration of the commercial gross written premium. It could be a function of you just getting larger

in the specialty lines, but I don't know if there are certain areas of commercial that you're starting to kind of pivot away or be more selective on. Just hoping to get a little colour on that as well.

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

Thank you, Doug. This is Fabian Richenberger answering the question. So, as Rowan mentioned in his remarks up front on the big picture is that we are not concerned about the large losses we had in Q4 as they were very much within our annual budget for large losses. And I think what is important to understand is that large loss margins, in a commercial portfolio of our size, will always vary a bit quarter by quarter. So any given year we will have a couple of quarters that don't have any large losses and then you're going to have a quarter where you have a few of those large losses coming through. I think what is important to do, if you want to gauge our overall profitability, is to look at our combined ratio in 2023 on an annualized basis and, as you've seen from our disclosures, that number came in at 88.8% and we are very pleased with that number. That number includes about 4.5 points of impact due to large and CAT losses, and that number, as I mentioned, is very much within our business plan assumption. So overall, what I would say is that we're very pleased with our large account segment performance and profitability and we really don't have any concerns.

And on your second question on growth, as you've seen, the growth rate in Q4 came in at 14%, which is very much in line with the 15% growth rate that we've had for 2023, and that's really a function of us continuing to benefit from firm market conditions. I think what's important to note is that about 60% of the growth rate came to us from rates and inflation adjustment that gives us the confidence that we'll

be able to sustain our combined ratio in that 90% range and that 40% of our growth rate came to us from the strong value proposition that we've built in small business, middle market, and specialties. And as you know, our broker partners are very supportive of what we do and how we do it. The point that you made is that in a couple of segments, where we have had a little more of competition coming into the marketplace with more firm capacity is coming into Canada as well, but overall what I would say is that we are very confident that we will continue to be able to cover the loss trends in our portfolio with adequate rates and inflation adjustments and, again, that gives us the confidence that we'll be able to sustain combined ratio in the 90% range and we are quite confident that we'll be able to continue to post growth rates in that low double digit range given the strong value proposition that we've built and the great support that we're getting from broker partners.

Doug Young— Analyst, Desjardins Capital Markets

And can you talk a bit or just like which area you see more foreign capacity come in or more competition?

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

It is mostly in the large accounts base with kind of a bit of Lloyd's capacity re-entering the Canadian marketplace. And, as you know, our specialty lines business is also a fairly new segment that we started building out four, five years ago, so our market share in specialties is maybe 2% now and our overall market share across our commercial portfolio is more in the 4% to 5% range. So the segment that faces more competition at this time would be actually the smaller segments that we have in our overall portfolio

and, again, that gives us a great deal of confidence that we can protect both the growth rate and the profitability against that increased foreign competition.

Doug Young— Analyst, Desjardins Capital Markets

Okay. And then maybe, Rowan, $1.3 billion of financial capacity, I mean I'll just ask the question I get asked a lot is, you know, the plan for that. And I know no one has a crystal ball, but maybe just some colour around like is stock buybacks in the cards? You did, obviously, a large dividend increase. And then on the M&A side, you can never time it, I get that, but what's going on in the market? I know it's a hard market. I assume that the bid/ask spreads probably are quite wide. Is this the biggest issue? And what gets activity in the Canadian market going again from an M&A perspective?

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

Thanks for that, Doug. Look, a couple of things there, I'd say. One is we're certainly in a great position here to have this level of financial capacity. And that's after being fairly active through last year in terms of deploying many hundreds of millions in terms of building out our distribution channel. So on the one hand, it kind of gives you a sense, obviously, we're a CBCA, we've got some more access, but there's strong earnings generation capability in the business.

As we've kind of said in the past, I think it's fair to say our thesis still remains. We're believers that consolidation is required and will continue to happen in the marketplace. There has been a dearth of transactions over the last couple of years. Those were unusual years through COVID. And I think that you're starting to see more pressure emerging on certain organizations. When we look at, you know, to

be a leading personal insurance provider, having modernized technology platforms, which is a really big investment, size, scale, influence into your supply chain, all of these criteria are becoming increasingly important and I think that there are some players they just may not be able to make that level of investment. And so that's one theme.

And the other one is in the commercial area as well, and whilst the results have been good for commercial insurance, we are getting to a stage where brokers are choosing their companies very carefully. Companies that in the past may have been smaller niche players in Canada operating in large commercial and specialty didn't have a lot of competition from domestics. That's really changed in the last couple of years, you know, just building on Fabian's comments on the remarkable specialty and large account capabilities that he's built and there are other domestic players that have bought that. I think that's putting a lot of pressure on those type of organizations.

And so, that's kind of our thesis, where you are going to find more pressure and, we think, more opportunities in the marketplace. But these are opportunistic. What I can say is that we feel we're in a good position. We know that clearly we've got strong balance sheet to move forward, but we've also worked really hard to build the platform to be an acquirer. The platform we've got is not, it's not tapped out, we've got lots of capacity to pick up other businesses and run them better and with significant synergies, so that's what we're very busy with. And whether and when that manifests into a transaction, you know, obviously we can't speculate on that and it does depend. You've got to have sellers as well as interested buyers. But we think that that's the right path.

I think when you refer to the dividend, I think the dividend is really just a good example of our confidence in the business, that we've always wanted to consistently grow our dividend. You'll recall, we IPO-ed in the middle of the pandemic. There was lots of kind of uncertainty at that stage. I think in the last couple of years we've got a lot of confidence in our business. Strategically, we've diversified our earnings significantly. And that's really a representation of the confidence we have in the earnings power going forward, which is why we moved the dividend up and we keep in mind where market empiric expectations for what our peers are.

I think it's too soon to kind of speculate on buybacks and things like that. We've always said, look, we've got a priority of how we plan to use our capital and we really believe we're more of a capital deployment story than a capital return story. But of course, we're not going to be lazy and sit on capital for an undue period of time. And I think if you look at even what we've done in the short time since being public, not just have we been very good in terms of generating earnings in the business, but we have also been very active and strategically and accretively deploying capital, which we did last year. At this stage, it's been a distribution, but that doesn't mean it's going to continue to stay in that area.

Doug Young— Analyst, Desjardins Capital Markets

I really appreciate that. That's great. And just if I can sneak one last one in. Sonnet, I know the thesis is always within a reasonable time after the IPO that you break even. You've had been thrown a few curve balls here, so I kind of get that break even has been pushed off. I think that target was to be break even by the end of this year, correct me if I'm wrong. How do you think about that? Because that's clearly a bit of a drag on the personal auto business in particular.

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

Yeah. I mean, Doug, you are right. It absolutely is a big investment for the Company and it is a drag on the personal auto in particular. And so, in a way, it kind of gives you a sense of, when you look at the performance that we're earning into, it tells you how strong the broker business actually is, and so I think that's a positive story for us.

Really there's no update today in terms of a change in guidance. The teams are working really, really hard to achieve that guidance, which was to get to break even by the end of this year. And when we look at the portfolio, there are a number of things that are going really, really well. You did call out Alberta. I mean, transparently, that is a real challenge for us. We're losing money in the province and that is why Paul's team has slowed down new business and we've turned off the marketing machines completely. That business is contracting, so that's a good-news story when you're actually not making money in the province, but outside of that, there is growth. But the focus on Sonnet is less about real growth this year and it's more about getting confidence on that path to profitability. So, even the growth outside of the province of Alberta, which there is growth, is really about changing the mix of business. It's writing more of the profitable affinity customers; it's leveraging some of the partnerships that we're very pleased with, with like Tangerine; it's tightened underwriting appetites; and it's really rate as opposed to unit count for this year. So that's kind of what we did in 2023. We're going to continue that strategy into 2024. Clearly, as we get a couple of quarters under our belt this year, we'll be able to be more precise about our confidence level of breaking even at the end of the year, but that's where the plans are geared to and what the teams are working flat out for.

Doug Young— Analyst, Desjardins Capital Markets

Appreciate it. Thank you.

Operator

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

Jaeme Gloyn — Analyst, National Bank Financial

Thanks. First question is just on the reserve development in the quarter. It came in a little bit lighter than last year and you called out industry pools in the auto segment. Are you able to break down the contribution of that industry pools? And then also a comment perhaps on how you see reserve development flowing through in 2024. Similar levels as 2023 or should we expect to see a little bit of a, perhaps, a step up as you continue to exit through maybe some increased conservatism during COVID.

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

Go ahead, Bryan.

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Thanks, Jaeme. I think really the story on the pools is more of a story of 2022 rather than 2023. So this year's at the 1.4% is really in line with our historic 1% to 2% range for our guidance on PYD and that's really unchanged in IFRS 17 is what you should expect to see going into 2024 as well. It's really more, as

you look at last year, a good chunk of that PYD was driven by the pools. Absent the pools, last year's PYD would have been about 0.8%. So more in line with the 1.4% you see this year.

Jaeme Gloyn — Analyst, National Bank Financial

I see. Okay. Thank you. Second question is on the distribution income. And if we take that 70/30 split, it looks like distribution income should come in around the low 50s. How much of that is driven by organic growth? How much of it is driven by M&A? And would you factor in several tuck-in transactions, let's say, during the course of the year to drive that result or is that something that's excluded from how you're thinking about distribution income?

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

So, thanks for the question again on that one, Jaeme. Your math is kind of right there. So when we think about that total contribution of $75 million, very roughly, it's close to $55 million of distribution and about $20 million of the commission offset. That commission offset is about a 0.5 point benefit to our expenses. So that's the way we do think about it.

What we've done, and as you've noticed, like last year, we've updated guidance a couple of times on more substantial transactions, and so that's why last year we kind of walked it up to $55 million, which is essentially what we were able to deliver. So that reflects organic growth and the full earnings of these brokers as they come on. There is some assumption in our growth for smaller, bolt-on transactions, there are a couple of small deals that have been done, but should anything more substantial occur that would be above our expectation, we would up guidance to reflect that.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. Okay. So it's got a couple of tuck-ins, but anything down the road, let's say, like if you were to do like three or four more tuck-ins during 2024, that's not something that's baked into this guidance.

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

That's correct.

Jaeme Gloyn — Analyst, National Bank Financial

Okay. And then lastly, just going back to the personal property segment and some of the actions that you were taking, I just want to understand the, let's say the changes in the underwriting that you've made around reducing exposures to CAT. Is it a regional impact or risk selection decision or is it something with reducing limits or reducing coverage of certain risks? Like what exactly are the changes in the underwriting standards on property?

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

Good question. It's Paul here. I think it's a little bit of all of that. And while CATs tend to be regional, we saw last year wildfires essentially impacted almost every region in which we transacted. So concentration and accumulation management is really a big topic for us, a big focal point for us. What we're looking to do and what we have been doing is reducing concentration of risks in areas that have a higher propensity for weather events and CATs like wildfire. Of course, those areas change. As I mentioned

earlier on another topic, these things tend to be quite dynamic. So where you have a wildfire one year can impact whether or not you have a wildfire in that same area next year.

But let me give you an example of some of the actions that we're taking. So, first and foremost, we've invested in talent and capabilities, for example in geographical information systems partnered with our partner, Google, in terms of understanding location risk. We've collaborated with global reinsurers on peril data analytics so we can better validate our wildfire and water high-risk exposure in areas of concentration. These are the mapping exercises that we do and update. Another example is we've done proactive product holds in Sonnet in wildfire-prone areas to avoid anti-selection, so if there's an anticipation that a wildfire may be coming, the last thing we want to do is accumulate risk in advance of that. To your point around rates, for example, we have surcharge policies in high-risk concentrated areas to slow down new business. We've also worked with the government on their national flood initiative to make sure we address the needs of high-risk flood-prone areas versus others. We developed renewal strategies to address higher concentrated areas prone to secondary perils. And maybe one last example on the underwriting side, we have introduced separate higher perils based deductibles for items like sewer backup, overland water, and hail. So it's a multifaceted approach to ensure that we're staying ahead of the weather trends in the marketplace and, as Rowan mentioned earlier, we are pricing for that and we are using that in coordination with our reinsurance program.

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

Thanks for that, Paul. And I think it makes sense for us, because strategically, if you think about what we've done in the last number of years, as we've deemphasized the percentage of regulated auto

by growing property and by growing commercial lines, you know, as you do that you need to make sure that you're doing that in a very sophisticated, segmented way and effectively have best-in-class capabilities. Those range from reinsurers to underwriting segmentation Paul's talked about also all the way through to claims management as well. So I think that's the point there.

And when you step back, even if you go back to our original point on Nat CAT guidance where we moved it from 4% last year to 4.5% this year, I mean there's a couple of reasons why we're doing that, but one of it is it reflects the mix of business that we've changed that I've just talked about, considers where we are in reinsurance programs, but it also recognizes the probability of increasing Nat CAT severity and frequency. So this is on our mind, how we're underwriting it, and of course how we're funding it. And I think that's the point we're making is even though we've moved that from 4% to 4.5%, in no way does that actually affect our overall combined ratio, because it's fully funded. We're just calling it out as a larger component of the loss ratio. But to Paul's point, those underwriting actions that Tim and his team are taking, along with the funding, offsets any adverse impact from that assumption.

Jaeme Gloyn — Analyst, National Bank Financial

Understood. Thanks very much for that colour.

Operator

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

Brian Meredith — Analyst, UBS Securities

Thanks. Rowan, I'm just curious, down here in the US there's been a lot of discussion this quarter with respect to social or tort inflation and we've seen a number of charges from a number of primary insurance companies. Is that something that could be an issue in Canada as maybe the litigation environment here kind of moves up there? Are you seeing any pressures at all on kind of prior accident years in your commercial insurance general liability book?

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

Brian, one of the things that I think we've noticed that certainly has been different from the trend through this inflationary period than south of the border here is that whilst we've seen the inflation on the physical components of our products, we haven't seen it on the social inflation. And so I know that there are some concerns south of the border of adverse development and long-tail liability lines and even on the auto part of the component. We're not seeing that, so no concerns here. It's very stable, the trends that we've seen in the last couple of years and now as we come out of the pandemic period. And I go back to, I think there's a couple of big drivers. Certainly our legal and judicial system is different in that it's way less litigious. I think that's the big driver why we don't see that on commercial particularly. And then you'll perhaps appreciate the structure of our auto product on bodily injury and legal and accident benefits, you know, has embedded caps into it as well, and so that's the other reason why, even in an inflationary environment, you don't see big tick up of social inflation. It's clearly something that's high on our radar and our claims team monitors and tracks it, but we've seen nothing of concern.

Brian Meredith — Analyst, UBS Securities

Great to hear. I guess my next question, ah, you've talked a little bit about M&A. Just curious, Rowan, how do you think about distribution versus buying carriers or underwriting? What would you prefer going forward?

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

So, Brian, I think on that one, you know, we don't have an allocation that says, look, of our excess capital and of the way we'd like to spend it there's a specific perspective. I come back to a little bit of strategy, because one of the things we wanted to do is to make sure that we've got a diversity of earnings. And when we think about delivery of our return on equity, what we wanted to do is to make sure that significant components of that are less volatile. So, for example, the net investment income. We can be pretty sure what that range is going to be. We then think about our distribution income and again we could be pretty sure what that range is going to be. So that's really very stable at reoccurring and no volatility. Of course, on the underwriting side for an insurance carrier, there's always some level of volatility, so that would range around. So that's how we've thought about getting real stability in that return. That's the first piece.

The second piece was, as we moved forward, we felt that we needed to build the plan. And so I think if you look at what we did in late 2022 and 2023, we're not expecting that level of activity going forward. That was to buy a few big, high-performing, well-regarded anchor brokers that now will do more bolt-on acquisitions. So it's not to say we're not going to keep funding that, of course we will, both organically and inorganically, but we're not anticipating the same level of expense or capital deployment now we've built the platform. We think it's organic and some more smaller, bolt-on acquisitions. Of

course, if we see a great opportunity, we would lean into it. And that's where our focus and our priority is now more on the underwriting carrier side of capital deployment. Back to one of the earlier questions, we've got the capabilities. We've got a corporate development team. We are, of course, active here. This is going to be timing driven and it's a bit opportunistic, of course. But if we think going forward, where we're putting more time and effort, we're putting more time and effort into carriers than we are to searching for more distribution. But that doesn't mean the distribution channel is not going to continue to build or grow. The team is very capable and has a track record of doing acquisitions, as you've seen, these bolt-ons occur. I hope that helps a bit.

Brian Meredith — Analyst, UBS Securities

Yeah, that's really helpful. And just one other add-on to that one. I'm just curious, your biggest competitor in Canada does have business in the US, right, which enables them to really leverage that when, you know, working with Canadian clients that have businesses down in the US. Is that a limiting factor for you all? Is that something that you think about? Is that something that you would ultimately want to kind of expand into to get maybe better access to those customers?

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

I think from our side, Brian, you know, we think that, two things would be we believe we can serve our cross-border customers really well and we have a cross-border partnership. And maybe Fabian could just talk about how in commercial lines we think we handle that in just a moment. And I think on the other side of things, as we think about deploying capital for M&A, it's not that we would never say we're not looking to go outside of Canada, but I think if you look at the opportunities in Canada, you know, an in-

market acquisition is something that we've got great capabilities. We'd have tremendous broker support. We've already built all the platforms for a business bigger than we are. So in terms of getting operational leverage in those synergies, this is really where we would get most of the benefit from that. And so our, let's call it, near-term priority is definitely Canadian-focused. So that's in terms of capital deployment.

In terms of servicing customers, Fabian, perhaps you could share your views.

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

Yeah. So what we did four years ago when we started leaning into the specialties and large account capabilities, what we did is that we developed a partnership with a global reinsurer which allows us to write business literally around the world. And that gives us a level playing field to compete with the global insurers that play in that segment. So we don't have a strategic disadvantage with the partnership that is in place so the reason why we would go into the US wouldn't be that we could expand our value proposition or our key customers. We are on the level playing field already. So I think there are other strategic and financial considerations that will be at play to guide our acquisition strategies going forward.

Brian Meredith — Analyst, UBS Securities

Thank you so much.

Operator

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

Tom MacKinnon — Analyst, BMO Capital Markets

Thanks very much. Good morning. The discussion really just about on slide 12 and the outlook, I think what you said for the expense ratio. Did I hear you correctly saying that you would expect that expense ratio to be a point higher going forward? I assume that you still have an outlook of 95-ish for combined for 2024, but that's with an expense ratio that would be a point higher? Did I hear that correctly?

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Yeah, Tom, it's Bryan. That's right. If you look at our full-year expense ratio of the 30.8%, so not the quarter but the full year, you should expect it to be about a point higher than that, largely because of the commissions coming in higher because the CAT exposure should be less, all else being equal.

Tom MacKinnon — Analyst, BMO Capital Markets

Understood. Okay. So that's kind of right-sizing the CATs from being north of 6% to more like 4.5%, okay?

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Correct.

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

Yeah, that's right. The way to think about that is a simple offset and, I think, if you look at the 30.8%, what we're saying is that that's a little flattered by the fact that there was less contingent profits. But the contingent profits are lower because the CATs are higher. So that's the offset. So it doesn't change any of the guidance around the 95% or mid-90s. Think about it more like a point higher than that is but then think about the loss ratio will be the corresponding offset.

Tom MacKinnon — Analyst, BMO Capital Markets

Great. Yeah. And then the other line there, that was at 42 for the year and 10 in the quarter. I mean just kind of growing that with inflation or just keeping that relatively flat?

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Part of what's driving that, Tom, is the acquisitions we've had over the years. There are two main components in that other line. The first one is our public company costs and those are going to be relatively flat year over year.

The other piece that goes through it is the non-controlling interest portion related to all of our acquisitions, so of course in 2023 that grew compared to 2022 because we bought McDougall, we bought Drayden. Going forward, that will just grow as we have other acquisitions and then it'll kind of tack with the distribution business overall.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. So it seems like something comparable to what we saw in the fourth quarter or perhaps just slightly higher.

Bryan Lillycrop — Vice-President, Financial Reporting, Definity Financial Corporation

Correct.

Tom MacKinnon — Analyst, BMO Capital Markets

Okay. And if you were looking at your expectation for top-line growth in the, I think it's high single digits up to 10%, what kind of conditions or what would it take for you to be sort of short on that estimate or actually be better on that estimate? Is that a function of unit growth? Pricing? Growth in distribution? Probably the answer is all of the above. But in a way, how do you think you could grow faster than that and do you have the capabilities internally to do that outside of just firming market conditions?

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

I mean I think it's a question that we spend a significant amount of time on. So the first question or first piece of that would be do we have the capability internally to do it. And the answer is absolutely yes. We balance this very carefully and so, if you just think about a couple of the big drivers here, writing new business has a lower margin than your renewal portfolio. So keeping that in balance is somewhat important if you're managing to an underwriting margin. So could our business grow faster? It could. But it would have a slight impact on the profitability. So we're trying to optimize and manage that all the time. But the capacity is absolutely there and we think that, certainly on the distribution side, the broker support is there.

What would make it go more or less I think it's really a couple of points. On the commercial lines side of things, the team has got tremendous broker support, and so if the market stays as firm as it has been, we're not concerned about the balance of new business with our renewal and we can get rate as well as unit count growth, because in commercial lines we're gaining share. We're moving into new segments. We're gaining share. Strong margins in the business. And if the rates stay firm and we can get more rate, then that's a way to outperform on the revenue side.

When it comes to personal lines automobile, what Paul and the team there have done is very much focused last year on rate adequacy and pricing. And again, what we've seen in the fourth quarter is that the market is kind of catching up to our rate levels, which means our retention goes up and it means we're more competitive on our new business. So if the market stays firm or gets firmer, then it's likely we will do better on our written premiums because of that function.

When it comes to personal property, again, it's a similar feature, what's going to happen to the indexation factor and what's going to happen to rate adequacy, but what we're also trying to balance there is we do think the world is going to have kind of these more Nat CAT events and we want to be cautious about being overexposed in some of the areas that we think may be more volatile. So it's that trade off of minimizing your exposure to Nat CATs, but of course getting the growth.

And when I look back at the business, I think that our sentiment is, look, we're very comfortable building and growing this business. We believe we've got great margins. And if you look at almost by line of business, that core accident year ratio is improving. And we've kind of gone after that hard with quality segmentation and pricing and that's more to come, because that pricing is still going to earn its way in.

And so you're seeing that very powerfully a little bit in the first quarter, which was Q4 of auto. That's going to get better as we go forward. We're bullish now on auto. You've definitely already seen it in personal lines and personal property and the same thing for commercial lines.

So growth, we see lots of opportunity, we're very comfortable with it, we feel we're in a good position, and the only part of our business where we kind of consciously are now slowing growth is actually Sonnet. And the reason for that, as we've said a couple of times, is we want to kind of get that loss ratio down on the path to profit by the end of the year. And then, assuming we're comfortable with that and we achieve that, we'd be thinking about stepping on the gas, but that will be the next year. So I look back, I think that is generally how we would feel about our growth story, Tom.

Tom MacKinnon — Analyst, BMO Capital Markets

Thanks for the colour and congratulations on a good quarter.

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

Thank you.

Operator

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

Mario Mendonca — Analyst, TD Securities

Good afternoon. Quick question first on net investment income. As rates rose, we saw every life insurance company, to some extent, to varying extent, become tactical, selling bonds, achieving the higher net investment income. The question I'm asking is, as rates come down or if rates come down more abruptly than expected, presumably you would change that approach and you wouldn't be quite as tactical and wouldn't be selling bonds and absorbing the lower net investment income. Is that fair? Is that correct way to describe it?

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

That's right. That's well said, Mario. It would be the strategy. And then I think we would we would be trading less and we would be protecting the yield.

Mario Mendonca — Analyst, TD Securities

Okay. Now a different type of question, and you might, Rowan, you might gather from the number of questions about acquisitions that your investor base, the thinking is changing. You're a bit of a victim of your own success here. Since demutualization things have gone well and now investors are thinking about the next chapter in Definity's life and that's why you're getting these questions. What I want to do is ask you to think about a hypothetical. The P&C sector is reminiscent of what the banking sector was and the life insurance sector was a few years back. There was a period there where smaller players wanted to do deals but were stepped all over by the larger players. I mean, in fact, there was a recent example of HSBC Canada where plenty of smaller banks wanted to do that deal but weren't able to. The hypothetical I'm proposing to you is one where precisely that environment plays out, Definity is eager to do a deal but can't in Canada because larger players are stepping all over Definity. What then? And this sort of goes

back to the question you got a moment ago, would you be—is it a return of capital story then or would you be, would you have sort of the nerve to go into the US and expand there? Like what do you do in that circumstance? Because there's certainly a lot of precedent for this in Canada.

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

Yeah. I mean, Mario, it's always interesting and dangerous to respond to hypothetical questions, but it's something that we think about and it's something that we discuss with the board. A couple of things that I would just kind of maybe offer is one is not every deal is done purely on maximum ability to pay. And I'll give you an example. We've been very successful building out a great broker distribution platform with some of the best brokers in Canada. We were not on the high bidder on any one of those transactions. So admittedly, that's a distribution deal versus an insurance company deal, but I do think that part of the proposition, and depending on what you're offering in one of those M&A opportunities, if you've got something unique to offer, it may not necessarily come down to just absolute maximum price each and every time. I don't really want to go any further than that, but the point I'm making is you're perhaps going to be a bit more innovative in terms of your approach.

I think the other part of that would be, you know, we've got a lot of confidence in the business and I think that thinking about something broader than Canada, whilst it's not in our priority list for now, it really depends on kind of what opportunities would be and where you believe you would bring something really unique and really a competitive advantage. And so, for example, just something off the top of my head, but going in as a scale player into a big market like the US with some unbelievably capable personal lines or carriers, it would be very difficult to think that you would be good enough to operate and

outperform in that marketplace. But there are other segments in more specialty areas where I think that maybe not be as true. So I think we're just sticking with our game plan. We really like the fact that we can, for a while, continue with leading industry growth. We've got these platforms that are going to still help us grow organically ahead, roughly twice the growth of the marketplace, and I think it's premature for us to kind of feel like we won't be able to be a successful acquirer in the Canadian marketplace.

Mario Mendonca — Analyst, TD Securities

One quick follow-up then: These platforms that were built, and I watched, even prior to demutualization I watched with interest the sort of blood, sweat, and tears that went into building those big platforms that are instrumental in your success to date. Those platforms, could those play a role in expansion outside of Canada or are those solely for the benefit of Canada?

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

No. They're not built for purpose for just the Canadian marketplace. They could be used for different product lines and different geographic territories.

Operator

Thank you. There are no further questions at this time. Please proceed with closing remarks.

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. A telephone replay will be available at 2:00 p.m. today until February 23rd and a transcript will be

made available on our website. Please note that our first quarter results for 2024 will be released on May 10th. That concludes our conference call for today. Thank you and have a great one.