S&P Global
Market Intelligence

Root, Inc. NasdaqGS:ROOT

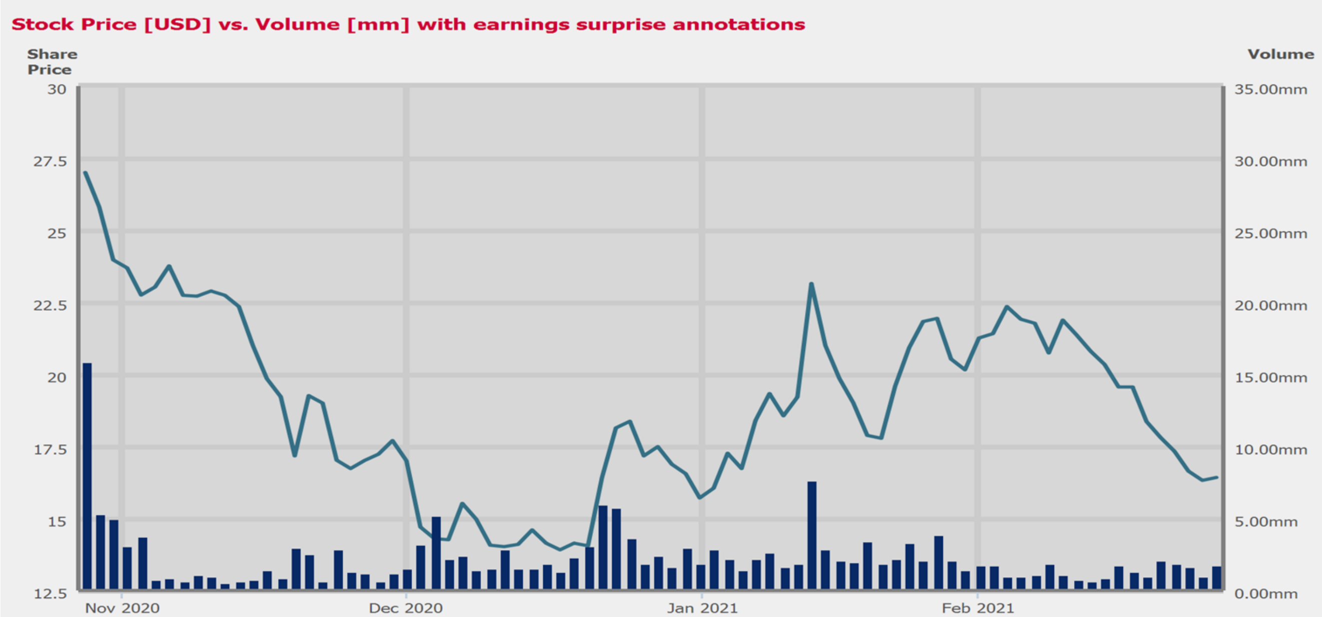
FQ4 2020 Earnings Call Transcripts

Thursday, February 25, 2021 10:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2020-			-FQ4 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.33)	(2.20)	NM	(0.80)	(4.12)	NA
Revenue (mm)	49.96	50.50	▲1.08	49.56	344.87	NA

Currency: USD
Consensus as of Feb-26-2021 12:21 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2020	(0.33)	(2.20)	NM

Table of Contents

Call Participants

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Co-Founder, CEO & Director

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Tracy Benguigui

Yaron Joseph Kinar
Goldman Sachs Group, Inc., Research Division

ATTENDEES

Joe Laroche

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Root, Inc. Fourth Quarter 2020 Earnings Conference Call. [Operator Instructions] Thank you.

I will now hand over the call to Joe Laroche, Investor Relations for Root. You may begin, sir.

Joe Laroche

Good afternoon, and thank you for joining us today. Root is hosting this call to discuss its fourth quarter earnings results for the period ended December 2020. Participating on today's call are Alex Timm, Co-Founder and CEO; and Dan Rosenthal, Chief Financial Officer.

Earlier this afternoon, Root issued a shareholder letter announcing its financial results. While this call will reflect items discussed within that document, for more complete information about our financial performance, we also encourage you to read our annual report on Form 10-K to be filed with the Securities and Exchange Commission next week.

Before we begin, I want to remind you that matters discussed on today's call will include forward-looking statements related to our operating performance, financial goals and business outlook, which are based on management's current beliefs and assumptions. Please note that these forward-looking statements reflect our opinions as of the date of this call, and we undertake no obligation to revise this information as a result of new developments that may occur. Forward-looking statements are subject to various risks, uncertainties and other factors that could cause our actual results to differ materially from those expected and described today. In addition, we are subject to a number of risks that may significantly impact our business and financial results.

For a more detailed description of our risk factors, once again, please review our upcoming Form 10-K, where you will see a discussion of factors that could cause the company's actual results to differ materially from these statements as well as our shareholder letter released today. A replay of this conference call will be available on our website under the Investor Relations section.

I would also like to remind you that during the call, we will discuss some non-GAAP measures in talking about Root's performance. You can find the reconciliation of those historical measures to the nearest comparable GAAP measures in our shareholder letter released today and our filings with the SEC, each of which will be posted on our website at ir.joinroot.com.

I will now turn the call over to Alex Timm, Root's Co-Founder and CEO.

Alexander Edward Timm
Co-Founder, CEO & Director

Thanks, Joe, and good afternoon, everyone. On today's call, I'll be underscoring a few highlights of Root's Q4 and fiscal 2020 performance and provide some additional context on 3 key drivers of our business: one, the powerful competitive advantages enabled by our investment in proprietary technology and telematics; two, how these advantages uniquely position us to manage risk as we expand our footprint and achieve scale; and three, how our seasoned states will increasingly contribute to our management of the business, the deployment of our capital and profitability. I'll then turn the call over to Dan, who will discuss our Q4 and fiscal 2020 results in detail, and then we'll open up the call for Q&A.

I'm happy to share that despite the unprecedented turbulence of 2020, Root is better positioned across almost every metric. We delivered a 37% increase in direct written premiums, while simultaneously delivering a 26-point improvement in our direct accident period loss ratio. That is tremendous.

Today, every large insurance carrier is eager to message to the consumers and to the world that they're developing advanced technologies. In reality, they are non-technology companies. Root is a technology company. So let me tell you a little bit about our technology and our models, and why we believe our models are so much better.

First, Root's pricing model has been built from the ground up based on modern technology and data, placing fairness at the center of our model. The realization that each individual is a universe of one has allowed us to create a better pricing and underwriting model and reward safe drivers. We put the customer in control, while simultaneously delivering a superior, modern experience via our mobile app.

It is Root's proprietary telematics that enables us to deliver these consumer benefits and deliver profitable growth to the business. The foundation of Root's proprietary telematics is the transparent collection and analysis of actual driving behavior off of a smartphone. This is the most powerful variable in our underwriting model. By collecting and synthesizing massive amounts of rich sensory behavioral data across thousands of driving variables, including identifying distracted driving, which is one of the biggest causes of car accidents today, we price based on actual causality rather than just correlation.

The data we collect identifies the worst 10% to 15% of drivers on the road. We call it like it is, and we don't sell to those drivers. This factor alone separates Root from any competitor. This allows us to then quote the remaining population fairly and at lower rates, which then allows us to build a more attractive book over time.

Let me be very clear. This technology is difficult to build. While telematics in one form or another has been around for decades, mobile telematics has actually only recently been feasible due to advancements in mobile technology, but as well as advancements in machine learning.

Today, we believe that Root has actually accumulated the largest proprietary data set of behavioral driving data tied to the associated claims data. We are the only insurance company to design our program to operate across our entire book of business. This has allowed us to build what we believe is the most powerful model in the industry. Almost all of our competitors outsource this capability, which prevents them from achieving similar results. This is evidenced by the Milliman study that validated Root is 10x more predictive than a leading industry competitor, and that was outlined in our prospectus.

So given all of this amazing technology, we often get the question, "Why can't we see it in the loss ratio?" To isolate the positive impacts of our proprietary technology and models, we've created a metric of seasoned states. As shared in today's letter, a seasoned state is a state where: one, the regulator has approved our data science-driven loss cost model; and two, we have been writing policies in the state for a minimum of 1 year, and we've gotten 2 price filings approved. Applying this criteria, we started 2020 with only 3 states that we considered seasoned. By the end of 2020, that number was 20. As expected, our percentage of earned premium in these seasoned states also increased throughout the year, and it totaled 60% in the second half of 2020, which has enabled us to draw meaningful conclusions about these states from that data.

What we've learned and what we see is that these seasoned states, during the second half of 2020, ran a loss ratio a full 15 points below unseasoned states. This demonstrates the success of our approach and the materially positive impact of our improvements in segmentation. This is possible through the increasing data that we have in these states, and this shows our data flywheel at work.

The strong loss ratio performance in our seasoned states in 2020 validates that the Root pricing model is working. It is consistent with our expectations at each iteration of our UBI model results in meaningful improvements in predictive power and segmentation, which then fuels our loss ratio trend. This is a trend that we fully expect to continue in the future.

As a management team, we take very seriously the deployment of your money. And as such, we are constantly balancing growth versus profitability. And something that's special about Root. In addition to driving growth and profits, growth actually also creates a natural moat around our business. This is what we call our flywheel. Basically, more data leads to better pricing. That drives faster growth as prices get better, which then leads to more data. That growth makes us smarter. And with each new learning, we create better products at better prices. And this is the beauty of a machine learning-based business.

Our seasoned state analysis is enabling us to learn and fine-tune our pricing model in each state before we aggressively drive growth. Once we have proof that our state's unit economics are sound, we quickly and efficiently then will throttle up marketing spend and the capital we are deploying in that state. This provides us confidence as we drive growth that we will also be driving profit. We look forward to sharing further details around the evolution of our telematics and our technology and the growth and performance of our business within these seasoned states in the quarters ahead.

With that, I'll turn that over to Dan. Dan?

Daniel Harris Rosenthal

CFO & Director

Thanks, Alex. Let me start by saying how proud both Alex and I are of the entire Root team's accomplishments in 2020. Together, we grew the business substantially, improved our path to profitability, made significant improvements around our debt structure and reinsurance arrangements and set the business up for long-term success with the completion of our initial public offering.

Against any backdrop, and particularly in the context of a global pandemic and all the disruption and uncertainty it caused, those accomplishments in 1 year are nothing less than extraordinary. We continued to show progress against our financial objectives in Q4. You'll find these, along with our GAAP financial results, contained in the shareholder letter we published this evening.

Highlights include: for the fourth quarter of 2020, we grew direct earned premium 30% year-over-year to $155 million; direct loss ratio totaled 76%, including $10 million of favorable direct prior period development, primarily in the most recent quarters. Adjusting for the impact of that prior development, direct accident period loss ratio totaled 82%, a 16-point improvement from the comparable period in Q4 of 2019. Direct contribution, a new metric that we're sharing with you, increased by $26.3 million to $13.5 million, with the majority of improvement coming from loss. I will be talking a little more about direct contribution in a few minutes as it's a really important profitability measure for the business. Adjusted gross profit increased by $18.1 million to $3.9 million.

And now pivoting to our full year 2020 results. We were able to show strong growth despite the decision to pull back on marketing spend towards the end of the first quarter, resulting from the global pandemic and surrounding macroeconomic and regulatory uncertainty. While this decision slowed our growth in the second half of 2020, overall, we were still able to deliver 37% growth in direct written premiums to $617 million. Direct earned premium grew by 71% to $605 million. Direct loss ratio improved 18 points to 82%, including $24 million of unfavorable prior period development. Adjusting for the impact of prior period development, direct accident period loss ratio improved 26 points from 104% in 2019 to 78% in 2020. Direct contribution improved $76.3 million to $18.9 million, with the majority of improvement coming from loss.

Adjusted gross profit improved by $75.2 million to a profit of $21 million. We ended the year with $1.1 billion in cash and cash equivalents at Root, Inc. and outside of our regulated insurance entities with an additional $255 million in cash and investments at our insurance subsidiaries. We feel great about our balance sheet, and it will enable all the progress yet to come.

Since our last earnings call, we've met with hundreds of investors and held nearly 70 one-on-one meetings. Your passionate interest in understanding the Root business model and differentiation was remarkable. Many of you asked great questions around our loss ratio trends. To be responsive, in our letter and as referenced by Alex, we provided additional cohort data around our seasoned state performance and the progress made in state management. I want to tie all that together to the 26 points of progress we made against the accident period loss ratio in 2020.

First, we attribute 15 points of improvement to pricing and underwriting actions taken in 2020. We separate these into 2 buckets. Our proprietary segmentation, which captures the power of our UBI and pricing algorithms to target superior risk segmentation, we believe improvements and further deployment of these models across 2/3 of our footprint delivered 8 points of annual loss ratio improvement. And state management, which was a focus for us in 2020, delivered a further 7 points of improvement. We attribute another 5 points to positive tenure mix as our renewal premiums increased as a percent of total earned premiums. And we attribute the remaining 6 points to COVID on a full year basis. Most of these came with lower claims frequencies in March, April and May, with a bit towards the end of the year as well.

So where are we going in 2021? We expect to continue to deliver meaningful improvements to the loss ratio through further seasoning of states and the launch of new iterations of our proprietary telematics model and pricing algorithm. In addition, our decision to enter fewer states in 2021 improves our loss ratio outlook. Net-net, we expect year-over-year improvement despite higher new writings and lapping the 2020 COVID-related favorability.

I also want to lay out where we are going in the longer term. We believe as our data grows and flywheel accelerates, we will continue to extend our pricing advantage. With a developed and tenured book, we expect to deliver a loss and loss adjustment expense ratio in the low 70s. We expect expansion of fee income via cross-sell of our homeowners product, where we collect an agency commission, as well as the embedded value of our telematics to grow a SaaS revenue stream. Minor variable cost efficiencies round out our long-term direct contribution target at 25% to 30%. We have added direct contribution to our ongoing reported KPIs. We, as a management team, focus on this metric and want to share it with you going forward.

Our capital strategy and reinsurance programs are also vital to our business. Part of my and my team's job is to take our direct outcomes and manage the net results. As detailed in our prospectus, we put in place a comprehensive reinsurance program. Our counterparties include 5 of the top 10 reinsurers in the world as well as a large pension fund. We've shared that our reinsurance program would be in place for at least the next several years because it enables us to both use reinsurance capital to fuel our growth and derisk the balance sheet. This program has a meaningful impact on our cost of capital and multiple lines of our consolidated financial statements.

We've also shared that our reinsurance program is made up of several layered treaties and is designed for flexibility. Earlier this year, we made the decision to delay the renewal of one of these reinsurance treaties. Because of positive loss ratio trends, we expect to receive superior terms by delaying the treaty from January 1 to April 1. This drives higher GAAP revenues as we retain more premium in the first half, but it has a negative impact on operating income due to reduced ceding commissions.

The decision to delay causes short-term noise in our quarterly financials. But as we have always said, we will make the right decisions for the long-term business rather than managing to quarterly results. While the modification to ceding levels will impact the P&L, we foresee only a minor change to overall 2021 capital needs because our structure has efficient alternatives, such as our Cayman captive, to manage the higher level of retained premiums.

I will close with a few more details on how we're thinking about the financial outlook for 2021, and then Alex and I will welcome your questions.

First, we plan to more than double our sales and marketing investments in 2021 following a COVID-driven pullback in 2020. This investment in marketing fuels an accelerating growth trajectory throughout the year. For the full year, we expect direct written premium in the range of $805 million to $855 million, and direct earned premium in the range of $685 million to $715 million.

Driven by my prior discussion of loss ratio, we expect direct contribution in the range of $25 million to $35 million. The delayed implementation of one of our reinsurance treaties results in ceded earned premium dropping to the mid-50s as a percent of earned premium by the second quarter, and then scaling back to our target ceding level by the fourth quarter. This reduced ceding level, along with fee income as a percent of earned premium consistent to 2020 and a nominal amount of investment income, results in GAAP revenues expected in the range of $270 million to $300 million.

Based on what we know today and our base case expectation of our reinsurance for the year, we expect other insurance expense to result in a small expense position in each of the first 2 quarters of the year, given reduced ceding commissions and transition to an offsetting contra-expense in the second half of the year as ceded premiums resume prior levels.

Our fixed expense base remains in line with 2020 as a percent of direct earned premium. Together, these assumptions result in operating income in the range of a loss of $555 million to $505 million.
With that, Alex and I look forward to your questions.

Question and Answer

Operator

[Operator Instructions] And we have our first question from Yaron Kinar from Goldman Sachs.

Yaron Joseph Kinar
Goldman Sachs Group, Inc., Research Division

Maybe a couple of questions on the loss ratio. So first, how exactly do you determine the various components of the loss ratio improvement? I thought it was fascinating the way you laid it out. I guess, as an outsider, I'm just curious, how do you know that 6 points of the improvement came from COVID as opposed to from seasoning or from the underwriting actions and then better segmentation?

Daniel Harris Rosenthal
CFO & Director

Thanks, Yaron. This is Dan, and nice to hear your voice. We obviously spent a lot of time talking to investors over the last couple of months who wanted to see additional data about the loss ratio, and we're thrilled to disclose the data today. We think it tells a very powerful story.

The chart that you see on Page 7 of the shareholder letter splits the 26 points of loss ratio improvement into the 4 different categories. And we talk about each of those categories in the letter itself.

I think, as you noted Yaron, it's very powerful to show that 20 points of that improvement, 20 of the 26, we believe were not related to COVID, but were related to the work that we have undertaken around getting our pricing algorithm and telematics models into market, working on state management directly state-by-state, as well as what you saw from the renewal customers increasing, which we showed later in the letter.

You asked about COVID itself. And we monitor very carefully COVID in a couple of different ways. And we think we have an ability to do that, that goes beyond most other carriers, given how we are able to use our telematics and track driving. So obviously, we're able to monitor miles driven, and we'll look forward to providing future updates on that on future calls.

We look at not just the quality of the miles driven, but the quantity as well. So we understand not only how many miles people are driving, but what time of day, what are the road conditions in those miles. So again, it gives us a good understanding of what's happening in the mileage itself.

And through all that, we did see, as we disclosed on our Q3 call, up 15 to 17 points of impact on claims frequency, mostly with a little bit of recognition of claim severity in that sort of mid- -- early to mid-March period through April and May. And then we saw a slight uptick towards the very end of the year that was not particularly material. So overall, blended across the year, it was 6 points represented in the loss ratio.

I think the other part that's relevant if you're looking and comparing to other carriers, is we -- our -- if you look at our footprint today of the 30 states, we are not licensed today in New York or in Massachusetts, which are obviously high commuting cities that had significant COVID restrictions in place for certain parts of 2020. And we're not particularly active in the California market, as you know, Yaron, given the inability to use telematics at this time. So that would include Los Angeles, San Francisco, again, high commuting areas with significant COVID restrictions.

So we think that that is part of the reason that as we've tracked the miles and understood our footprint, that's part of the reason as well understanding the 6% delta due to COVID.

Yaron Joseph Kinar
Goldman Sachs Group, Inc., Research Division

Okay. And it's not necessarily that I was trying to pick on COVID. I'm just trying to better understand how it is that you know that proprietary segmentation was -- accounted for 8% of the improvement versus say management accounted for 7%. How are you able to neatly allocate between the buckets, I guess, is what I'm trying to understand.

Alexander Edward Timm
Co-Founder, CEO & Director

Yes, that's a good question, Yaron, and this is Alex. Essentially, when we ship things in 1 state, they don't -- it doesn't all go out all at once. So for instance, if we have a new model that we're going to deploy, let's say, we deployed in Texas first. Well, we know that maybe another one of our states, maybe Ohio doesn't have that. And what we can do is we will look at what did the delta in the loss ratio do between those states before and after. And it's actually the same thing even with COVID. COVID hit all of these -- the mileage driven, we can look at that across a bunch of different states.

And so when you can look at state versus state, and you see certain state management actions, and then you start to see the loss ratios actually changed relative to one another, then that's really how you control for all of those confounding factors. And so that gives us -- we then load that in, and that gives us a good data set to begin to actually attribute where the loss ratio is coming from and sort of what are those principal components that are driving it.

Yaron Joseph Kinar
Goldman Sachs Group, Inc., Research Division

Got it. That's helpful color. And my follow-up, still on the loss ratio, would be, just looking at '21, I think you gave some qualitative commentary that you've shipped -- you expected the loss ratio to improve over the course of the year relative to 2020. Are you able or willing to quantify or give some sort of range, bridge the gap between where we ended 2020 and the longer-term target of the low-70s range?

Daniel Harris Rosenthal
CFO & Director

Yes, Yaron, I'll jump in on that one. And as you know, we haven't guided direct loss ratio specifically. We've instead guided to direct contribution, which really is how we manage the business, and we think an important metric for investors. Ultimately, there are some different offsets happening to the loss ratio in 2021 in terms of the outlook.

There are headwinds in 2 ways. One, we are anticipating elimination of the abatement of sort of the COVID benefit being abated year-over-year. So that is the way we are planning for 2021, although we're cognizant that no one knows precisely what will happen with COVID and its impact on driving and claims. That's what we're planning for the year. So if you think about that 6 points, that was 2020 benefit. We are planning that that is not showing up in 2021.

We also are planning negative tenure mix, and we showed this in the letter, because we are ramping up our growth and ramping up our level of new writings with our sales and marketing spend. That means that new writings will again be a larger percentage of our overall earned premium compared to renewals. And obviously, as you know, that will drive a bit higher loss ratio.

So we have headwinds from both of those things. That said, we believe we're going to have year-over-year improvement in the loss ratio itself due to continued benefits of the proprietary segmentation and state management work. So those first 2 buckets that we talked about are going to improve and overcome the headwinds from tenure mix and COVID abatement.

And so that's the way the loss ratio picks or takes shape. Although, again, we're not guiding direct loss ratio specifically for 2021.

Operator

We have our next question from Michael Phillips from Morgan Stanley.

Michael Wayne Phillips
Morgan Stanley, Research Division

I guess I want to touch on the comments in the letter and some things you said here about how there'll be some fluctuations in the KPIs for this year, given the way you're changing kind of new marketing plans in state expansion. Maybe can you expand upon what -- things that we should look for in terms of those near-term fluctuations?

Daniel Harris Rosenthal
CFO & Director

Mike, this is Dan. I'm not sure -- maybe if you could be a little more specific. There are some different puts and takes. Although, by and large, the strategy is the same strategy, consistent with what we've talked about during the IPO. Are there specific KPIs that you're thinking about beyond the loss ratio we just talked about?

Michael Wayne Phillips
Morgan Stanley, Research Division

No. I mean I'm referring, I guess, more so to, and maybe I read it wrong in your letter, but I'm referring more to, is it sounds like you're slowing down a bit of the state expansion to focus on the states where you've got the regulatory approval, so you can focus more on the loss ratio. I guess what that means going forward for this year and customer count and premium -- you've given your guidance on premium, but customer counts. I mean your sentence was, "Our investments are going to cause near-term fluctuations in our KPI as a result of our new investments in 2021." So I'm kind of just focused on that, and what KPIs you're referring to? Does that help? Or if not, we can...

Alexander Edward Timm
Co-Founder, CEO & Director

Yes, that helps. This is Alex. And maybe I'll start with sort of how we're managing those big investments that we're making, and then turn it over to Dan, and he can talk a little bit about those impacts.

In terms of state expansion, we do want to be very cognizant of the balance between growth and profitability and ensuring that we're really making the right and appropriate trade-off in that -- in states we have in testing mode versus states that we have in -- that are fully seasoned. And that process is somewhat volatile. And as we add new states, we're going to learn our way into those states. And additionally, when we do that and how we do that can be dependent on regulatory timelines.

Now as we add those states and the faster we build confidence in those states, we'll certainly be able to then accelerate growth in those states. And so that's going to be some of the things where you may see some noise, which, like I said, there's just some inherent variability, whether it be from regulators or how long it takes us to really build confidence in those states to push growth.

Now the second is we're continuing to push out new products, right? We're still in mostly monoline auto. We are now -- we've launched our renters product, and we're scaling that. We're also launching and scaling our homeowners product, which is going to also materially change the business, but that's still some investments that we're making.

And then lastly, what I'll touch on, too, is we're still investing in brand, and we've been very happy with those results, the Bubba Wallace campaign around progress as an apology, which was really our way of explaining our brand in a very authentic, modern way. That got almost 0.5 billion impressions in a matter of a month. And so we're starting to see early signs of success of those brand initiatives. And so that's something we're going to continue to invest in, which we believe, long term, definitely pays off, but we also understand you don't build a household brand in a matter of a couple of months.

So those are some of the big investments that we're making today that we believe, long term, it certainly pays off well for the business, but predicting the exact timing can be difficult.

Dan, do you want to talk maybe about some of the other key KPIs that may be impacted?

Daniel Harris Rosenthal
CFO & Director

Yes. I think, Mike, now I understand your question, and I appreciate it. I think we've talked about there are 4 fundamental things that matter in the business as we manage it on a day-to-day basis: growth, loss ratio, retention and customer acquisition cost. And Alex just touched on most of those 4, but just to hit them quickly.

On growth, I think what we're trying to guide to is that there are going to be accelerations throughout the year. As we increase this marketing spend, you're going to see that show up in written and earned premium over the course of the year with acceleration along the way but starting off smaller.

On loss ratio, I think I've touched on that in terms of that trend. And obviously, part of what -- the decision that we've made is to approach data expansion a little bit more moderately, although we expect to be in 85% of the U.S. addressable market by year-end. So again, quite significant growth, quite a significant footprint.

On retention, retention for us is consistent with what we reported in our prospectus. The guidance accounts for continued seasoning of states, which could include pricing changes in a couple of places and temporary retention changes, not significant material near-term fluctuations. But that's a little bit about how we expect retention to progress through the year.

And then CAC, Alex talked about the brand spend. And we talked about this, Mike, in our third quarter earnings call that we were going to invest into the IPO and the Bubba Wallace campaign and frankly, testing out some of our marketing and branding to prepare us better to be in that larger footprint as we go throughout 2021 and beyond. So it's consistent with what we talked about in the third quarter.

We're expecting our customer acquisition cost levels to be a bit higher in the fourth quarter, and then in the early part of this year. And then you'll see that scale, I think, in a more efficient manner as the year continues. And we'll see the impact of the marketing investments we're making in the back half pay off even as we get into 2022. So that's a little bit of how we expect the year to progress across those 4 key KPIS.

Michael Wayne Phillips
Morgan Stanley, Research Division

Okay. No, that's very helpful. I guess, this question will be geared more towards the states that you call the seasoned states and maybe the one specifically that you show on Page 9, kind of your bigger states, Texas and Kentucky and PA and Arizona. Do you think, given where you're -- where you showed the loss ratios are at this year, do you think your current level of pricing in those seasoned states is where you need it to be? Or is there more work to be done on just an absolute level of pricing in those season states?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes. The absolute level of pricing, we feel good, we feel is adequate in the seasoned states, for sure. That being said, right now, we have UBI 4.0 in the hopper, and it's going to be shipped out sometime in the first half of this year. It is -- has a material improvement, showing roughly a 30% improvement in predictive power over our current -- of our prior model, so that's substantial.

We're also continuing to find other segmentation benefits. And so we're going to keep rolling those out into those states. Now when we're comfortable with the target loss ratio that the state is running at, which like I said, most of those seasoned states, we are, what we do is we actually float those benefits to conversion and allows us to grow faster and reduce customer acquisition costs even further. And so that's really the plan there. But we -- in those seasoned states, we feel very good about rate levels.

Michael Wayne Phillips
Morgan Stanley, Research Division

Okay. Last one, more generically for me guys is just -- if you look back over your history so far, mobile-based UBI telematics is fairly unique and something probably a lot more difficult than other forms of telematics. But what do you -- what would you classify as, I guess, the hardest piece to get right for a mobile-based? Is it data integrity? Data quality? Or what would it be? How would you classify what's been the biggest challenge for you using mobile-based technology for telematics?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes. That's a very good question. And it's something that is hard to answer because, really, the thing you have to nail about mobile telematics is everything. And why it's not so simple to say there's only one thing, right? You've got to understand the engineering components of each of the smartphones and each of the makes of smartphones, you have to understand the quality of data you're pulling off the phone. You have to then understand the physical events going on in the vehicle. And that alone is very difficult, to actually understand what a hard brake looks like, what texting and driving looks like. All of that is very difficult.

But what makes it much harder and what very few people are then able to do is to then take all of that data and all of those insights and technology and correlate it to actual underlying claims data. And that's the benefit we get as a carrier. We're not using any sort of implied claims or anything like that, we are just tuning on the actual underlying data. And that's why our model has become so much more predictive than, really, any of our competitors because we can do and build all of this technology fully in-house.

So if I was to say one thing that's difficult, the most difficult thing is, if you want to do this right, you have to be a technology company and an insurance company. And that's a very difficult business to build.

Operator

[Operator Instructions] We have our next question from Tracy Benguigui from Barclays.

Tracy Benguigui

Maybe we could touch on the favorable reserve development. I remember last quarter, you experienced unfavorable, and now it's favorable. And I'm wondering if it's a little bit of Goldilocks and porridge, if maybe you took too high of a charge last quarter. And you were able to release some this quarter, and we should be just about the right spot on a going-forward basis?

Daniel Harris Rosenthal
CFO & Director

Thanks, Tracy. This is Dan. And if my kids are listening to the call, they will be thrilled that this might be the first part of the call that they actually understand with the Goldilocks and porridge reference. I'm not sure I remember enough of it to be accurate in sticking with your analogy. But here's what I would say. They really are not related. We talked about the first part back on our Q3 call. The new disclosure for the fourth quarter, specifically, you're right. On a direct basis, we took $10 million in favorable prior development. The vast majority of this related to accident year 2020. Whereas what we talked about on the Q3 call, were mostly related to prior years. So it really is apples and oranges, if you will.

Overall, I would just note, Tracy, we really feel great about our reserving process. We've invested considerable resources in it, just like Alex was talking about on Mike's question. I think it's one of the places that, for us, traditional insurance principles with a great reserving actuary, combined with technology and data science has really made a difference in supporting the critical work around reserving. So we're really thrilled about the position we're in and feel good about it going forward.

Tracy Benguigui

Excellent. And then my follow-up is really on the delay of implementing your reinsurance -- one of your reinsurance treaties. I'm just wondering if that would lead you to conserve more capital and not be able to grow at the same speed until you're able to close on that contract?

Daniel Harris Rosenthal
CFO & Director

Yes. Tracy, the good news is -- this is Dan again. As you know, we've got over $1 billion in cash and cash equivalents on the balance sheet, as well as a couple of hundred million in the insurance company. And so we are well positioned for the year. We're certainly not managing month-to-month.

We're doing the right thing for the long term. And frankly, as we talked about, we've put in place a really comprehensive reinsurance program that we're proud of. Our counterparties include 5 of the top 10 reinsurers in the world, as well as a large pension fund. And the way we've talked about our reinsurance program has been really consistent. It will be in place for the next several years because it allows us to use reinsurance capital both to fuel growth through the ceding commissions, as well as derisk the balance sheet. So really twin positives.

The program does have a meaningful impact on overall our cost of capital. And the way we've talked about it is there are several layered treaties, and it's designed for flexibility. So earlier this year, we saw the way that our loss ratio is trending in the fourth quarter, and frankly, into January. And so we made the decision to delay the renewal of the January 1 treaty, and we intend to delay it until April 1. Frankly, we're making great progress on the April 1 treaty. We have soft commitments that indicate oversubscription at favorable terms. So we're excited about it. It was not motivated by any short-term financial concern. It will not at all impact our strategic plan and growth investments for 2021. In fact, it's quite the opposite. It's the right thing to do for the long term of the business. And again, the support from our reinsurers at improving terms shows that our loss ratio is trending well.

Tracy, as you know, reinsurers care about 3 things: loss ratio, loss ratio and loss ratio. So the fact that this is moving positively as we approach April 1, is, again, a nice positive reinforcement of the way our loss ratio is trending. So we'll look forward to coming back on our Q1 call and talking more about where it stands.

Tracy Benguigui

I appreciate the comment about the oversubscription because then that would -- that was like my follow-up question if there wasn't a meeting of the minds, but that's good information.

Operator

We have our next question from Elyse Greenspan from Wells Fargo.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

So my first question, you guys -- I recognize this is the first time you guys are giving 2021 guidance. And obviously, a bunch of moving parts, and you guys obviously don't want to guide to a specific loss ratio. But is there a way, just kind of diving back into some of the prior questions, that you could give us a sense, like, how we can think about it? It sounds like the profitability that you're expecting for 2021 kind of when we adjust for some of the timing of the reinsurance noise is better than what it would have been 3 months ago. And so can you just give us a sense on, obviously, as you're doing less state expansion, just how do we can think about the profit, how it looks better perhaps today than it would have been a few months ago?

Daniel Harris Rosenthal
CFO & Director

Yes. Elyse, thanks for the question. This is Dan. You're right. Just to reiterate a little bit on the loss ratio and tie it into your question. If you look at all the puts and takes in the loss ratio, what we're saying is we are -- we expect a bit of year-over-year improvement overall in the loss ratio, although we're not guiding to a specific number.

You can see in direct contribution, we're guiding to a range of $25 million to $35 million that we're very pleased about and reflects the fact that we are moderating state expansion so we are going to have a bit of, frankly, loss ratio relief from starting those states in the right manner and trying to put in place our pricing algorithm and telematics and appropriate rate plans from early on. And so as opposed to trying to do every state this year, and that remains, the goal is to get to 85% of the addressable market by year-end, which we still believe is obviously very significant. We will protect the loss ratio, and frankly, protect our capital that we are investing.

So then as you go down the profitability lines, I think that was sort of the other part of your question around operating income. And most of that, frankly, is tied to the sales and marketing expense and the ramp-up in that, which we've talked about at several different points. There are -- as you alluded to, Elyse, there are some puts and takes from the reinsurance. The fact is we are going to be ceding less premiums by delaying the treaty from January 1 to April 1. So that means our GAAP revenues will be increased because we are retaining a bit more premium. But it means we'll be paid a little bit less in ceding commissions.

And so obviously, if you think about that on that other insurance expense line as a contra expense, that will be a bit lower. Again, we think that directionally, this is absolutely the right thing to do for the business in terms of how we're managing our state expansion. And from a capital standpoint, our plan around reinsurance is highly consistent with what we talked about during the IPO. And frankly, just taking advantage of the fact that our loss ratio continues to trend in the right direction in the overall market conditions.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. And then your policy growth actually looked pretty good and picked up in the quarter. Obviously, growth may be a little bit lower than you would have expected in 2021, right, just due to your kind of state expansion plans switching a little bit. We've also, in the market, right, heard about some other players trying to use the UBI at the point-of-sale similar to what you guys are doing. So I just want to get a sense, it sounds like the growth being lower is due to your own decision, right, not to expand in certain states and not due to some other competitors in the space?

Alexander Edward Timm

Co-Founder, CEO & Director

Yes. Absolutely. You're totally right. This has completely been within our own control and is our own decision because we think it's prudent and we really haven't seen -- although there's a lot more advertisement out there around apps -- there were apps. Every major competitor had an app that presumably did what Root did 5 years ago when we started the company. And we haven't seen any material changes in that technology that has made us see any sort of increased competition or difficulty in actually acquiring customers.

Elyse Beth Greenspan
Wells Fargo Securities, LLC, Research Division

Okay. And then one last one for me. There's an ongoing event in Texas. I recognize that usually cats are not typically big auto losses whatsoever. But due to just kind of the winter -- the storms there and just that it's kind of an unprecedented event. Do you guys have a sense of your exposure that we should be thinking about some losses there?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes. First, I'll jump in here and then let Dan talk a little bit about the financial impact. But first, I do want to say we do have employees in Texas and customers and partners, and we are very aware that a lot -- that they are going through a lot right now and have been affected by these events. And we're definitely thinking of them, and we have proactively reached out to our customers to allow them to know about extending grace periods as they may not be able to pay their bills. And so we're certainly thinking about everybody down there.

Dan, would you like to maybe cover some of the financial impacts?

Daniel Harris Rosenthal
CFO & Director

Yes. Thanks, Alex, very well said about the events in Texas. And Elyse, thanks for the timely question. I mean we've seen insurance industry loss estimates ranging from $5 billion to $20 billion on risks affecting several lines of business across the entire state. So obviously, a significant event. But as you noted, Elyse, much less so from an auto perspective. We're protected in a couple of ways. We've observed the slight uptick in claims being reported in Texas in the last 2 weeks, but the losses don't look like they will materially impact our book.

It's still obviously a bit early to estimate an aggregate loss on our book. But it's worth noting and reinforcing that we have a robust catastrophe reinsurance cover in place that limits our exposure to $3 million per catastrophe event or just under about 50 basis points loss ratio impact to the overall annual result.

And then in addition to that cat coverage, we renewed our XOL coverage on January 1 of this year for $900,000 by $100,000, which obviously limits our exposure to large claims. I think the other thing that we've done nicely, although Texas is our largest state, obviously, is we've diversified our premium across our 30 states in a really good way, that in addition to the reinsurance coverages, really minimizes our overall risk tied to any 1 event in a single state.

Operator

We have our next question from Phil Stefano from Deutsche Bank.

Philip Michael Stefano
Deutsche Bank AG, Research Division

So in the shareholder letter, you talked about routinely changing the pricing, fine-tuning the models, being able to reprice the algorithms every 9 months. I was hoping you could talk about, like, the state regulators, in my mind, don't move as fast as you do. And what are the frictional pressures of having new pricing so often, but the regulators may be not being able to keep up with you?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes, that's a fantastic question. It's something certainly that I think we've pushed in the industry. One, I will say, like, not all the states are sort of created equally at all. There are certain states where, theoretically, you can file every day and change your pricing structure every day or every week. Certainly, that's not something we tend to do, but we do want to file more frequently.

And that goes all the way to other states that want you to only change your prices a couple of times a year or maybe 4 times a year or once a quarter. And those states we reach out to, and we've got really good relationships there. And we look to see, okay, how do we actually build in flexibility to that rate plan specifically that then allows us to iterate around meaningful things. So for instance, when we update the UBI model, that just makes it more accurate, how do we make sure that maybe we can expedite some of those filings.

You know, in the early days of state launch, that's usually where we have the biggest changes. And so those are really the ones that we expect to take the longest. But then typically, from there, as we build these relationships out and as they get more comfortable with what our models are doing, the updates don't take nearly as long going forward.

Philip Michael Stefano
Deutsche Bank AG, Research Division

Okay. Okay. And maybe a follow-up to a question that Elyse had earlier about the competitive dynamics in the industry. But mine is less so focused on the UBI and telematics, and just more broadly, it feels like some of the legacy personal lines insurers have been cutting price recently on the auto business in reaction to COVID and the auto frequency benefit. I mean have you seen this in any way impacting the growth or the retention metrics that you have? Are you feeling this in the market yet?

Alexander Edward Timm
Co-Founder, CEO & Director

No. We have no data that suggests right now that we're feeling that in the market. It is a massive market. Again, it's a $266 billion market. And so we're still quite small, and so we believe, particularly, because our product is so unique with our telematics differentiation that that does provide a pretty robust book of business against a lot of the more macro trends. So if State Farm lowers their rates 3%, we're probably not going to be very heavily impacted by that just because we are so differentiated in the market, and we are still so small relative to the size of the market.

Operator

And now we have our next question from Matt Carletti from JMP.

Matthew John Carletti
JMP Securities LLC, Research Division

A question on the top line, and as we think about the '21 guidance and kind of, for lack of a better term, a rebalance a little bit between growth and loss ratio. Well, I know you aren't -- you haven't provided any guidance on kind of a 2- or 3-year view, I'm sure you have it internally. Would there be any change to where you'd expect to be from either a PIF or a direct written premium standpoint 2 or 3 years out from these changes? Or is this more of just kind of steepness of the line in which you get there?

Alexander Edward Timm
Co-Founder, CEO & Director

Yes. I'll maybe talk first and then pass it over to Dan for some of the particular timing. We do not think that these changes, the small change in top line or rebalancing in our projection for 2021, we do not think that that changes the fact that we're still in a giant industry, that we are still, long term, going to be national and that we still see a massive opportunity to build market share via our differentiated products.

So I do not think that this changes, whatsoever, the long-term nature or value of the business. And so Dan, you could talk a little bit about maybe some of those nearer-term metrics and what we think -- how our -- as our strategy evolves, how some of those things might change.

Daniel Harris Rosenthal
CFO & Director

Yes. Thanks, Alex, and thanks, Matt, for the question. Nice to hear your voice. As I talked about at the top of the call, we have been out on the road talking to investors, and it's been wonderful. I mean the interest in Root, the interest in understanding our business plan. Alex and I have really enjoyed it, and we're looking forward in the conferences ahead and the one-on-ones to getting back out there.

And frankly, the message that has come through loud and clear that is highly consistent with our strategy is to drive our investments towards sustainable, repeatable, durable growth. That's our focus. So we're really excited about the seasoned states and the progression in the seasoned states because for us, that's sustainable, repeatable, durable growth. We see it in the data. And so that's where we want to focus our investments.

So we don't feel like this is a significant slowdown in growth. We're still going to add 7 states this year, and we expect to be in 85% of the addressable market in the United States by year-end. That's a big deal.

So as far as what happens then in '22 and beyond, as you noted, Matt, we're not providing specific guidance at this time. But our overall outlook remains really consistent. This is just a massive opportunity in auto. And as we further enter states and season them, we're confident, as Alex said, that we're going to progress to our longer-term goals.

Matthew John Carletti
JMP Securities LLC, Research Division

Great. And then just a quick follow-up. Kind of as a -- as we think about kind of that little bit slower state rollout. Can you talk a little bit about what that might mean for kind of the -- as you're implementing the UBI 3.0 and rolling out 4.0, will it allow you to do that more efficiently because you're just focused on a smaller set of states, a more mature set of states? And if so, what might we expect or what might that mean for test drive periods, difference between pre- and post-telematics loss ratios, which I know you quantified a little bit in the shareholder letter. I'd be curious if you could talk about that for a second.

Alexander Edward Timm
Co-Founder, CEO & Director

Absolutely. I'll talk about it at a higher level, and then pass it over to Dan for any further details. Focusing on a smaller set of states, while still getting to 85% of the U.S. population is definitely, I view it as a win-win because that's still a material increase in addressable market, but while being able to focus on fewer states. And so that allows us then to roll out these models much quicker. And too, really in a controlled sense, measure how these models are performing real-time in these states. And so certainly, it will allow us to continue to iterate faster and to push faster on our pricing models.

So what you'll see, too, is as we've iterated on these models, things like the test drive period, for instance, actually have become shorter. We're actually able to identify good risks versus bad risks much sooner and better and more accurately. One of the things that our new model also does quite well is it does better with limited and sparse data. So as we know that there are phone models out there that, for whatever reason, you may not get high-quality data off of. And as we've advanced these models, we've gotten much better at that.

So where there are consumers that maybe we can want -- we watch for a long period of time. And we say, "Hey, maybe we still don't know or we don't have a degree of confidence enough to give that person a quote." That number is reducing quite a bit. And so you're seeing improvements, really, throughout all of the product in terms of shorter test drives, usually means happier customers, they don't have to wait as long. And that really does sort of compound and create a better product experience.

In terms of numbers, I do believe we found some good ways to reduce even the pre-telematics loss ratios, and even optimize the post-telematics loss ratios. But I'll leave that, Dan, if you'd like to comment on that.

Daniel Harris Rosenthal
CFO & Director

No. I think you nailed it. And maybe just in the interest of time, happy to catch up later. But I think you nailed it in terms of the evolution.

Operator

And we have our next question from David Motemaden from Evercore ISI.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

I just wanted to confirm, it sounds like you still expect marketing spend to more than double in 2021, but you are entering into fewer states and, I guess, will be acquiring fewer customers than originally is planned. I guess, have you changed at all the marketing expense expectation? Or are you just kind of continuing with the same level of marketing spend as a sort of, I guess, down payment on growth post 2021? Or whenever you enter into the remaining states after 2021?

Daniel Harris Rosenthal
CFO & Director

Yes, David, it's a great question, and it's really the latter. We're continuing with the similar level of marketing spend. We are going to invest in brand spend. And we talked about earlier how we've really seen it work through the fourth quarter, and now we want to continue to test, even recognizing that the payoff may be later in the year or into '22. We think it's really important as we continue to expand our footprint and outweighs any near-term pressure.

So while overall, CAC is going to remain a little bit elevated in the earlier part of the year, we do expect to see gradual efficiency throughout the year, particularly as we do enter those new states where we should see benefit from improved awareness and high efficiency, social and digital ad placements. So that's the plan that we are implementing in '21.

Operator

And then we will take our final question from Mark Hughes from Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Just a quick one. Dan, did you quantify how much GAAP revenue might be impacted by the delay on the reinsurance agreement? Presumably, it's a little bit of a tailwind, but any sense what that could be?

Daniel Harris Rosenthal
CFO & Director

I didn't specifically, but I'd point you to the guidance, obviously, with the revenue range from $270 million to $300 million from the year, which is reflective of the reinsurance plan. And I talked in my remarks at the top a little bit about how we expect the ceding levels to flow throughout the year. And so that effectively can help you understand the direct impact to GAAP revenues.

Operator

This concludes today's presentation. Participants may now disconnect. Thank you for participating.

Daniel Harris Rosenthal
CFO & Director

Thanks, everyone.

Alexander Edward Timm
Co-Founder, CEO & Director
Thanks guys.