

Qualitas Controladora (Q): Mexico's Largest Auto Insurance Company

Qualitas Controladora (Q) is Mexico's largest auto insurance company in Mexico with operations in El Salvador, Costa Rica, and the United States. It offers insurance for personal cars and pickups, cargo pickups, trucks, public passenger service, border and regularized, tourists, motorcycles, and civil liability insurance. The company also provides automotive spare parts and windshields.

Elevator Pitch: Q commands 30% market share in an under-penetrated auto insurance market. The company's grown revenues at a 24% 10YR CAGR while expanding operating margins by 10%. Q has a history of returning capital to shareholders via dividends and share buybacks (5% buyback in 2019). Insiders own over 50% of the business with the CEO owning 47% of the common stock. We believe the company can generate 25%+ ROC per-year over the next five years by:

- Expanding penetration rates in Mexico
- Commanding higher market shares in adjacent regions (El Salvador & Costa Rica)
- Vertically integrating the auto repair process into their existing operations

Investors get all this for <10x normalized earnings and 1x EV/Sales.

A 25-Year Overnight Success

Q's journey from start-up to largest auto insurance company in Mexico is astounding. The company was founded in 1994 by Joaquin Brockman Lozano. Lozano is still the CEO and chairman of the company.

The company wrote its first policy on March 22, 1994. It's inaugural year-end stats included:

- 15 service agents
- 38 employees
- 2,000 policyholders
- \$5M pesos in written premium

Over the next 25 years Lozano created the largest auto insurance company in Mexico. He expanded service agents, hired more employees and wrote more premiums. On top of this he increased employee economic productivity by ten-fold.

Check out Qualitas' 2019 numbers:

- 13,809 service agents (+91,960%)
- 4,898 employees (+12,789%)
- 4.1M policyholders (+204,900%)

- \$34.2B pesos in written premium (+684,880%)

Moreover, Qualitas turned -\$76K in economic loss per employee to **positive** \$1.3M per employee *while increasing employees 12,800%*!

So how did this quiet, almost forgotten auto insurer come to dominate the entire Mexican market?

The short answer: **nobody cared about auto insurance 25 years ago**. Nobody except Lozano.

Afterthoughts Create Niche Opportunities

25 years ago, Lozano realized insurance companies completely forgot about auto insurance. He elaborates on this idea in a [2019 interview](#) (emphasis mine):

*“A quarter of a century ago, **automobiles were seen by employers and agents as a complementary and not a main insurance branch, which forced them to dedicate themselves to Life, Medical Expenses or Damages.** Perhaps for this reason, many considered the **creation of a specialized Insurer crazy.** However, I saw possibilities for it, and today Quálitas is a company that is not only a leader in its field, but also already has a presence in El Salvador, Costa Rica, the United States and Peru is about to be added.”*

Where others saw the “ridiculous”, Lozano saw opportunity. When insurance markets opened in Mexico, it was the Fire, Transportation and Life policies that saw change and lower prices. Autos were left in the dust. It was *then* that Lozano founded Qualitas.

It's not enough to enter a complacent industry with a vision to capture leading market share. Lozano realized the company needed **focus** to win. Here's his thoughts (emphasis mine):

*“What has made Quálitas great? There are several factors. **A first one that I would mention would be focus.** If we ask ourselves if we sell a product or a service, the answer is a service. Understanding this, **we structure the company so that the service is provided.** That makes the contact with our Clients, who for us are Agents - insurance buyers for their prospects - strong and committed. With this philosophy is that from within the company **we seek that we are all aligned and operate with that vision.**”*

This focus enabled Qualitas to take the No.1 market share spot in 2007 and never look back.

Now, the company has its sights set on maintaining its lead in Mexico while capturing greater market share in adjacent countries like El Salvador and Peru.

Here's the wild part. Qualitas is *just now* starting to implement massive cost-saving measures through vertical integration. These cost savings should flow through to customers, which allow Qualitas to write more premiums and command larger portions of the auto insurance mindshare.

Additionally, Mexico [passed a law in 2019](#) mandating liability insurance against third-party damages. In other words, auto insurance wasn't even *legally mandated* until last year. Qualitas didn't have the *massive* regulatory wind at its back yet commanded 24% 10YR revenue CAGRs.

Assessing The Mexican Auto Insurance Industry

There's five main players in the Mexican auto insurance business (and their respective market share %):

- Qualitas: 29.9%
- GNP Seguros: 12%
- Chubb Seguros: 10.6%
- AXA Seguros: 9%
- HDI Seguros: 7%

The second-largest competitor commands less than *half* of Qualitas' market share. That's market dominance.

When you examine only the top five competitors, Qualitas' scale gets *that much more* impressive. For example, out of the top five Qualitas:

- Wrote 42% of premiums
- Earned 48% of premiums
- Generated 67% of operating profit
- Generated 60% of net profit

We can also see Q's Loss & Combined Ratios against its competitors. For those new to insurance markets, here's what those ratios measure:

- **Loss Ratio:** The ratio of losses to premiums earned
- **Combined Ratio:** measure of underwriting profitability in insurance, calculated using the sum of incurred losses and expenses divided by earned premiums

Insurance ratios are like golf scores. The lower the better. A high loss ratio means the company pays a higher percentage of claims than they receive in premiums. A loss ratio >100 means the company is *losing* money on each premium written.

The same goes for combined ratio. Combined ratios >100 indicate an underwriting loss on the company's insurance policies.

This doesn't mean insurance companies report *operating* losses if their ratios are above 100. Just know that if they do, all their operating income from that period came from their investment gains.

That's important because investment portfolio gains are *very* unreliable. And since GAAP changed the way companies report investment gains/losses, it could drastically change the perceived valuation of a company.

It's best to focus on the insurance business' profits and ratios.

In short, Qualitas destroys its competition in Loss Ratios:

- Qualitas: **59%**
- Market average: **63%**

- Difference: +400bps

They also dominate in Combined Ratio:

- Qualitas: **86.5%**
- Market average: **91.3%**
- Difference: +480bps

Another way to view Combined Ratio is subtract those ratios from 100 to find your profit margins.

The Four Segments of Mexican Auto Insurance

We can break the Mexican auto insurance market into four categories:

1. Cars
2. Trucks
3. Tourists
4. Other (mainly motorcycle)

Qualitas ranks either 1 or 2 in each category. They're first in cars (22% share), trucks (47% share) and motorcycles (27% share). Second in Tourists (18% share).

An Unrivaled Industry Leader

No matter how you slice the industry, Qualitas reigns supreme. The company generates more net income and investment income than its closest four competitors **combined**.

I can't stress how important this lead is in an industry like auto insurance. Since the company writes more premiums and captures more earnings than its peers, it's able to reinvest at higher rates back into its business. This leads to stronger competitive advantages and deeper moats through increased service agents, faster response times and greater technology.

Those advantages beget *even more* premiums, earnings and investable float. This allows Qualitas to invest *more capital* than its peers, which (hopefully) creates more income. It's a tremendous virtuous cycle.

The Qualitas Advantage

We can see Qualitas' competitive advantages best if we walk through the steps of buying the policy and using it in an accident.

There's two parts to the Qualitas consumer experience: **Advice & Contracting** and **Claim Assistance**.

Qualitas has over 16K service agents "in the field" to help find and inform consumers about insurance options. Such information includes policy conditions, parties' rights and a glossary of terms to facilitate interpretation.

After finding customers, Qualitas uses a risk-based pricing model. Schemes like double-deductions for heavy trucks mainly driven at night on high-risk roads. Once Qualitas understands the risks and the type of vehicle

they're insuring they move to vehicle inspection. This is where customers snap photos of their vehicle through the Qualitas app or with a Qualitas service agent.

Now let's talk about **Claim Assistance**. This is where Qualitas shines. Because Qualitas is the largest auto insurer in the country, it can reach its policyholders *where they are* faster than anyone else in the industry.

There's four steps in Qualitas' Claim Assistance:

- Report the accident
 - Q customers can report claims three ways: calling a service agent, using the Qualitas app or scanning the QR code on their policy card.
 - The last two steps allow Qualitas to geotrack the policyholder's phone and send out a field agent or medical assistance to their location.
 - Like Uber, Qualitas customers can track in real-time the ETA of their service agent.
 - Here's Qualitas' advantage: **Q claim officers arrive 85% faster than their competitors.**
- Adjustment
 - Qualitas takes care of making sure the vehicle is off the road safely and towed to a repair shop of the customers' choice.
- Valuation, Repair and Payment
 - Once the vehicle is at the repair shop, Qualitas expert staff inspect the damage and assign a valuation for the estimated repair cost. The company then takes care of the sourcing of parts and materials needed for the repair.
- Medical / Legal Assistance
 - Finally, Q policyholders have access to medical and legal advice in the event they were hurt because of the accident.

It's easy to see why people choose Qualitas to insure their car. With the largest network, fastest response time and latest technology, why choose another insurer?

Narrative To Numbers

Qualitas had a record 2019 by any metric. The company wrote \$36B pesos of premiums, earned \$35B of those premiums and generated \$5.3B pesos in net profits.

There's two reasons for this growth. First, Q experienced double-digit growth in its "Traditional" business segment. They attribute this to their competitively priced offering and footprint with 16K service agents across the country. Second, the company expanded their foreign business, growing El Salvador and US premiums by 14% and 16% respectively. They also tripled the number of policyholders in Peru.

Another thing to note is the company's 47.3% ROE. This is *well above* the company's internal target of 20-25%. The higher-than-average ROE is due to stronger underwriting margins and a decrease in theft and higher accident prevention.

Strong underwriting margins coupled with strict cost-control measures leads to a *giant* investment float portfolio.

Qualitas Investment Assets (Float)

Qualitas has nearly \$32B pesos of invested assets (or float). The company earned 8.2% on its float in 2019.

Here's their portfolio allocation at the end of Q3 2020:

- 63% government debt
- 17% private investments
- 11% public equities
- Rest in cash & international debt

Q's investment portfolio averaged 5.6% returns over the last five years.

Qualitas Today: Still Breaking Records

2019 looked like an outlier year for the company. Or so we thought. So far Qualitas is *smashing* their 2019 record in 2020. That's *during* the pandemic.

Their latest Q3 presentation reveals what will likely be *another* record-setting year. What's impressive isn't their written premium or earned premium growth (+0.4% and +6.3% YoY). It's their underwriting results.

YTD 2020 Qualitas has increased underwriting results 90.3%, from \$3.2B pesos to \$6.15B pesos. That's good for 19% net margin and 45.7% ROE. Not bad!

How did they do it? Ruthless reduction in loss and combined ratios. Qualitas' YTD ratios are incredible. They're sporting a 49.1% loss ratio and 79.4% combined ratio. Remember these figures were 59% and 87.6% a year ago.

The company also has \$12.44B pesos in surplus reserves for a 718% solvency margin.

Why Qualitas Can Grow Premiums & Profits

There's two main engines for Q's future profit and premium growth:

- Mandatory insurance requirements



Mexican auto insurance penetration rates are 39% as of Q3 2020. That means there's *plenty* of room for Q to grow policyholders and number of written premiums.

We believe Q will capture *most* of these new customers for the simple reason that it's the largest and most popular insurance provider. It likely has the largest mind-share with customers and citizens. Think about US auto insurance. Would a new customer likely go with Geico or Elephant Insurance?

- Vertical integration of ancillary services

Last year Qualitas spent over \$11B pesos on suppliers to deliver products and services for Qualitas' policyholders.

This is a **huge** market for Qualitas to roll-up the services they use the most. And we're already seeing that with the company's acquisition of three subsidiaries:

1. Outlet de Refacciones

Acquires second-hand automotive spare parts, completing its inventory with its own operation of disassembly of cars declared as total loss in claims. Qualitas increased its sales by 30% in 2019.

2. Easy Car Glass

It operates as a wholesaler of automotive windshields, which markets and distributes to CristaFácil and other repair sites. Qualitas increased the subsidiary's sales by 38%.

3. CristaFácil

Service provider of repair or replacement of windshield glass, works mainly under the franchise model. Provides important synergies with the activities of Easy Car Glass. Qualitas increased service calls by 21%

These bolt-on integrations are low-hanging fruit and Qualitas is *just* getting started.

There's a few more services they could roll-up in the next few years, including tow trucks, legal departments and auto body repair shops.

Valuation

Qualitas trades at an absurd 1.1x EV/Sales, 6x EV/FCF and 7x normalized EBIT.

Let's assume the company grows top-line premium revenues 5%-per-year for the next five years. That gets us 2024 \$46.4B pesos in revenue. Now let's assume they maintain roughly 19-20% gross premium margins. That's \$9.3B pesos in underwriting profit. Subtract operating and income tax and you get \$5B pesos in net profits and nearly \$6B pesos in FCF (14% yield).

By 2024 you're looking at a company with \$82B pesos in terminal value, \$70B pesos in Enterprise Value and \$87B pesos in shareholder value (+\$17B net liquid assets).

That gets us \$215 pesos/share, or 117% upside from the current stock price.

If we assign a 15x EBITDA multiple on 2024 figures we get ~\$94B pesos in EV and \$110B pesos in shareholder value (175% upside).

Risks

There's three leading risks with the Qualitas thesis. First, interest rates are low and expected to stay low for the foreseeable future. This means Qualitas has to allocate its float to higher expected return instruments like private and public equity. This carries with it greater risk, thus higher probability of investment losses in any given year.

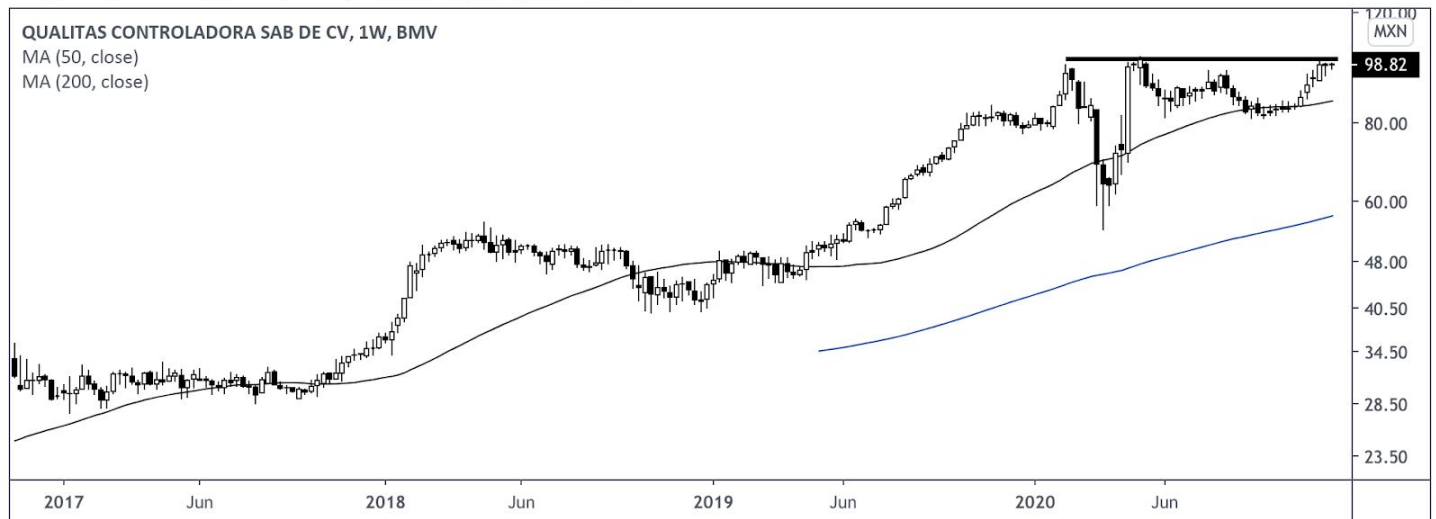
The second big risk is failure to gain market share in its adjacent markets and new Mexican customers. That's a **red flag** if another competitor starts taking more market share as the Mexican policyholder pool expands.

Third, Joaquin Lozano is a master allocator and manager of the company. We would tread lightly if we saw him step down, sell loads of stock or leave the company.

Reading The Tape

Q is at the tail-end of its long-term cup-and-handle pattern. A breakout above the neckline would signal risk-on and a continuation of the bull trend into new all-time-highs.

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Concluding Thoughts

It's not every day you can invest in a monopoly-like auto insurance company run by its founder (who owns 47% of the company) in a country where market penetration is about to explode for <10x normalized earnings and 7x FCF.

Qualitas has everything we want in a long-term bet:

- Founder-led with skin in the game
- Attractive unit economics and strong top-line growth
- Robust operating margins
- Strong competitive advantage
- Shareholder-friendly history
- Long secular runways

We'll let you know when we put a position on! Keep your eyes peeled!