



---

Lemonade (re-rec)

April 2022

---

Steve Symington

Lead Advisor

Investment Type:	Growth
Industry:	Industry
Risk Level:	High Risk
Company Size:	Small Cap

<b>The 7investing Key Takeaway</b>	<b>3</b>
<b>What Does Lemonade Do?</b>	<b>4</b>
<b>Why is Lemonade a Good Investment?</b>	<b>6</b>
<b>What's Happening in the Bigger Picture?</b>	<b>11</b>
<b>Management and Vision</b>	<b>15</b>
<b>What are the Key Risks?</b>	<b>16</b>
<b>Thoughts About Valuation</b>	<b>18</b>
<b>What Should We Be Watching?</b>	<b>19</b>

# The 7investing Key Takeaway

You'd be forgiven if the consumer-facing insurance market doesn't exactly strike you as the most exciting industry. Sure, the opportunity is enormous at \$4 trillion globally. But it's also currently dominated by a small number of massive, 100+ year-old incumbent players who are loath to give up their respective slices of the pie. And sure, these traditional insurers have decent websites and mobile apps that seem to indicate they've embraced modern technology to complement their armies of insurance agents, mature books of business, geographic permeation, and proven underwriting models.

But times are changing. And I believe we're at an inflection point where the structure of consumer-facing insurance is ripe for disruption.

Enter **Lemonade** (NASDAQ: LMND), a fast-growing, 7-year-old insurtech (insurance technology) company with a digital substrate, artificial intelligence, and behavioral economics as its foundations.

This is the third time I've recommended shares of Lemonade on the 7investing scorecard. Make no mistake: This extraordinarily volatile stock is not for the faint of heart. Shares have climbed more than 60% over the past three weeks as of this writing, for example -- but they're also still down around 75% from their 52-week high set last summer.

Even so, with many traders misunderstanding the source of Lemonade's recent elevated loss ratios -- and with shares now trading below their July 2020 IPO price -- I continue to believe this is a fantastic opportunity for patient, long-term investors with a stomach for volatility to open or add to their positions.

## What Does Lemonade Do?

When I [first recommended](#) buying shares of Lemonade back in September 2020, the company offered three insurance products: Homeowners, renters, and pet health insurance. Lemonade has since expanded into life insurance (launched in early 2021) and auto insurance (launched in November 2021).

So, with five insurance products officially live, what makes Lemonade different from its larger, more established insurance competitors?

Well, those large established competitors generally rely on thousands of agents, underwriters, and adjusters taking calls, assessing risk, scheduling appointments and handling claims. By contrast, from its genesis in early 2015, Lemonade's co-founding co-CEOs Daniel Schreiber and Shai Wininger have said they "built a company purely on a digital substrate with AI and behavioral economics as our foundations."

Indeed, Lemonade customers primarily interact with the company through its mobile app via two AI chatbots.

Maya, the first AI bot, asks all the relevant questions Lemonade needs to build an insurance policy for you in as little as 90 seconds. And A.I. Jim, the [empathetic claims bot](#), processes and pays claims in as little as three seconds.

You read that right. Roughly 30% of Lemonade’s claims are handled almost instantly -- assuming all necessary information is provided and it successfully passes dozens of anti-fraud algorithms run by the AI system -- while the rest are passed to Lemonade’s streamlined team of actual humans to process as soon as possible.

## How Lemonade Claims Work

Seamlessly file claims from your phone - anytime, anywhere



Image source: Lemonade

You can also feel good about investing in Lemonade considering its mission -- which I discussed in more detail in [this 2021 article](#) -- is “to be a force for public good.”

And that’s not just (puckered) lip service. Lemonade is the world’s only insurance company organized as a certified Public Benefit Corporation (or B-Corp), a for-

profit business whose fiduciary obligations include promoting both shareholder value and social good.

In Lemonade's case, that means fulfilling a stated public benefit of "[delivering] insurance products where charitable giving is a core feature." That charitable giving is largely realized through Lemonade's [annual Giveback program](#), where unused premiums are given to nonprofits selected by Lemonade customers each year (and yes, Lemonade can still turn a profit at scale by giving away those unused premiums...we'll talk more about its cost structure below).

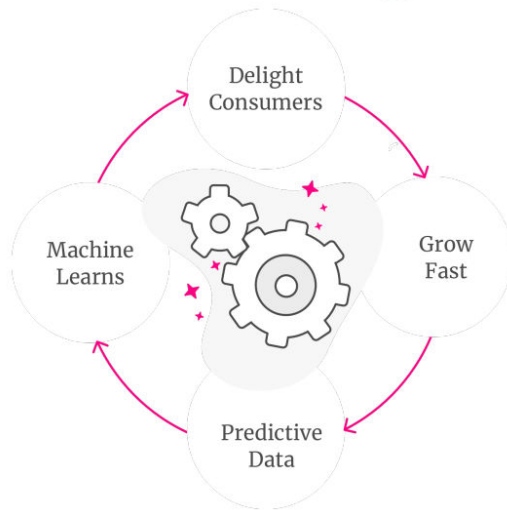
All in all, Lemonade says it wants you to "[f]orget everything you know about insurance. Instant everything. Incredible prices. Big heart."



## Why is Lemonade a Good Investment?

This approach clearly resonates with younger tech-savvy consumers; 75% of Lemonade's customers are under the age of 35, and 90% are purchasing insurance for the first time. As such, Lemonade has formed a two-pronged strategy: To "win with technology" and to "grow with [its] customers" as their own financial and insurance needs mature.

## Win With Technology



## Grow With Our Customers

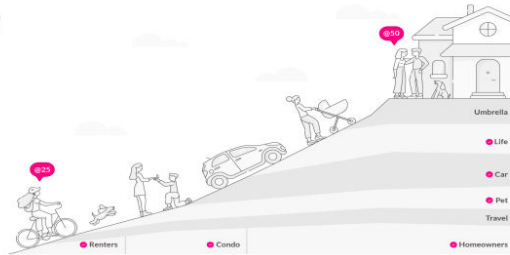


Image source: Lemonade

To reiterate, Lemonade boasts key advantages over other up-and-coming insurtech companies and legacy incumbents alike. On the former, most other insurtechs are monoline (single-product) businesses -- offering car insurance, or homeowners, or renters, or life, or pet insurance. Lemonade offers all five in a single app. Meanwhile, incumbent insurers do provide comprehensive insurance product offerings, but don't have the same technological foundations and are unwilling (or, perhaps arguably unable) to upend their current bulky infrastructures in order to meaningfully lower expense ratios through automation.

Let's take a closer look at Lemonade's operating structure.

First, Lemonade's founders made the decision early on to make the company a licensed insurance carrier, rather than "just" selling insurance policies that are backed by established industry giants (as several other small insurtech companies like Jetty or Hippo do). This gives Lemonade better control over its underwriting

process, and -- over the long term -- the ability to drive expense ratios lower than incumbents could possibly manage.

Next, Lemonade takes a flat fee of 25% of insurance premium revenue for operating costs and potential profits. It then transfers, or “cedes,” the other 75% of premiums to reinsurance partners -- where reinsurance is a form of insurance purchased from another insurance company to insulate risk -- who pay Lemonade a 25% “ceding commission” and take on the responsibility of funding their portion (75%) of corresponding claims.

Here’s a handy diagram outlining that structure for Lemonade’s latest proportional reinsurance model:

# Reinsurance Program, Effective 7/1/2020

Property per Risk and Facultative reinsurance covers entire book  
Estimated cost = ~2.5% of GEP

Remaining premium (~97.5% of total) subject to proportional reinsurance

**25%**  
retained by Lemonade

Lemonade pays  
proportional share of  
customer claims

Remainder used to  
service expenses

**75%**  
ceded to proportional reinsurer

Reinsurer pays  
proportional share of  
customer claims

Reinsurer pays ceding  
commission to  
Lemonade

Commission = ~25% of  
ceded amount

Source: Lemonade

As Lemonade's insurance products mature and their respective books of business continue to scale, I expect Lemonade will seek to renegotiate the amount of premium it opts to cede (likely ceding less in order to capture more of the economic benefit of its earned premiums). But in these early stages of its story, this proportional reinsurance model not only makes Lemonade's revenue streams more predictable, but also improves capital efficiency by allowing Lemonade to expand gross margin while remaining a capital-light business.

Then, if there's money left over at the end of each year from the part of customers' premiums outside of Lemonade's flat fee, it's dedicated to a pre-vetted charity of each customer's choosing through Lemonade's annual Giveback program. The Lemonade Giveback is scaling quickly along with in-force premium (IFP) growth, donating \$2,303,381 to more than 65 nonprofit organizations around the world in 2021, up from just over \$1.1 million in 2020 (and a little more than \$50,000 in 2017, its first year).

To be clear, though, the Lemonade Giveback isn't entirely altruistic. It also fosters positive behavioral economics for Lemonade's insurance business. By taking a flat fee for itself, Lemonade removes any temptation to try and maximize profits by either investing its float (as many larger insurance companies do) or by paying out less in claims. This in turn removes any perceived conflict of interest between Lemonade and its customers, bolstering trust and brand loyalty. Lemonade further argues that customers are less likely to submit fraudulent claims if they know their excess premiums would otherwise be donated to charity.

This won't stop everyone from committing insurance fraud or embellishing claims. But with its AI bots collecting around 1,700 data points in the process of writing any given home insurance policy, for example -- compared to around 20 to 50 data points collected by traditional insurance carriers -- Lemonade has a distinct technological edge over incumbents when it comes to both underwriting efficiency and its ability to detect and prevent fraud.

# What's Happening in the Bigger Picture?

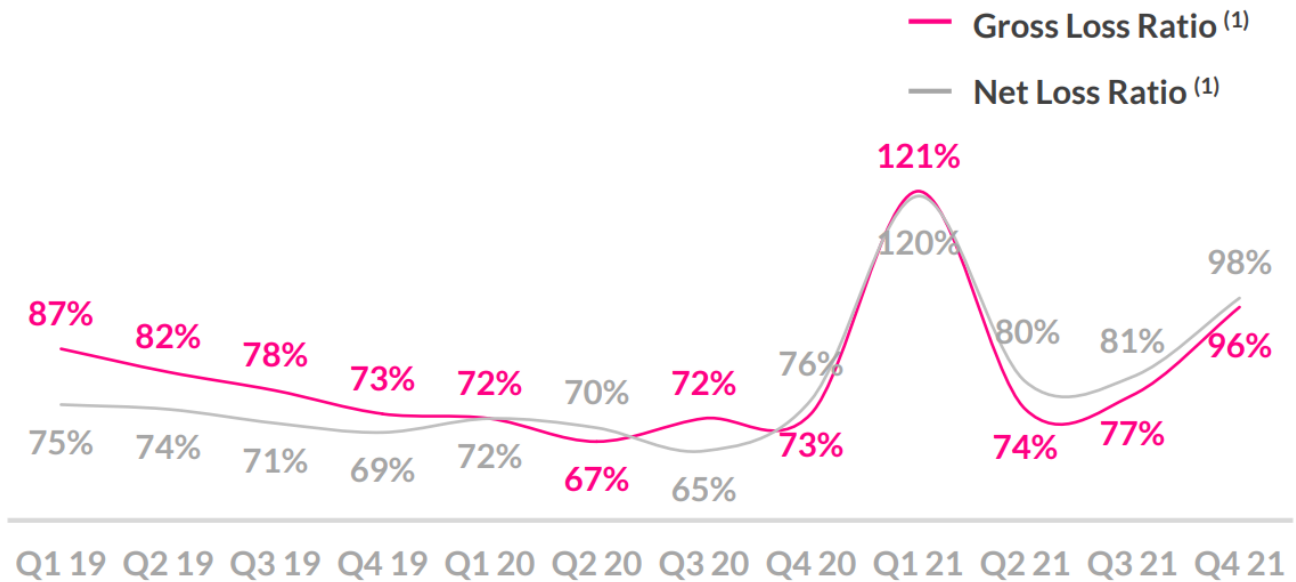
Of course, I already covered several of these topics in my previous recommendations. So why is Lemonade still a good investment today?

For one, even as its share price has languished -- partly the consequence of a significant valuation contraction in high-growth tech names over the last several months -- the underlying business has continued to rapidly make progress toward its long-term goals.

Take its recent (fourth-quarter 2021) results released in late February, for example: In-force premium (IFP) climbed a healthy 78% year over year to \$380 million, driven by 43% customer growth (to 1,427,481) and a 25% increase in premium per customer (to \$266) -- the latter figure aided by a combination of premium increases and multi-policy customers.

However, skeptics seized on one glaring point of concern in Lemonade's latest quarter: Its gross loss ratio worsened by 23 percentage points year over year (and 19 percentage points sequentially) to 96%:

## Loss Ratio



Source: Lemonade

With the exception of that big spike in early 2021 -- marking the infamous “Texas Freeze” that provided a solid stress test for Lemonade’s operations during that period -- it was hard to blame investors for their concern this past quarter. The first kneejerk reaction many people had was to assume Lemonade’s AI models and automated underwriting had failed to keep the company anywhere near its longer-term goal for maintaining a loss ratio of 75% or lower across all its products. But therein lies the answer to these profitability concerns: Lemonade’s products. Or more specifically, the relative youth of those products’ books of business. Management explained in the company’s [Q4 2021 letter to shareholders](#) [emphasis mine]:

To understand our elevated loss ratio in recent quarters, we'd like to highlight a theme from last quarter's letter. Our business mix has evolved considerably since a year ago, with US-based renters comprising less than half the book, relative to around two thirds a year ago. The lines of business that have captured that share (home & pet) demonstrate higher loss ratios than our more mature, stable renters book.

We have many ongoing projects, across the organization, to improve underwriting profitability in our newer lines of business, and these are yielding steady improvements in both home, and pet loss ratios. ***Nevertheless, these improvements have been outpaced by these products' growth, meaning that our aggregate loss ratio has climbed even as our per product loss ratios have improved. We expect the one to catch up with the other over time.***

They went on to reiterate that they continue to expect loss ratios across all Lemonade product lines to ultimately settle below 75%, while reminding investors "in the near term it's possible we'll see quarters with loss ratios above this level as our newer lines mature."

"This is to be expected, and is a natural and temporary cost of launching and scaling new products," they concluded.

Speaking of new products, Lemonade Car is about to receive a turbocharged boost in scale. In early November 2021, Lemonade announced an all-stock deal to acquire data science-driven auto insurance specialist **Metromile** (NASDAQ: MILE). Per the terms of the transaction, which was valued at \$500 million at the

time (or \$200 million, net of Metromile's cash), Metromile shareholders will receive one share of Lemonade for every 19 shares of Metromile they own when the transaction closes (expected by the end of Q2 2022). In turn, Lemonade looks forward not only to integrating Metromile's teams, systems, and processes into its own organization, but also benefits from 49 state licenses (Lemonade Car is still technically only available in Illinois), \$250 million of additional cash on the balance sheet, and more than \$100 million of seasoned in-force premium on its books.

The combination will effectively propel Lemonade Car to a nationwide presence -- something that would have otherwise represented a years-long journey as Lemonade secured additional individual state licenses -- for a relatively modest acquisition price.

Finally, note Lemonade's global expansion remains in its infancy. With products currently available in France, Germany, and The Netherlands, the company teases on its website plans to "soon" expand to Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Norway, Poland, Portugal, Republic of Cyprus, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom.

# Management and Vision

Lemonade's co-founders each boast deep backgrounds in tech: Schreiber previously served as senior VP of marketing and Business Development at SanDisk, was on the board of Powermat Technologies, and co-founded an internet security software company that was acquired back in 2002; Winger previously founded and served as the CTO of Fiverr in 2009, and held a variety of senior management positions at companies specializing in everything from aerospace technology to mobile apps and VR web browsers.

But they lacked expertise in the insurance industry. So, with a vision of how insurance could be disrupted using technology to solve the issues of convenience and trust, they embraced their status as insurance "outsiders" and brought on insurance industry veterans including their current Chief Insurance Officer John Peters (formerly of Liberty Mutual and McKinsey & Co.) and Ty Sagelow (a 38-year insurance veteran who since authored "The Making of Lemonade," detailing on his experience shaping the company in its earliest stages) to help them scale and guide crucial decisions such as the move to make Lemonade a licensed carrier.

As for their vision, you'll often hear Schreiber say their focus is on building an "enduring, iconic company" with a runway for growth that will last decades. That growth will almost certainly come at the expense of industry incumbents that are largely helpless to do anything about Lemonade's rise -- perhaps short of acquiring it outright.

Writing in their Founders' Letter of the ongoing revolution they see in the insurance industry, they elaborated:

As transformative as the prior revolutions were for insurance, there is reason to believe that today's will be even more so. No part of the value chain is immune this time: distribution models, business models, statistical tools, systems of management, cost structures, corporate structures, corporate culture, technology stacks, user experience, marketing channels, data sources, data uses, value propositions, human capital -- all these and more are being upended.

Which is why we founded Lemonade.

We wouldn't know how to shepherd incumbents through these momentous changes; nor do we know of a technological solution to their innovator's dilemma. Our analyses led us to conclude that a new kind of insurance company, built from scratch on an unconflicted business model and cutting-edge technology, will enjoy structural advantages that will manifest ever more powerfully over time.



## What are the Key Risks?

A lot needs to go right in the coming years, however, for Lemonade to realize its vision to truly disrupt the insurance industry.

First, it will need to prove its currently high 96% gross loss ratio is indeed temporary, and not a function of the failure of its automated models. Over the long term, if investors don't see loss ratios once again trend lower and ultimately hover below its targeted 75% goal across all products, its business and resulting cash burn would ultimately prove unsustainable.

Geographic concentration also remains a significant risk. Around 56.9% of gross written premiums (GWP) came from just three states combined in 2021: California (25%), Texas (19.3%), and New York (12.6%). That's also down from around 58% in 2020 and 63.3% of GWP from those three states in 2019, so its trending in the right direction as Lemonade scales. This risk should also further abate with the acquisition of Metromile and continued international and domestic expansion.

On that note, we should keep an eye on integration risk for Lemonade's impending acquisition of Metromile. With nearly 400 employees, its own distinct technology stack, and a substantial seasoned book of business in place, nobody can guarantee a perfectly smooth transition under Lemonade's umbrella. But if all goes well, it should serve as a strong catalyst to accelerate Lemonade's auto insurance ambitions.

Finally, competition will remain stiff for years to come as Lemonade fends off not only industry giants like State Farm, Geico, and Allstate, but also smaller insurance industry upstarts trying to accomplish similar disruption (albeit often with a narrower, monoline product scope). Still, there should be plenty of room for multiple disruptive winners in the space, and Lemonade is poised to play a leadership role in the process.

# Thoughts About Valuation

With a market cap of only \$1.85 billion and an enterprise value of \$1.6 billion as of this writing, Lemonade now stands firmly in small-cap territory and is absolutely dwarfed by comparatively steady large-caps in the space such as Allstate (\$39.3B) and Progressive (\$68.3B). But while I admitted the stock certainly wasn't "cheap" trading at steep premiums at the time of my last recommendation, the severity of its valuation multiple contraction has been absolutely staggering since then:



But Lemonade remains cash-rich after raising \$640 million early last year when the stock traded at \$165 per share -- a capital raise that now looks like a prescient move from management, by the way -- with over \$270 million in cash and cash equivalents and just over \$800 million in investments on its balance sheet at the end of 2021 (before adding Metromile's cash hoard to its total). Expect Lemonade to continue to put this cash to good use as it works to reinvest in growing its business.

With Lemonade stock now trading slightly below its July 2020 \$29/share IPO price and *far* below its first-day close of over \$50/share, I'm happy to continue building my position at these levels.



## What Should We Be Watching?

There are several metrics and developments Lemonade investors should keep an eye on in the coming quarters:

- **Customer count:** Lemonade's customer count grew 42.6% year over year last quarter to 1,427,481 (up from almost exactly 1 million at the end of 2020). Even as other insurtech specialists grapple with falling customer counts in this difficult customer-acquisition environment, I continue to expect Lemonade to maintain strong double-digit growth in customer counts for the next several quarters with the help of its five-product flywheel and expanding geographic presence.

- **Premium per customer** stood at \$266 last quarter, up 25% year over year and from \$190 at the time of my first recommendation. As Lemonade continues enjoying a shift in product mix toward higher-value homeowner policies, auto policies, and multiple-policy customers, this trend should continue.
- **In-force premium (IFP)** measures the annualized dollar value of premiums on all written policies outstanding. This is similar to annualized recurring revenue for software-as-a-service companies, is an excellent measure of growth for Lemonade, and is a function of growth in both customer count and premium per customer. IFP grew 78% year over year to \$380 million in the fourth quarter of 2021.
- **Gross loss ratio** was elevated at 96% last quarter due to the relative youth of Lemonade’s new products and books of business. Over the long term, watch for gross loss ratio to trend lower toward Lemonade’s targeted range of 75% or below across all products.
- **Metromile acquisition completion/integration:** Lemonade anticipates closing its all-stock acquisition of Metromile by the end of the second quarter of 2022. Once it closes, watch for how Lemonade handles the integration of Metromile’s teams, systems, and processes, as well as progress on its expected development of a new pay-per-mile car product built on Lemonade’s infrastructure.
- **Annual Dollar Retention (ADR):** Recall starting with its first-quarter 2021 report, Lemonade introduced a new metric to watch called Annual Dollar Retention, or ADR. Lemonade defines ADR as “the percentage of IFP retained over a twelve month period, inclusive of changes in policy value, changes in the number of policies, changes in policy type, and churn.” This

metric is similar to dollar-based net retention rates (DBNRR) for software-as-a-service (SaaS) companies, where anything above 100% indicates existing customers are spending more with each passing year. While significantly improved from around 69% at the end of 2019, Lemonade's ADR has leveled off at around 82% for the past three quarters -- in part a function of new product launches similar to its currently elevated gross loss ratios. Over the longer term, I'd like to see Lemonade's ADR improve to 90% or better as is consistently achieved by more mature legacy insurers.

Interested in learning even more about Lemonade? For more information about the company's financial and operational results, here are links to its [investor relations page](#) and its [latest \(Q4 2021\) shareholder letter](#).

*Disclosure: As of April 1, 2022, 7investing Lead Advisors Steve Symington and Simon Erickson own shares of Lemonade.*