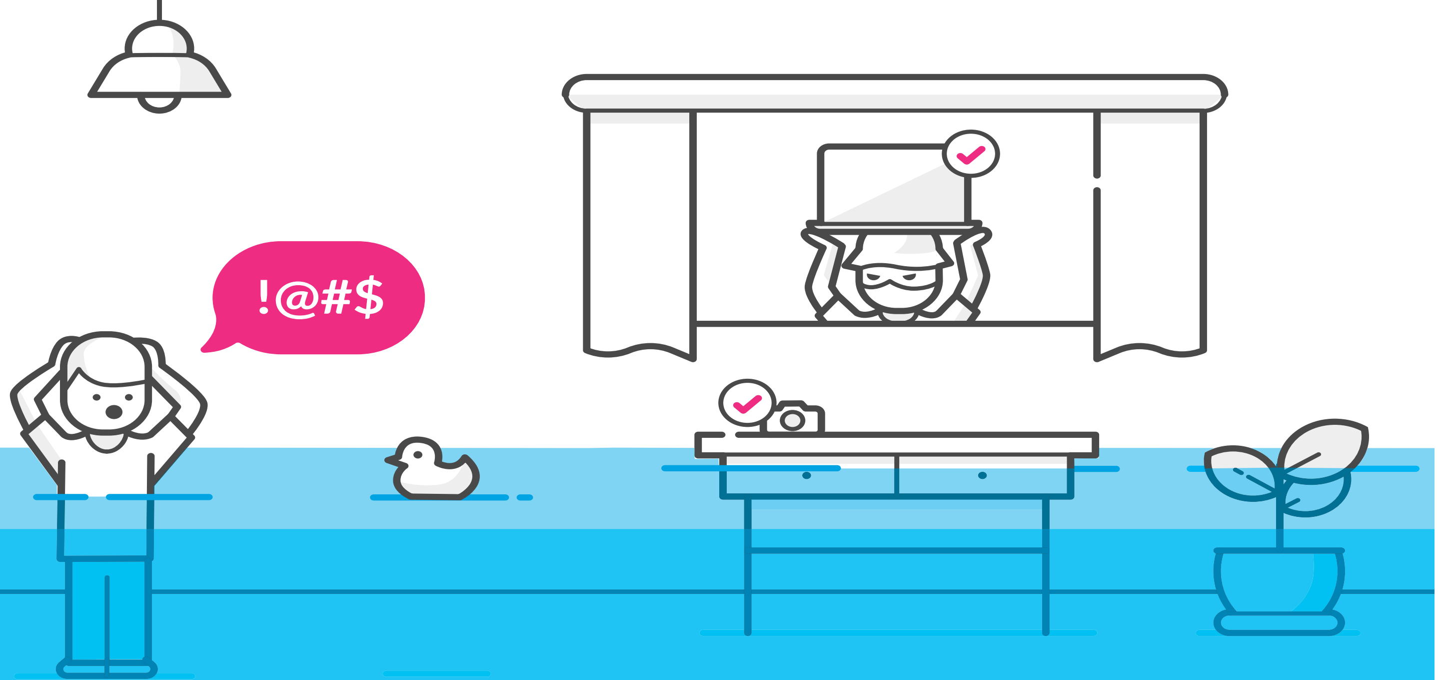
THE LEMONADE LOCK-IN

How AI is disrupting the insurance market

By Jim Harris

Lemonade is disrupting traditional insurers in an industry that takes weeks, or even months, to settle most property and casualty insurance claims. A New York-based insurer, Lemonade set the world record in December 2016 for settling a claim in just three seconds by using its claims bot powered by artificial intelligence (AI) running 18 fraud algorithms. The customer, Brandon Pham, clicked the “submit” button for a $979 claim for a stolen Canada Goose Parka. Just seconds later, the claims bot texted him that his claim was approved and payment instructions had been sent to the bank.



Lemonade is revolutionizing the sleepy insurance industry. As of June 2017, 27 percent of Lemonade's claims have been settled instantly by its AI claims bot. The company's long-term goal is to settle 90 percent of claims instantly.

The claims bot is called Jim and was morphed from the real Jim Hagerman, who is Lemonade's Chief Claims Officer (CCO), and was formerly CCO of a large insurance firm. The Lemonade team spent months moving the decision process from traditional claims procedures and automating it using algorithms based, in large part, on Jim's knowledge. The AI works to understand the nature of a claim, its severity and its urgency. It also assesses the likelihood of a fraudulent claim. If a claim is too complex, AI Jim refers it to the real Jim.

However, Lemonade AI is still learning. In an industry where expense ratios average 28 percent, this offers huge savings. Lemonade's founders didn't come from the insurance world. They are technologists who have built the company on artificial intelligence, algorithms and technology. Customers can only apply for a policy using a smartphone and receive approval in as little as 90 seconds.

By eliminating bureaucracy and digitizing the experience, Lemonade cut the cost of customer acquisition by 90 percent compared to traditional insurers. In part, this is what allows it to issue a tenant policy for 68 percent cheaper than the four largest traditional insurers.

HOW CAN THIS BE?

One answer is that while it costs traditional insurers $792 to acquire a new customer, insurance firms with independent agents spend up to $900 to write an initial home insurance policy. Lemonade issues tenant policies for as little as $5 a month — or $60 a year. No traditional insurers — with paper-based, time-intensive bureaucratic processes — have bothered with small tenants policies because their cost structure prohibits it.

Price is the key determinant for most customers in deciding which insurance company to buy from, notes Bain & Company's Customer Loyalty Study. This gives Lemonade a huge advantage.

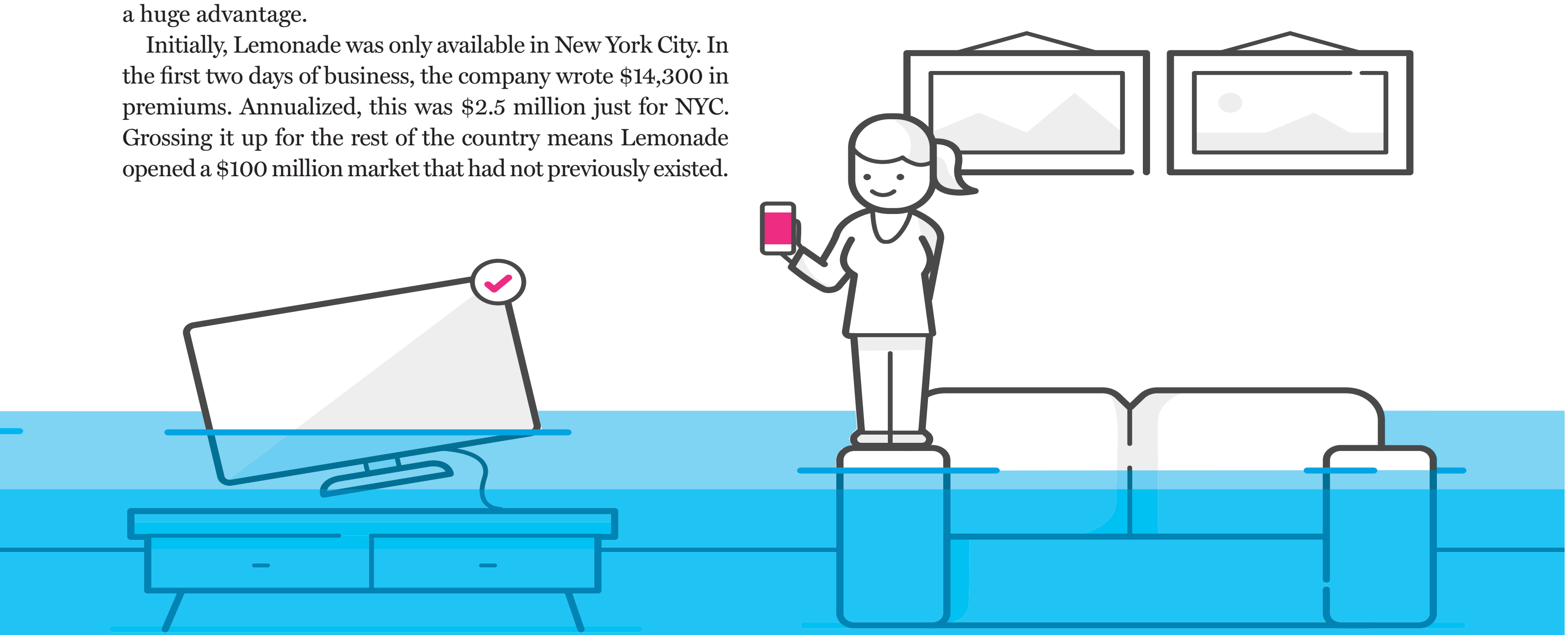
Initially, Lemonade was only available in New York City. In the first two days of business, the company wrote $14,300 in premiums. Annualized, this was $2.5 million just for NYC. Grossing it up for the rest of the country means Lemonade opened a $100 million market that had not previously existed.

In those first 48 hours, the average renter's policy gross premium sold was $86 a year, condos $528 and homeowners $691. Today, Lemonade's average homeowner's policy is roughly double the average at launch. This should frighten traditional home insurers.

By the end of 2016, tenants' packages represented 90 percent of Lemonade's policies issued — but only 53 percent of the company's premium revenue. By contrast, homeowners make up only 10 percent of policies but account for 47 percent of premiums. In other words, homeowner policies provide Lemonade with nine times more premium dollars than renter's policies, which is another reason traditional insurance firms have ignored tenants insurance. Given that 110 million Americans are renters (30 percent of the U.S. population), Lemonade has a long runway for growth. Seventy percent of these renters are under 35 years old — a target group that has historically not purchased insurance.

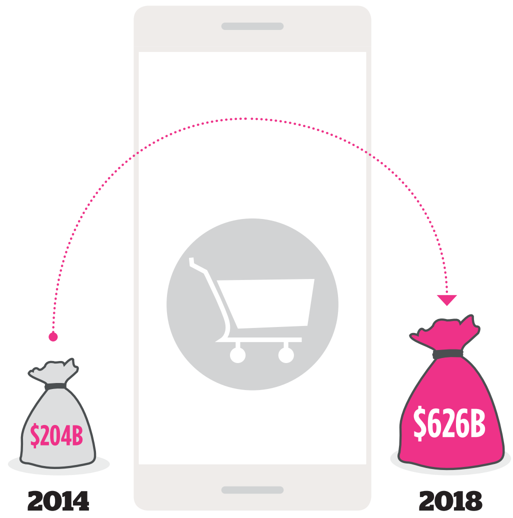
In fact, a staggering 87 percent of Lemonade customers have never bought insurance before. So in one sense Lemonade is not disrupting traditional insurance companies, but has created a new market that did not exist because it was prohibitively expensive for incumbent insurers to serve.

However, in another sense, Lemonade is highly disruptive, although traditional insurance companies may not have realized it yet. Lemonade is acquiring the best possible customers – ones with great credit, great jobs and a desire for insurance – five years before any traditional insurer could consider them as clients, says Lemonade Co-Founder Daniel Schreiber.



Mobile Sales On the Rise

Consumer spending via mobile will increase from $204b in 2014 to $626b in 2018. Almost half of all e-commerce sales will be from m-commerce.



SOURCE: Ernst & Young

Daniel Schreiber, Co-Founder and CEO (left), and Shai Wininger, Lemonade Co-Founder and President (right).

Traditional insurers will realize Lemonade is highly disruptive in five years when they discover waves of first-time home buyers, who already bought Lemonade's tenant insurance policy and likely will buy homeowners policies from them as well. It's the Lemonade lock-in.

As of June 1, 2017 Lemonade is active in three states — California, Illinois and New York — representing 22 percent of the U.S. population. But the company is now licensed in an additional seven states — Arizona, Michigan, New Jersey, North Carolina, Rhode Island, Texas and Virginia — representing another 26 percent of the U.S. population. Once Lemonade is actively selling in these seven new states it will be serving 48 percent of the U.S. population — very close to achieving the corporate goal of offering insurance to the majority of Americans by the end of 2017.

As of June 1 the company had sold 14,315 policies and the average policy size is growing. This means that Lemonade is moving up in the market, selling higher premium homeowner policies.

In the most recent period for which the company disclosed sales, it sold 4,300 policies in 20 days in New York, Illinois and California. Annualized this is a run rate of 78,500 policies a year. When Lemonade begins operations in the next seven states that it's become licensed to operate in, it will be selling 160,000 new policies a year if the run rate holds constant.

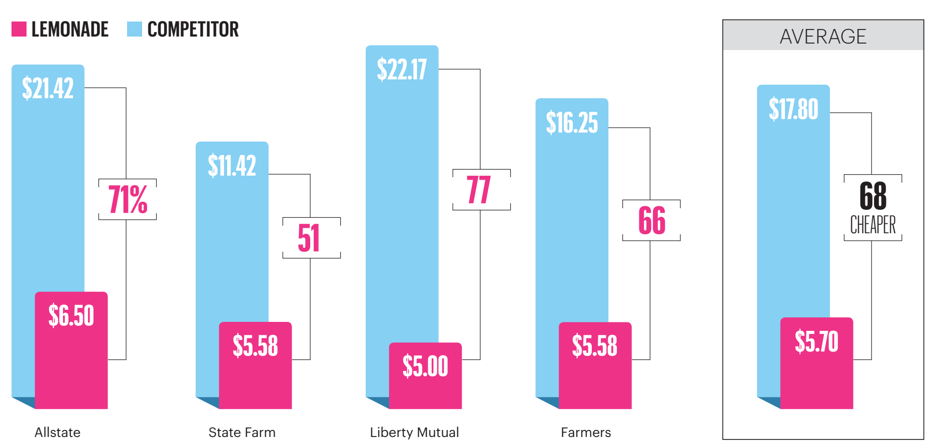
Lemonade wrote $179,855 of insurance in the first 100 days to December 30, 2016. Extrapolating this to Lemonade's sale of 14,315 policies by May 31, 2017, means that the company sold more than $2.1 million in premiums. (The company won't release any figures beyond what it has already published on its blog and transparency chronicles. But as the average policy has been growing due to the average homeowner's policy size growing significantly, this figure is conservative.)

Lemonade is on an exponential growth trajectory, more than doubling the number

The Cost Advantage

In the insurance race, Lemonade's prices prove 68 percent cheaper on average.

The largest homeowners' insurance companies offer different entry-level coverage, with rates to match. This chart compares their total monthly fees with Lemonade's, for equivalent coverage of the same renter.



SOURCE: Lemonade

Previouse spread and photograph courtesy of Lemonade

Who's Backing Lemonade's Growth Trajectory?

Lemonade is backed by some heavy-hitting insurance and tech names among its financial backers, insurance backstop providers and key team members.

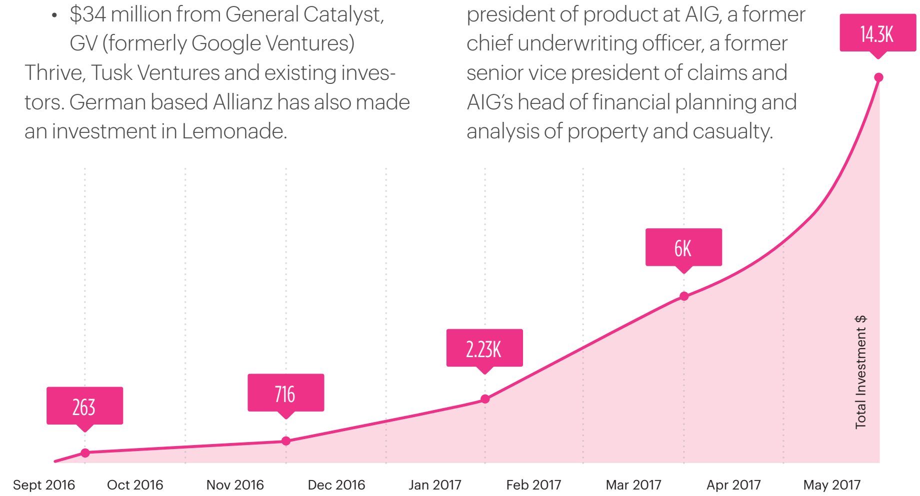
Venture Capital
Lemonade has raised $60 million in three finance rounds:

- $13 million seed investment by Aleph and Sequoia in late 2015
- $13 million from XL Innovate and existing investors, and
- $34 million from General Catalyst, GV (formerly Google Ventures)

Thrive, Tusk Ventures and existing investors. German based Allianz has also made an investment in Lemonade.

Insurance
Warren Buffet's Berkshire Hathaway is providing backstops for Lemonade's coverage.

Key Team Members
Team members include former president of product at AIG, a former chief underwriting officer, a former senior vice president of claims and AIG's head of financial planning and analysis of property and casualty.



SOURCE: Lemonade

of policies sold every 10 weeks. Revenue is growing even faster as the company is attracting more homeowners, translating into significantly higher premiums. However, many people don't understand exponential growth. If Lemonade were to continue doubling its policies in force every 10 weeks, after 16 more doublings (160 weeks) it would be larger than the entire current U.S. homeowner's insurance industry.

This exponential growth can only be achieved by moving insurance from being reliant on agents and paperwork into one that is built on bots and tech notes, says Peter Diamandis, the founder of the XPrize and one of Lemonade's founding board members.

Based on its annualized run rate of policies and average premium, at the end of its first year of operations, Lemonade will be selling $23 million worth of policies a year. But at the moment, Lemonade is a tiny drop in the bucket compared to the $42.6 billion that traditional U.S. property and casualty insurers collected in 2016.

DEMOGRAPHIC DRIVERS

In its first quarter of business, 75 percent of Lemonade's customers were 25-34 year olds. This is not a demographic that traditional insurance companies have targeted, for reasons previously mentioned. In fact, the average age for first time homebuyers in the U.S. is 33.

Young tenants have limited income, and are therefore price sensitive in their initial insurance purchase. They are also driven by their values. Lemonade is different than other insurance companies. It takes a 20 percent fee of every premium dollar. The remainder pays for claims and any funds left over at the end of the year are donated to charities and not-for-profits, as directed by policyholders. The company is the first ever B Corp certified insurance firm in the world.

Millennials care about their communities and the state of the world. They want to deal with organizations that share their values. So Lemonade's focus on giving back to the community not only attracts value conscious millennials, but also builds trust — something traditional insurance firms are lacking.

Financial services are one of the least trusted industries by consumers, according to the 2017 Edelman Trust Barometer. And among financial services, only 53 percent of the public trust the insurance industry, making it the second least trusted. The experience consumers have with insurance companies becomes antagonistic once they file a claim.

Edelman's top three pieces of advice to the insurance sector are: 1) solve customer pain points; 2) invest in smarter technology to serve digital natives; and 3) focus on social purpose. Edelman's advice seems to be exactly what Lemonade is doing. And so better prepare for the revolution. ■

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