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## **FORM 10-Q**

**Heritage Insurance Holdings, Inc. - HRTG**

**Filed: May 08, 2015 (period: March 31, 2015)**

Quarterly report with a continuing view of a company's financial position

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549**

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**Form 10-Q**

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**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2015

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number  
001-36462

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**Heritage Insurance Holdings, Inc.**

(Exact name of Registrant as specified in its charter)

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Delaware  
(State of Incorporation)

45-5338504  
(IRS Employer  
Identification No.)

2600 McCormick Drive, Suite 300  
Clearwater, Florida 33759  
(Address, including zip code, of principal executive offices)

(727) 362-7200  
(Registrant's telephone number, including area code)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate number of shares of the Registrant's Common Stock, \$0.0001 par value, outstanding on May 5, 2015 was 29,807,460.

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## FORWARD-LOOKING STATEMENTS

Statements in this Quarterly Report on Form 10-Q this “Form 10-Q” or in documents incorporated by reference that are not historical facts are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include statements about anticipated growth in revenue, earnings per share, estimated unpaid losses on insurance policies, investment returns and expectations about our liquidity, and our ability to meet our investment objectives and to manage and mitigate market risk with respect to our investments. These statements are based on current expectations, estimates and projections about the industry and market in which we operate, and management’s beliefs and assumptions. Without limiting the generality of the foregoing, words such as “may,” “will,” “expect,” “believe,” “anticipate,” “intend,” “could,” “would,” “estimate,” or “continue” or the negative variations thereof or comparable terminology are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance and involve certain known and unknown risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements. The risks and uncertainties include, without limitation:

- increased costs of reinsurance, non-availability of reinsurance, and non-collectability of reinsurance;
- the potential for discontinuation of the Citizens depopulation program and our inability to select favorable Citizens policies to assume;
- a lack of significant redundancy in our operations;
- our failure to attract and retain qualified employees and independent agents or our loss of key personnel;
- our inability to generate investment income;
- our inability to maintain our financial stability rating;
- effects of emerging claim and coverage issues relating to legal, judicial, environmental and social conditions;
- our exposure to catastrophic events;
- the failure of our risk mitigation strategies or loss limitation methods; and
- other risks and uncertainties described in the section entitled “Risk Factors” in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2014.

Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or operating results.

These forward-looking statements are subject to numerous risks, uncertainties and assumptions about us described in our filings with the Securities and Exchange Commission (the “SEC”). The forward-looking events that we discuss in our Form 10-Q are valid only as of the date of our Form 10-Q and may not occur in light of the risks, uncertainties and assumptions that we describe from time to time in our filings with the SEC. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from our forward-looking statements is included in the section entitled “Risk Factors” in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2014. Except as required by applicable law, we undertake no obligation and disclaim any obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**PART I – FINANCIAL INFORMATION**

**Item 1 – Financial Statements**

**HERITAGE INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Balance Sheets**  
**(Amounts in thousands, except share data)**

	<u>March 31, 2015</u> <i>(unaudited)</i>	<u>December 31, 2014</u>
<b>ASSETS</b>		
Fixed maturity securities, available for sale, at fair value (amortized cost of \$360,885 and \$290,951 in 2015 and 2014, respectively)	\$ 364,896	\$ 293,085
Equity securities, available for sale, at fair value (cost of \$31,282 and \$30,555 in 2015 and 2014, respectively)	31,702	31,225
Mortgage loan, held to maturity, at amortized cost	6,150	6,849
<b>Total investments</b>	<u>402,748</u>	<u>331,159</u>
Cash and cash equivalents	160,813	160,481
Restricted cash	4,339	4,339
Accrued investment income	3,019	2,617
Premiums receivable, net	22,785	20,028
Prepaid reinsurance premiums	19,406	43,148
Deferred income taxes	5,336	6,622
Deferred policy acquisition costs, net	25,843	24,370
Property and equipment, net	17,734	17,087
Other assets	6,626	5,180
<b>Total Assets</b>	<u>\$ 668,649</u>	<u>\$ 615,031</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Unpaid losses and loss adjustment expenses	\$ 61,846	\$ 51,469
Unearned premiums	249,103	241,136
Reinsurance payable	16,323	17,113
Income taxes payable	7,325	12,808
Advance premiums	14,329	5,143
Accrued compensation	5,075	442
Other liabilities	26,842	31,831
<b>Total Liabilities</b>	<u>\$ 380,843</u>	<u>\$ 359,942</u>
Commitments and contingencies (Note 12)		
<b>Stockholders' Equity:</b>		
Common stock, \$0.0001 par value, 50,000,000 shares authorized, 29,807,460 and 29,794,960 shares issued and outstanding at March 31, 2015 and December 31, 2014, respectively	3	3
Additional paid-in capital	190,004	188,342
Accumulated other comprehensive income	2,722	1,723
Retained earnings	95,077	65,021
<b>Total Stockholders' Equity</b>	<u>287,806</u>	<u>255,089</u>
<b>Total Liabilities and Stockholders' Equity</b>	<u>\$ 668,649</u>	<u>\$ 615,031</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

**HERITAGE INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Operations and Other Comprehensive Income**  
**(Unaudited)**  
**(Amounts in thousands, except per share and share data)**

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
<b>REVENUE:</b>		
Gross premiums written	\$ 133,968	\$ 68,903
Increase in gross unearned premiums	(7,967)	(8,043)
Gross premiums earned	126,001	60,860
Ceded premiums	(24,512)	(18,624)
Net premiums earned	101,489	42,236
Net investment income	1,633	618
Net realized losses	(3)	(42)
Other revenue	2,009	1,066
<b>Total revenue</b>	<b>105,128</b>	<b>43,878</b>
<b>EXPENSES:</b>		
Losses and loss adjustment expenses	32,539	20,587
Policy acquisition costs	13,093	4,473
General and administrative expenses	11,204	6,997
<b>Total expenses</b>	<b>56,836</b>	<b>32,057</b>
Income before income taxes	48,292	11,821
Provision for income taxes	18,236	3,933
<b>Net income</b>	<b>\$ 30,056</b>	<b>\$ 7,888</b>
<b>OTHER COMPREHENSIVE INCOME:</b>		
Change in net unrealized gains on investments	1,622	2,010
Reclassification adjustment for net realized investment losses	3	42
Income tax expense related to items of other comprehensive income	(626)	(792)
<b>Total comprehensive income</b>	<b>\$ 31,055</b>	<b>\$ 9,148</b>
<b>Weighted average shares outstanding</b>		
Basic	29,798,571	16,360,800
Diluted	30,115,935	18,997,500
<b>Earnings per share</b>		
Basic	\$ 1.01	\$ 0.48
Diluted	\$ 1.00	\$ 0.42

*See accompanying notes to unaudited condensed consolidated financial statements.*

**HERITAGE INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Stockholders' Equity**  
**Three Months Ended March 31, 2015 and 2014**  
**(Unaudited)**  
**(Amounts in thousands, except share amounts)**

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
	Shares	Amount				
<b>Balance at December 31, 2014</b>	29,794,960	\$ 3	\$ 188,342	\$ 65,021	\$ 1,723	\$ 255,089
Net unrealized change in investments, net of tax	—	—	—	—	999	999
Exercise of stock options	12,500	—	212	—	—	212
Stock-based compensation	—	—	1,450	—	—	1,450
Net income	—	—	—	30,056	—	30,056
<b>Balance at March 31, 2015</b>	<u>29,807,460</u>	<u>\$ 3</u>	<u>\$ 190,004</u>	<u>\$ 95,077</u>	<u>\$ 2,722</u>	<u>\$ 287,806</u>

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount				
<b>Balance at December 31, 2013</b>	14,007,150	\$ 1	\$ 62,849	\$ 17,924	\$ (790)	\$ 79,984
Net unrealized change in investments, net of tax	—	—	—	—	1,260	1,260
Temporary equity reclassified to equity	2,338,350	—	20,921	—	—	20,921
Issuance of equity	17,850	—	88	—	—	88
Net loss	—	—	—	7,888	—	7,888
<b>Balance at March 31, 2014</b>	<u>16,363,350</u>	<u>\$ 1</u>	<u>\$ 83,858</u>	<u>\$ 25,812</u>	<u>\$ 470</u>	<u>\$ 110,141</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

**HERITAGE INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows**  
(Unaudited)  
(Amounts in thousands)

	<i>For the Three Months Ended March 31,</i>	
	<u>2015</u>	<u>2014</u>
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 30,056	\$ 7,888
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	1,450	—
Amortization of bond discount	1,335	431
Depreciation and amortization	294	104
Net realized losses	3	42
Deferred income taxes	660	(1,408)
Changes in operating assets and liabilities:		
Accrued investment income	(402)	(151)
Premiums receivable, net	(2,757)	(2,009)
Prepaid reinsurance premiums	23,742	18,610
Reinsurance premiums receivable	—	4,757
Income taxes receivable	—	4,457
Deferred policy acquisition costs, net	(1,473)	(2,461)
Other assets	(1,446)	(1,149)
Unpaid losses and loss adjustment expenses	10,377	9,112
Unearned premiums	7,967	8,042
Reinsurance payable	(790)	(26,091)
Income taxes payable	(5,483)	(1,550)
Accrued compensation	4,633	1,359
Advance premiums	9,186	3,210
Other liabilities	(4,989)	818
Net cash provided by operating activities	<u>72,363</u>	<u>24,011</u>
<b>INVESTING ACTIVITIES</b>		
Proceeds from sales and maturities of investments available for sale	13,497	16,750
Purchases of investments available for sale	(85,498)	(30,051)
Proceeds from sale of mortgage loan	699	—
Cost of property and equipment acquired	(941)	(1,165)
Net cash used in investing activities	<u>(72,243)</u>	<u>(14,466)</u>
<b>FINANCING ACTIVITIES</b>		
Proceeds from issuance of equity and redeemable shares	—	88
Proceeds from exercise of stock options	212	—
Net cash provided by financing activities	<u>212</u>	<u>88</u>
Increase in cash and cash equivalents	332	9,633
Cash and cash equivalents at beginning of period	160,481	65,059
Cash and cash equivalents at end of period	<u>\$ 160,813</u>	<u>\$ 74,692</u>
<b>Supplemental Cash Flows Information:</b>		
Income taxes paid, net	<u>\$ 23,059</u>	<u>\$ 2,434</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*



**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

**NOTE 1. BASIS OF PRESENTATION**

***Basis of Presentation***

Nature of Operations and Principles of Consolidation: The consolidated financial statements as of and for the three months ended March 31, 2015 and 2014 include Heritage Insurance Holdings, Inc. ("Parent Company") and its wholly owned subsidiaries; Heritage Property & Casualty Insurance Company ("Heritage P&C"), which provides personal and commercial residential insurance; Heritage MGA, LLC, the managing general agent that manages substantially all aspects of our insurance subsidiary's business; Contractors' Alliance Network, LLC, our vendor network manager; Skye Lane Properties, LLC, our property management subsidiary; First Access Insurance Group, LLC, our retail agency; Osprey Re LTD; our reinsurance subsidiary that provides a portion of the reinsurance protection purchased by our insurance subsidiary; and Heritage Insurance Claims, LLC an inactive subsidiary reserved for future development, together referred to as "the Company".

Our primary products are personal and commercial residential insurance, which we currently offer only in Florida under authorization from the Florida Office of Insurance Regulation ("FLOIR"). We conduct our operations under one business segment.

The condensed consolidated financial information included herein as of and for the three months ended March 31, 2015 and 2014 does not include all of the information and footnotes required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements. However, such information reflects all adjustments consisting of normal recurring accruals which are, in the opinion of management, necessary for a fair statement of the financial condition and results of operations for the interim periods. The results for the three months ended March 31, 2015 and 2014 are not indicative of annual results. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The December 31, 2014 consolidated balance sheet was derived from the Company's December 31, 2014 audited Consolidated Financial Statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in Heritage Insurance Holdings, Inc. Annual Report on Form 10-K for the fiscal year ended December 31, 2014. References to "we," "us," "our," or the "Company" refer to Heritage Insurance Holdings, Inc. and its consolidated subsidiaries.

The Company qualifies as an "emerging growth company" as defined in Section 2(a)(19) of the Securities Act, of 1933, as amended as modified by the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"). As a result, the Company is eligible to take advantage of certain exemptions from various reporting requirements applicable to other public companies that are not emerging growth companies. The Company intends to continue to take advantage of some, but not all, of the exemptions available to emerging growth companies until such time that it is no longer an emerging growth company. The Company has, however, irrevocably elected not to take advantage of the extended transition period afforded by the JOBS Act for the implementation of new or revised accounting standards. As a result, the Company will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-emerging growth companies.

**NOTE 2. SIGNIFICANT ACCOUNTING POLICIES**

***Changes to significant accounting policies***

We have made no material changes to our significant accounting policies as reported in our Annual Report on Form 10-K for the year ended December 31, 2014.

***Accounting Pronouncements***

The Company describes below recent pronouncements that have had or may have a significant effect on its financial statements or on its disclosures. The Company does not discuss recent pronouncements that a) are not anticipated to have an impact on, or b) are unrelated to its financial condition, results of operations, or related disclosures.

In April 2015, the Financial Accounting Standards Boards ("FASB") issued new guidance related to *Internal-Use Software*. Under the new guidance, if a cloud computing arrangement includes a software license, then the customer should

**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. This guidance is effective for fiscal years beginning after December 15, 2015 and interim periods within those fiscal years. The Company is currently evaluating this guidance to determine the impact on its consolidated financial statements.

In April 2015, the FASB issued new guidance related to *Debt Issuance Costs*. The new guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. This guidance is effective for fiscal years beginning after December 15, 2015 and interim periods within those fiscal years. The adoption of this guidance is not expected to be material to the consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," ("ASU 2014-09") which supersedes current revenue recognition guidance, including most industry-specific guidance. ASU 2014-09 requires a company to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. The guidance also requires additional disclosures regarding the nature, amount, timing and uncertainty of revenue that is recognized. ASU 2014-09 is effective for annual and interim periods beginning after December 15, 2016. Early adoption is not permitted. The Company is evaluating the impact of the new guidance on its consolidated financial statements.

In June 2014, FASB issued ASU 2014-12, *Compensation - Stock Compensation*, which clarifies accounting for share-based payments for which the terms of an award provide that a performance target could be achieved after the requisite service period. That is the case when an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target could be achieved and still be eligible to vest in the award if and when the performance target is achieved. The updated guidance clarifies that such a term should be treated as a performance condition that affects vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the periods for which the requisite service has already been rendered. The guidance will be effective for the Company beginning with fiscal year 2016, and may be applied either prospectively or retrospectively. The Company does not anticipate that this guidance will materially impact its condensed consolidated financial statements and related disclosures.

**Subsequent Events**

The Company follows the provisions of ASC Topic 855-10, "Subsequent Events," relating to subsequent events. This guidance establishes principles and requirements for subsequent events. This guidance defines the period after the balance sheet date during which events or transactions that may occur would be required to be disclosed in the company's financial statements. The Company has evaluated subsequent events up to the date of issuance of this report (see **Note 18**).

**NOTE 3. INVESTMENTS**

The following table details the difference between cost or adjusted/amortized cost and estimated fair value, by major investment category, at March 31, 2015 and December 31, 2014:

<i>March 31, 2015</i>	<i>Cost or Adjusted / Amortized Cost</i> <i>(In thousands)</i>	<i>Gross Unrealized Gains</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>
U.S. government and agency securities	\$ 22,052	\$ 84	\$ 32	\$ 22,104
States, municipalities and political subdivisions	52,806	614	52	53,368
Special revenue	165,778	1,813	204	167,387
Industrial and miscellaneous	116,842	1,685	43	118,484
Redeemable preferred stocks	3,407	153	7	3,553
<b>Total fixed maturities</b>	<b>360,885</b>	<b>4,349</b>	<b>338</b>	<b>364,896</b>
Nonredeemable preferred stocks	12,052	419	28	12,443
Equity securities	19,230	1,385	1,356	19,259
<b>Total equity securities</b>	<b>31,282</b>	<b>1,804</b>	<b>1,384</b>	<b>31,702</b>
Mortgage loan participation	6,150	—	—	6,150
<b>Total investments</b>	<b>\$ 398,317</b>	<b>\$ 6,153</b>	<b>\$ 1,722</b>	<b>\$402,748</b>

**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

<i>December 31, 2014</i>	<i>Cost or Adjusted / Amortized Cost</i>	<i>Gross Unrealized Gains</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>
	<i>(In thousands)</i>			
U.S. government and agency securities	\$ 7,002	\$ 22	\$ 16	\$ 7,008
States, municipalities and political subdivisions	41,578	560	18	42,120
Special revenue	133,269	1,349	237	134,381
Industrial and miscellaneous	105,591	668	254	106,005
Redeemable preferred stocks	3,511	84	24	3,571
<b>Total fixed maturities</b>	<b>290,951</b>	<b>2,683</b>	<b>549</b>	<b>293,085</b>
Nonredeemable preferred stocks	11,494	237	53	11,678
Equity securities	19,061	1,525	1,039	19,547
<b>Total equity securities</b>	<b>30,555</b>	<b>1,762</b>	<b>1,092</b>	<b>31,225</b>
Mortgage loan participation	6,849	—	—	6,849
<b>Total investments</b>	<b>\$ 328,355</b>	<b>\$ 4,445</b>	<b>\$ 1,641</b>	<b>\$331,159</b>

The Company calculates the gain or loss realized on the sale of investments by comparing the sales price (fair value) to the cost or adjusted/amortized cost of the security sold. The Company determines the cost or adjusted/ amortized cost of the security sold using the specific-identification method. The following tables detail the Company's realized gains (losses) by major investment category for the three months ended March 31, 2015 and 2014.

	<i>March 31, 2015</i>		<i>March 31, 2014</i>	
	<i>Gains (Losses)</i>	<i>Fair Value at Sale</i>	<i>Gains (Losses)</i>	<i>Fair Value at Sale</i>
	<i>(In thousands)</i>			
Fixed maturities	\$ 37	\$ 3,526	\$ 1	\$ 255
Equity securities	46	1,653	15	15,015
<b>Total realized gains</b>	<b>83</b>	<b>5,179</b>	<b>16</b>	<b>15,270</b>
Fixed maturities	(86)	1,490	(18)	184
Equity securities	—	—	(40)	878
<b>Total realized losses</b>	<b>(86)</b>	<b>1,490</b>	<b>(58)</b>	<b>1,062</b>
<b>Net realized gain (losses)</b>	<b>\$ (3)</b>	<b>\$ 6,669</b>	<b>\$ (42)</b>	<b>\$ 16,332</b>

The table below summarizes the Company's fixed maturities at March 31, 2015 by contractual maturity periods. Actual results may differ as issuers may have the right to call or prepay obligations, with or without penalties, prior to the contractual maturity of those obligations.

	<i>March 31, 2015</i>			
	<i>Cost or Amortized Cost</i>	<i>Percent of Total</i>	<i>Fair Value</i>	<i>Percent of Total</i>
	<i>(In thousands)</i>			
Due in one year or less	\$ 20,034	6%	\$ 20,058	5%
Due after one year through five years	179,851	50%	181,000	50%
Due after five years through ten years	91,167	25%	93,118	26%
Due after ten years	69,833	19%	70,720	19%
<b>Total</b>	<b>\$ 360,885</b>	<b>100%</b>	<b>\$ 364,896</b>	<b>100%</b>

The following table summarizes the Company's net investment income by major investment category for the three months ended March 31, 2015 and 2014:

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
	<i>(In thousands)</i>	
Fixed maturities	\$ 1,479	\$ 519
Equity securities	425	186
Cash, cash equivalents and short-term investments	123	13
Other investments	17	85
Net investment income	2,044	803
Investment expenses	411	185
Net investment income, less investment expenses	<u>\$ 1,633</u>	<u>\$ 618</u>

**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

During the Company's quarterly evaluations of its securities for impairment, the Company determined that none of its investments in debt and equity securities that reflected an unrealized loss position were other-than-temporarily impaired. The issuers of the debt securities in which the Company invests continue to make interest payments on a timely basis and have not suffered any credit rating reductions. The Company does not intend to sell nor is it likely that it would be required to sell the debt securities before the Company recovers its amortized cost basis. All the issuers of the equity securities it owns had near-term prospects that indicated the Company could recover its cost basis, and the Company also has the ability and the intent to hold these securities until the value equals or exceeds its cost.

The following tables present an aging of our unrealized investment losses by investment class as of March 31, 2015 and December 31, 2014:

	<i>Less Than Twelve Months</i>			<i>Twelve Months or More</i>		
	<i>Number of Securities</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>	<i>Number of Securities</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>
	<i>(In thousands)</i>					
<b>March 31, 2015</b>						
U.S. government and agency securities	5	\$ 32	\$ 4,034	—	\$ —	\$ —
States, municipalities and political subdivisions	20	50	13,159	1	3	169
Industrial and miscellaneous	35	32	15,260	5	12	733
Special revenue	67	200	39,172	2	3	340
Redeemable preferred stocks	34	4	429	7	3	104
Total fixed maturities	161	318	72,054	15	21	1,346
Nonredeemable preferred stocks	78	20	1,454	6	8	175
Equity securities	158	1,355	10,077	—	—	—
Total equity securities	236	\$ 1,375	\$ 11,531	6	\$ 8	\$ 175
<b>Total</b>	<b>397</b>	<b>\$ 1,693</b>	<b>\$ 83,585</b>	<b>21</b>	<b>\$ 29</b>	<b>\$ 1,521</b>

	<i>Less Than Twelve Months</i>			<i>Twelve Months or More</i>		
	<i>Number of Securities</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>	<i>Number of Securities</i>	<i>Gross Unrealized Losses</i>	<i>Fair Value</i>
	<i>(In thousands)</i>					
<b>December 31, 2014</b>						
U.S. government and agency securities	11	\$ 15	\$ 2,451	1	\$ 1.00	\$ 109
States, municipalities and political subdivisions	14	15	7,661	1	3	177
Industrial and miscellaneous	98	204	51,156	10	50	1,975
Special revenue	71	213	36,643	6	23	1,592
Redeemable preferred stocks	18	9	854	9	15	355
Total fixed maturities	212	457	98,765	26	92	4,208
Nonredeemable preferred stocks	1	31	2,552	1	22	490
Equity securities	1	1,039	9,792	—	—	—
Total equity securities	2	\$ 1,070	\$ 12,344	1	\$ 22	\$ 490
<b>Total</b>	<b>214</b>	<b>\$ 1,527</b>	<b>\$111,109</b>	<b>27</b>	<b>\$ 114</b>	<b>\$ 4,698</b>

**NOTE 4. FAIR VALUE OF FINANCIAL INSTRUMENTS**

For the Company's investments in U.S. government securities that do not have prices in active markets, agency securities, state and municipal governments, and corporate bonds, the Company obtains the fair values from its custodian, which uses a third-party valuation service, and we evaluate the relevant inputs, assumptions, methodologies and conclusions associated with such valuations. The valuation service calculates prices for the Company's investments in the aforementioned security types on a month-end basis by using several matrix-pricing methodologies that incorporate inputs from various sources. The model the valuation service uses to price U.S. government securities and securities of states and municipalities incorporates inputs from active market makers and inter-dealer brokers. To price corporate bonds and agency securities, the valuation service calculates non-call yield spreads on all issuers, uses option-adjusted yield spreads to account for any early redemption features, then adds final spreads to the U.S. Treasury curve as of quarter end. The inputs the valuation service uses in its calculations are not quoted prices in active markets, but are observable inputs, and therefore represent Level 2 inputs.

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The following table's present information about the Company's assets measured at fair value on a recurring basis. The Company assesses the levels for the investments at each measurement date, and transfers between levels are recognized on the actual date of the event or change in circumstances that caused the transfer in accordance with the Company's accounting policy regarding the recognitions of transfers between levels of the fair value hierarchy. For the three months ended March 31, 2015 and the year ended and December 31, 2014, there were no transfers in or out of Level 1, 2, and 3.

<u>March 31, 2015</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
	<i>(in thousands)</i>			
<b>Fixed maturity investments:</b>				
U.S. Government and government agencies	\$ 22,104	\$ —	\$ 22,104	\$ —
States, municipalities and political subdivisions	53,368	—	53,368	—
Special Revenue	167,387	—	167,387	—
Industrial and miscellaneous	118,484	—	118,484	—
Redeemable preferred stocks	3,553	3,553	—	—
<b>Total fixed maturity investments</b>	<b>\$364,896</b>	<b>\$ 3,553</b>	<b>\$361,343</b>	<b>\$ —</b>
Equity securities	\$ 19,259	\$19,259	\$ —	\$ —
Non-redeemable preferred stocks	12,443	12,443	—	—
<b>Total equity securities</b>	<b>\$ 31,702</b>	<b>\$31,702</b>	<b>\$ —</b>	<b>\$ —</b>
<b>Total investments</b>	<b>\$396,598</b>	<b>\$35,255</b>	<b>\$361,343</b>	<b>\$ —</b>
<u>December 31, 2014</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
	<i>(in thousands)</i>			
<b>Fixed maturity investments:</b>				
U.S. Government and Government agencies	\$ 7,008	\$ 3,211	\$ 3,797	\$ —
States, municipalities and political subdivisions	42,120	—	42,120	—
Special Revenue	134,381	—	134,381	—
Industrial and miscellaneous	106,005	—	106,005	—
Redeemable preferred stocks	3,571	3,571	—	—
<b>Total fixed maturity investments</b>	<b>\$293,085</b>	<b>\$ 6,782</b>	<b>\$286,303</b>	<b>\$ —</b>
Equity securities	\$ 19,547	\$19,547	\$ —	\$ —
Non-redeemable preferred stocks	11,678	11,678	—	—
<b>Total equity securities</b>	<b>\$ 31,225</b>	<b>\$31,225</b>	<b>\$ —</b>	<b>\$ —</b>
<b>Total investments</b>	<b>\$324,310</b>	<b>\$38,007</b>	<b>\$286,303</b>	<b>\$ —</b>

The Company acquired a 55% participation in a commercial real estate mortgage loan for \$6.1 million in 2013. The underlying \$11.5 million loan was originated by unaffiliated lenders, and collateralized by commercial real estate located in Polk County, Florida. The Company records an asset in the amount of our pro rata share of the outstanding principal and carries the investment at amortized cost. The Company receives monthly principal and interest payments and recognizes income when collectible. The Company decreased its participation in this commercial real estate mortgage loan by \$0.7 million to \$6.1 million during the three months ended March 31, 2015.

**NOTE 5. PROPERTY AND EQUIPMENT**

Property and equipment, net consisted of the following at March 31, 2015 and December 31, 2014:

	<u>March 31, 2015</u>	<u>December 31, 2014</u>
	<i>(in thousands)</i>	
Land	\$ 2,582	\$ 2,582
Building	9,599	9,599
Computer hardware and software	2,527	2,155
Office furniture and equipment	639	445
Tenant and leasehold improvements	3,077	2,812
Vehicle fleet	531	421
<b>Total, at cost</b>	<b>18,955</b>	<b>18,014</b>
Less: accumulated depreciation and amortization	1,221	927
<b>Property and equipment, net</b>	<b>\$ 17,734</b>	<b>\$ 17,087</b>

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Depreciation and amortization expense for property and equipment was \$0.3 million and \$0.8 million for the three months ended March 31, 2015 and December 31, 2014, respectively. The Company's real estate consists of 13 acres of land and two buildings with a gross area of 148,000 square feet. The Company relocated to these facilities during March 2014. These facilities and the related existing tenant lease agreements were acquired in April 2013 for a total purchase price of \$9.8 million paid in cash.

The Company currently leases space to non-affiliates and its subsidiary Heritage P&C, and occupies space in one of the buildings.

**NOTE 6. EARNINGS PER SHARE**

Basic earnings per share ("EPS") is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share amounts are based on the weighted average number of common shares including outstanding warrants and the net effect of potentially dilutive common shares outstanding.

The following table sets forth the computation of basic and diluted EPS for the periods indicated.

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
<b>Basic earnings per share:</b>		
Net income attributable to common stockholders (000's)	\$ 30,056	\$ 7,888
Weighted average shares outstanding	<u>29,798,571</u>	<u>16,360,800</u>
<b>Basic earnings per share:</b>	<u><b>\$ 1.01</b></u>	<u><b>\$ 0.48</b></u>
<b>Diluted earnings per share:</b>		
Net income attributable to common stockholders (000's)	\$ 30,056	\$ 7,888
Weighted average shares outstanding	29,798,571	16,360,800
Weighted average dilutive shares	317,364	2,636,700
Total weighted average dilutive shares	<u>30,115,935</u>	<u>18,997,500</u>
<b>Diluted earnings per share:</b>	<u><b>\$ 1.00</b></u>	<u><b>\$ 0.42</b></u>

**NOTE 7. DEFERRED POLICY ACQUISITION COSTS**

The Company defers certain costs in connection with written policies, called Deferred Policy Acquisition Costs ("DPAC"), net of corresponding amounts of ceded reinsurance commissions, called Deferred Reinsurance Ceding Commissions ("DRCC"). Net DPAC is amortized over the effective period of the related insurance policies.

The Company anticipates that its DPAC costs will be fully recoverable in the near term. The table below depicts the activity with regard to DPAC during the three-month periods ended March 31, 2015 and 2014:

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
	<i>(in thousands)</i>	
Beginning balance	\$ 24,370	\$ 9,765
Policy acquisition costs deferred	14,566	6,934
Amortization	<u>(13,093)</u>	<u>(4,473)</u>
Ending balance	<u>\$ 25,843</u>	<u>\$ 12,226</u>

The DPAC at March 31, 2015 includes the unamortized portion of \$10 million of deferred costs paid during June 2014 in connection with the Company's assumption of policies from Sunshine State Insurance Company ("SSIC"). Likewise, \$1.9 million amortization has been recorded related to the SSIC policy acquisition costs in the three months ended March 31, 2015. The unamortized DPAC cost is \$0.6 million related to SSIC at March 31, 2015.

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**NOTE 8. INCOME TAXES**

During the three months ended March 31, 2015, the Company recorded \$18.2 million of income tax expense which corresponds to an estimated annual effective tax rate of 37.76%.

The table below summarizes the significant components of our net deferred tax assets/liabilities:

	<u>March 31, 2015</u>	<u>December 31, 2014</u>
	<i>(in thousands)</i>	
Deferred tax assets:		
Unearned premiums	\$ 15,269	\$ 15,567
Tax-related discount on loss reserve	1,187	1,022
Stock-based compensation	1,359	1,258
Other	541	545
Total deferred tax assets	<u>18,356</u>	<u>18,392</u>
Deferred tax liabilities:		
Deferred acquisition costs	10,031	9,401
Unrealized gain	1,709	1,081
Property and equipment	632	633
Other	648	655
Total deferred tax liabilities	<u>13,020</u>	<u>11,770</u>
Net deferred tax asset	<u>\$ 5,336</u>	<u>\$ 6,622</u>

In assessing the net realizable value of deferred tax assets, the Company considered whether it is more likely than not that it will not realize some portion or all of the deferred tax assets. The ultimate realization of deferred tax assets depends upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

No taxing authorities are currently examining any of the Company's 2014, 2013 or 2012 federal or state income tax returns.

As of March 31, 2015 and December 31, 2014 we had no significant uncertain tax positions.

**NOTE 9. REINSURANCE**

The Company's reinsurance program is designed, utilizing the Company's risk management methodology, to address its exposure to catastrophes. The Company's program provides reinsurance protection for catastrophes including hurricanes, tropical storms, and tornadoes. The Company's reinsurance agreements are part of its catastrophe management strategy, which is intended to provide its stockholders an acceptable return on the risks assumed in its property business, and to reduce variability of earnings, while providing protection to the Company's policyholders.

During the second quarter of 2013, the Company placed its reinsurance program for the period from June 1, 2013 through May 31, 2014. The Company's reinsurance program, which was segmented into layers of coverage, protected it for excess property catastrophe losses and loss adjustment expenses. The Company's previous year's reinsurance program incorporated the mandatory coverage required by law to be placed with the Florida Hurricane Catastrophe Fund, a state-mandated catastrophe reinsurance fund ("FHCF"). The Company also purchased private reinsurance below, alongside and above the FHCF layer, as well as aggregate reinsurance coverage. The following describes the various layers of the Company's June 1, 2013 to May 31, 2014 reinsurance program.

- *The Company's Retention.* For the first catastrophic event, the Company had a primary retention of the first \$9 million of losses and loss adjustment expenses, of which the Company's reinsurance subsidiary, Osprey Re Ltd ("Osprey"), was responsible for \$3 million. For a second and third catastrophic event, Heritage P&C's primary retention decreased to \$3 million per event. To the extent that there was reinsurance coverage remaining, Heritage P&C had no primary retention for events beyond the third catastrophic event. Osprey had no primary retention beyond the first catastrophic event.



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- *Layers Below FHCF.* Immediately above the Company's retention, the Company purchased \$94 million of reinsurance from third party reinsurers and Osprey. Through Osprey, the Company retained an aggregate participation in this coverage of \$3.5 million, comprised of a 3% participation of \$31 million of losses and loss adjustment expenses in excess of \$9 million, or \$0.9 million, and a 4% participation of \$63 million of losses and loss adjustment expenses in excess of \$40 million, or \$2.5 million. Through the payment of a reinstatement premium, the Company was able to reinstate the full amount of this reinsurance one time. To the extent that \$94.0 million or a portion thereof was exhausted in a first catastrophic event, the Company purchased reinstatement premium protection insurance to pay the required premium necessary for the reinstatement of this coverage.
- *FHCF Layer.* The Company's FHCF coverage included an estimated maximum provisional limit of 90% of \$270 million, or \$243 million, in excess of the Company's retention and private reinsurance of \$103 million. The limit and retention of the FHCF coverage was subject to upward or downward adjustment based on, among other things, submitted exposures to FHCF by all participants. The Company purchased coverage alongside and above the FHCF layer from third party reinsurers. The layer alongside was in the amount of \$27 million and the layer immediately above was in the amount of \$28.5 million. To the extent the FHCF coverage was adjusted, this private reinsurance would adjust to fill in any gaps in coverage up to the reinsurers' aggregate limits for this layer. Through the payment of a reinstatement premium, the Company was able to reinstate the full amount of this private reinsurance one time. To the extent that all or a portion of either of these private layers was exhausted in a first catastrophic event, the Company purchased reinstatement premium protection insurance to pay the required premium necessary for the reinstatement of this coverage. The FHCF coverage could not be reinstated once exhausted, but it did provide coverage for multiple events.
- *Aggregate Coverage.* In addition to the layers described above, the Company also purchased \$170 million of aggregate reinsurance coverage for losses and loss adjustment expenses in excess of \$401.5 million for a first catastrophic event. To the extent that this coverage was not fully exhausted in the first catastrophic event, it provided coverage commencing at its reduced retention levels for second and subsequent events and where underlying coverage has been previously exhausted. There is no reinstatement of the aggregate reinsurance coverage once exhausted, but it did provide coverage for multiple events.

For a first catastrophic event, the Company's 2013 reinsurance program provided coverage for \$571.5 million of losses and loss adjustment expenses, including its retention, and the Company was responsible for all losses and loss adjustment expenses in excess of such amount. For subsequent catastrophic events, the Company's total available coverage depended on the magnitude of the first event, as the Company may have had coverage remaining from layers that were not previously fully exhausted. The Company also purchased reinstatement premium protection insurance to provide an additional \$149.5 million of coverage. The Company's aggregate reinsurance layer also provides coverage for second and subsequent events to the extent not exhausted in prior events.

During April 2014, Heritage P&C entered into two catastrophe reinsurance agreements with Citrus Re Ltd., a newly-formed Bermuda special purpose insurer. The agreements provide for three years of coverage from catastrophe losses caused by certain named storms, including hurricanes, beginning on June 1, 2014. The limit of coverage of \$200 million is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. Heritage P&C pays a periodic premium to Citrus Re Ltd. during this three-year risk period. In April 2014, Citrus Re Ltd. issued \$200 million of principal-at-risk variable notes due April 2017 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements. The Company has determined that, while Citrus Re Ltd. is a variable interest entity, the Company does not have any variable interests in Citrus Re Ltd. Accordingly, consolidation of or disclosures associated with Citrus Re Ltd. are not applicable.

During the second quarter of 2014, the Company placed its reinsurance program for the period from June 1, 2014 through May 31, 2015. The Company's reinsurance program, which is segmented into layers of coverage, protects it for excess property catastrophe losses and loss adjustment expenses. The Company's current reinsurance program incorporates the mandatory coverage required by law to be placed with FHCF. The Company also purchased private reinsurance below, alongside and above the FHCF layer, as well as aggregate reinsurance coverage. The following describes the various layers of the Company's June 1, 2014 to May 31, 2015 reinsurance program.

- *The Company's Retention.* For the first catastrophic event, the Company has a primary retention of the first \$15 million of losses and loss adjustment expenses, of which Osprey is responsible for \$6 million. For a second

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event, Heritage P&C's primary retention decreases to \$2 million and Osprey is responsible for \$4 million. To the extent that there is reinsurance coverage remaining, Heritage P&C has a \$2 million primary retention for events beyond the third catastrophic event. Osprey has no primary retention beyond the second catastrophic event.

- *Layers Below FHCF.* Immediately above the Company's retention, the Company has purchased \$185 million of reinsurance from third party reinsurers. Through the payment of a reinstatement premium, the Company is able to reinstate the full amount of this reinsurance one time. To the extent that \$185 million or a portion thereof is exhausted in a first catastrophic event, the Company has purchased reinstatement premium protection insurance to pay the required premium necessary for the reinstatement of this coverage. A portion of this coverage wraps around the FHCF and provides coverage alongside the FHCF.
- *FHCF Layer.* The Company's FHCF coverage includes an estimated maximum provisional limit of 90% of \$484 million, or \$436 million, in excess of its retention and private reinsurance of \$181 million. The limit and retention of the FHCF coverage is subject to upward or downward adjustment based on, among other things, submitted exposures to FHCF by all participants. The Company has purchased coverage alongside from third party reinsurers. The layer alongside is in the amount of \$48 million. To the extent the FHCF coverage is adjusted, this private reinsurance will adjust to fill in any gaps in coverage up to the reinsurers' aggregate limits for this layer. The FHCF coverage cannot be reinstated once exhausted, but it does provide coverage for multiple events.
- *CAT Bond Layer.* Immediately above the FHCF layer is the coverage provided by the reinsurance agreements entered into with Citrus Re Ltd., as described above in this footnote. The first contract with Citrus Re Ltd. provides \$150 million of coverage and the second contract provides an additional \$50 million of coverage. Osprey provides \$25 million of coverage alongside the second contract.
- *Aggregate Coverage.* In addition to the layers described above, the Company has also purchased \$105 million of aggregate reinsurance coverage for losses and loss adjustment expenses in excess of \$825.0 million for a first catastrophic event. To the extent that this coverage is not fully exhausted in the first catastrophic event, it provides coverage commencing at its reduced retention levels for second and subsequent events and where underlying coverage has been previously exhausted. There is no reinstatement of the aggregate reinsurance coverage once exhausted, but it does provide coverage for multiple events. Osprey Re Ltd. provides \$20 million of protection in the layer above \$940 million.

For a first catastrophic event, the Company's reinsurance program provides coverage for \$990 million of losses and loss adjustment expenses, including its retention, and the Company is responsible for all losses and loss adjustment expenses in excess of such amount. For subsequent catastrophic events, the Company's total available coverage depends on the magnitude of the first event, as the Company may have coverage remaining from layers that were not previously fully exhausted. The Company has also purchased reinstatement premium protection insurance to provide an additional \$185 million of coverage. The Company aggregate reinsurance layer also provides coverage for second and subsequent events to the extent not exhausted in prior events.

**Property Per Risk Coverage**

The Company also purchased property per risk coverage for losses and loss adjustment expenses in excess of \$1 million per claim. The limit recoverable for an individual loss is \$9 million and total limit for all losses is \$27 million. There are two reinstatements available with additional premium due based on the amount of the layer exhausted. In addition, the Company purchased facultative reinsurance in excess of \$10 million for any commercial properties it insured that the total insured value exceeded \$10 million.

**Assumption Transactions and Assumed Premiums Written**

On June 27, 2014, the Company assumed approximately \$58.9 million (representing 33,000 policies in force) of annualized premiums from Sunshine State Insurance Company ("SSIC"). At March 31, 2015, approximately 28,465 SSIC policies were in force representing approximately \$49.8 million of annualized premium. The SSIC policies account for approximately 12.9% of the Company's total policies in force as of March 31, 2015.

Prior to June 27, 2014, substantially all of the Company's policies had been obtained in connection with assumption transactions with Citizens, pursuant to which the Company recorded the assumed premiums written in the amount of the unearned premiums transferred to the Company. In connection with each assumption transaction, the Company assumes the responsibility of the primary writer of the risk through the expiration of the term of the policy.

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The following table depicts written premiums, earned premiums and losses, showing the effects that the Company's assumption transactions have on these components of the Company's consolidated statements of operations and comprehensive income:

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
<i>(in thousands)</i>		
<b>Premium written:</b>		
Direct	\$ 101,501	\$ 52,100
Assumed	32,467	16,803
Ceded	(770)	(14)
Net premium written	<u>\$ 133,198</u>	<u>\$ 68,889</u>
<b>Change in unearned premiums:</b>		
Direct	\$ (26,521)	\$ (17,957)
Assumed	18,554	9,914
Ceded	(23,742)	(18,610)
Net decrease (increase)	<u>\$ (31,709)</u>	<u>\$ (26,653)</u>
<b>Premiums earned:</b>		
Direct	\$ 74,980	\$ 34,143
Assumed	51,021	26,717
Ceded	(24,512)	(18,624)
Net premiums earned	<u>\$ 101,489</u>	<u>\$ 42,236</u>
<b>Losses and LAE incurred:</b>		
Direct	\$ 26,643	\$ 10,250
Assumed	5,896	10,337
Ceded	—	—
Net losses and LAE incurred	<u>\$ 32,539</u>	<u>\$ 20,587</u>

The following table highlights the effects that the Company's assumption transactions have on unpaid losses and loss adjustment expenses and unearned premiums:

	<i>March 31, 2015</i>	<i>December 31, 2014</i>
	<i>(in thousands)</i>	
<b>Unpaid losses and loss adjustment expenses:</b>		
Direct	\$ 41,344	\$ 34,420
Assumed	20,502	17,049
Gross unpaid losses and LAE	61,846	51,469
Ceded	—	—
Net unpaid losses and LAE	<u>\$ 61,846</u>	<u>\$ 51,469</u>
<b>Unearned premiums:</b>		
Direct	\$ 182,138	\$ 155,617
Assumed	66,965	85,519
Gross unearned premiums	249,103	241,136
Ceded	(19,406)	(43,148)
Net unearned premiums	<u>\$ 229,697</u>	<u>\$ 197,988</u>

Prepaid reinsurance premiums related to twenty-one reinsurers for both periods at March 31, 2015 and December 31, 2014. There were no amounts receivable with respect to reinsurers at March 31, 2015 and December 31, 2014. Thus, there were no concentrations of credit risk associated with reinsurance receivables as of March 31, 2015 and December 31, 2014. The percentages of assumed premiums earned to net premiums earned for the three months ended March 31, 2015 and March 31, 2014 were 50.3% and 63.3%, respectively.

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**NOTE 10. RESERVE FOR UNPAID LOSSES**

The Company determines the reserve for unpaid losses on an individual-case basis for all incidents reported. The liability also includes amounts for which are commonly referred to as incurred but not reported, or “IBNR”, claims as of the balance sheet date.

The table below summarizes the activity related to the Company’s reserve for unpaid losses:

	<i>Three Months Ended March 31,</i>	
	<i>2015</i>	<i>2014</i>
	<i>(In thousands)</i>	
Balance, beginning of period	\$ 51,469	\$ 19,344
Less: reinsurance recoverable on paid losses	—	—
Net balance, beginning of period	<u>51,469</u>	<u>19,344</u>
Incurred related to:		
Current year	37,052	20,555
Prior years	(4,513)	32
Total incurred	<u>32,539</u>	<u>20,587</u>
Paid related to:		
Current year	9,815	5,241
Prior years	12,347	6,234
Total paid	<u>22,162</u>	<u>11,475</u>
Net balance, end of period	61,846	28,456
Plus: reinsurance recoverable on unpaid losses	—	—
Balance, end of period	<u>\$ 61,846</u>	<u>\$ 28,456</u>

The significant increase in the Company’s reserves for unpaid losses in 2015 from 2014 is primarily due to the increase in policy count.

The Company writes insurance in the state of Florida, which could be exposed to hurricanes or other natural catastrophes. Although the occurrence of a major catastrophe could have a significant effect on our monthly or quarterly results, such an event is unlikely to be so material as to disrupt our overall normal operations. However, the Company is unable to predict the frequency or severity of any such events that may occur in the near term or thereafter. The Company believes that the reserve for unpaid losses reasonably represents the amount necessary to pay all claims and related expenses which may arise from incidents that have occurred as of the balance sheet date.

The Company’s losses incurred during the three months ended March 31, 2015 and 2014 reflect prior year redundancy of \$4.5 million and deficiency of \$32,000, respectively, due to changes in the Company’s estimate of ultimate losses on claims incurred in prior years not attributable to any specific trend or claims handling dynamic.

**NOTE 11. STATUTORY ACCOUNTING AND REGULATIONS**

State laws and regulations, as well as national regulatory agency requirements, govern the operations of all insurers such as our insurance subsidiary. The various laws and regulations require that insurers maintain minimum amounts of statutory surplus and risk-based capital, they restrict insurers’ ability to pay dividends, the Company specify allowable investment types and investment mixes, and the Company’s subject insurers to assessments.

The Company’s insurance subsidiary, Heritage P&C, must file with the insurance regulatory authorities an “Annual Statement” which reports, among other items, net income and surplus as regards policyholders, which is called stockholder’s equity under GAAP. For the three months ended March 31, 2015 and 2014, the Company’s insurance subsidiary recorded statutory net income of \$12.8 million and \$2.2 million, respectively. The Company’s insurance subsidiary is domiciled in Florida, and the laws of that state require that the Company’s insurance subsidiary maintain capital and surplus equal to the greater of \$15 million or 10% of its liabilities. The Company’s statutory capital surplus was \$194.1 million and \$172.7 million at March 31, 2015 and December 31, 2014, respectively. State law also requires the Company’s insurance subsidiary to adhere to prescribed premium-to-capital surplus ratios, with which the Company is in compliance.

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In 2014, the Florida legislature passed Senate Bill 1308, which was signed into law by the Governor. Among other things, this bill incorporates the National Association of Insurance Commissioners (“NAIC”) recommendations with regard to expansion of the regulation of insurers to include non-insurance entity affiliates. Specifically, the new law permits the FLOIR to examine affiliated entities within an insurance holding company system in order to ascertain the financial condition of the insurer. The law also provides for certain disclosures with regard to enterprise risk, which are satisfied by the provision of related information filed with the SEC. This legislation was designed to bolster regulation for insurer solvency and governance and became effective January 1, 2015.

**NOTE 12. COMMITMENTS AND CONTINGENCIES**

The Company is involved in claims-related legal actions arising in the ordinary course of business. The Company accrues amounts resulting from claims-related legal actions in unpaid losses and loss adjustment expenses during the period that it determines an unfavorable outcome becomes probable and it can estimate the amounts. Management makes revisions to its estimates based on its analysis of subsequent information that the Company receives regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) judicial decisions and legal developments in the awarding of damages; and (iv) trends in general economic conditions, including the effects of inflation. When determinable, the Company discloses the range of possible losses in excess of those accrued and for reasonably possible losses.

**NOTE 13. OTHER LIABILITIES**

At March 31, 2015 and December 31, 2014, other liabilities included approximately \$16.6 million and \$21.1 million, respectively, related to amounts owed to Citizens for policies assumed by the Company, where the policyholder subsequently opted-out of the assumption program.

**NOTE 14. RELATED PARTY TRANSACTIONS**

The Company has been party to various related party transactions involving certain of its officers, directors and significant stockholders as set forth below. The Company has entered into these arrangements without obligation to continue its effect in the future and the associated expense was immaterial to its results of operations or financial position as of March 31, 2015 and 2014.

- The Company entered into an agreement for the construction of a parking facility for its Clearwater property with a relative of one of its directors. As of March 31, 2014, the Company had made payments of \$82,000 under this agreement. The project was completed during September 2014 and was paid in full by the year ended December 31, 2014 for approximately \$2.6 million.
- The Company leased the space that it had occupied through March 2014 at 700 Central Avenue, Ste. 500 St. Petersburg, Florida from a real estate management company controlled by a stockholder. The Company leased the space without obligation to continue doing so in the future. For the three months ended March 31, 2014 the Company incurred rent expense of approximately \$70,000. We relocated to one of the buildings located on our Clearwater property in March 2014 and did not pay any rent under the lease, as it was effectively terminated upon date of relocation.
- The Company has entered into an agreement with a real estate management company controlled by one of its directors to manage its Clearwater office space. Management services are provided at a fixed fee, plus ordinary and necessary out of pocket expenses. Fees for additional services, such as the oversight of construction activity, are provided for on an as-needed basis.

**NOTE 15. EMPLOYEE BENEFIT PLAN**

The Company provides a 401(k) plan for substantially all of its employees. The Company contributes 3% of employees’ salary, up to the maximum allowable contribution, regardless of the employees’ level of participation in the plan. For the three-month periods ended March 31, 2015 and 2014, the Company’s contributions to the plan on behalf of the participating employees were \$76,000 and \$39,000 respectively.

**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

**NOTE 16. EQUITY**

The total amount of authorized capital stock consists of 50,000,000 shares of common stock and 5,000,000 shares of preferred stock. As of March 31, 2015, the Company had 29,807,460 shares of common stock, 30,600 warrants and 596,282 unvested stock options outstanding reflecting total paid in capital of \$190 million as of such date.

**Common Stock**

Holders of common stock are entitled to one vote for each share held on all matters subject to a vote of stockholders, subject to the rights of holders of any outstanding preferred stock. Accordingly, holders of a majority of the shares of common stock entitled to vote in any election of directors may elect all of the directors standing for election, subject to the rights of holders of any outstanding preferred stock. Holders of common stock will be entitled to receive ratably any dividends that the board of directors may declare out of funds legally available therefor, subject to any preferential dividend rights of outstanding preferred stock. Upon the Company's liquidation, dissolution or winding up, the holders of common stock will be entitled to receive ratably its net assets available after the payment of all debts and other liabilities and subject to the prior rights of holders of any outstanding preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of the Company's capital stock are fully paid and nonassessable.

**Equity Issuances**

As more fully disclosed in our previously referred to financial statements for the year ended December 31, 2014, there were, as of December 31, 2014, 29,794,960 shares of common stock outstanding and 30,600 warrants and 1,685,923 stock options outstanding, representing \$188.3 million of additional paid-in capital. The following discloses the changes in our stockholders' equity during 2015.

**First Quarter 2015**

In March 2015, the Company issued 12,500 shares of common stock from the exercise of 12,500 stock options grant at an exercise price of \$16.89 per share of common stock and received proceeds of \$211,125.

**NOTE 17. STOCK-BASED COMPENSATION**

The Company has adopted the Heritage Insurance Holdings, Inc., Omnibus Incentive Plan (the "Plan") effective on May 22, 2014. The Plan has authorized 2,981,737 shares of common stock reserved for issuance under the Plan for future grants.

At March 31, 2015 and December 31, 2014, there were 1,295,814 shares available for grant under the Plan.

The Company recognizes compensation expense under ASC 718 for its stock-based payments based on the fair value of the awards. The Company grants stock options at exercise prices equal to the fair market value of the Company's stock on the dates the options are granted. The options have a maximum term of ten years from the date of grant and vest primarily in equal annual installments over a range of one to five year periods following the date of grant for employee options. If a participant's employment relationship ends, the participant's vested awards will remain exercisable for the shorter of a period of 30 days or the period ending on the latest date on which such award could have been exercisable. The fair value of each option grant is separately estimated for each grant date. The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the award and each vesting date. The Company estimates the fair value of all stock option awards as of the date of the grant by applying the Black-Scholes-Merton multiple-option pricing valuation model ("Black-Scholes model"). The application of this valuation model involves assumptions that are judgmental and highly sensitive in the determination of compensation expense.

**Stock Options**

On September 24, 2014, the Company granted 359,000 options to certain employees and directors. No stock options were granted in 2013 or 2012. These options were awarded with the strike price set at the fair market value at the grant date, and vested March 15, 2015 with an expiration date of September 24, 2017. The fair value of each option grant, which was \$2.70 per option granted in 2014, is estimated on the date of grant using the Black-Scholes model.

**HERITAGE INSURANCE HOLDINGS, INC.**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

On December 2, 2014, the Company granted 1,326,923 options to certain employees and directors. The employee options were awarded with the strike price set at the fair market value at the grant date. Fifty percent of these options were immediately vested and 50 percent on April 30, 2015, and these options expire on December 2, 2017. The directors' options were awarded with the strike price set at the fair market value at the grant date, and vest quarterly commencing on January 1, 2015 with an expiration date of December 2, 2017. The fair value of each option grant, which ranged from \$3.07 to \$3.54 per option granted in 2014, is estimated on the date of grant using the Black-Scholes model.

The following table provides the assumptions utilized in the Black-Scholes model for options granted on September 24, 2014 and December 2, 2014. No options were granted during the three months ended March 31, 2015 and 2014.

	December 2, 2014	September 24, 2014
Weighted-average risk-free interest rate	51%	42%
Expected term of option in years	1.6	1.7
Weighted-average volatility	35.56%	36.47%
Dividend yield	0%	0%
Weighted average grant date fair value per share	\$ 3.19	\$ 2.70

A summary of information related to stock options outstanding at March 31, 2015 is as follows:

	Shares	Weighted-Average Grant Date Fair Value	Shares Available for Grant
Balance at December 31, 2014	1,685,923	\$ 3.09	1,295,814
Granted	—		
Exercised	(12,500)	\$ 16.89	
Balance at March 31, 2015	1,673,423	\$ 3.20	1,295,814
Vested and exercisable as of March 31, 2015	1,077,141	\$ 2.80	

The Company had approximately \$0.5 million of unrecognized stock compensation expense at March 31, 2015 related to non-vested compensation, which the Company expects to recognize ratably over the period of 0.4 years. The Company recognized \$1.4 million of compensation expense during the three months ended March 31, 2015.

**NOTE 18. SUBSEQUENT EVENTS**

During April 2015 (closed April 8, 2015), Heritage P&C entered into three catastrophe reinsurance agreements with Citrus Re Ltd., The agreements provide for three years of coverage from catastrophe losses caused by certain named storms, including hurricanes, beginning on June 1, 2015. Heritage P&C pays a periodic premium to Citrus Re Ltd. during this three-year risk period. Citrus Re Ltd. issued \$277.5 million of principal-at-risk variable notes due April 2017 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class A notes provide up to \$150 million of coverage; the Class B notes provide \$97.5 million of coverage, and the Class C notes provide \$30 million of coverage. The Class B and Class C notes provide reinsurance coverage for a sliver of the catastrophe coverage that had previously been provided by the Florida Hurricane Catastrophe Fund. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements. The Company has determined that, while Citrus Re Ltd. is a variable interest entity, the Company does not have any variable interests in Citrus Re Ltd. Accordingly, consolidation of or disclosures associated with Citrus Re Ltd. are not applicable.



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### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with our condensed consolidated financial statements and related notes and information included and elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 Form 10-K"). Unless the context requires otherwise, as used in this Form 10-Q, the terms "we," "us," "our," "the Company," "our company," and similar references refer to Heritage Insurance Holdings, Inc., a Delaware corporation, and its subsidiaries.

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of Heritage Insurance Holdings, Inc. This discussion should be read in conjunction with the consolidated financial statements and related notes found under Part II, Item 8 on our 2014 Form 10-K with the filed with the SEC on March 18, 2015.

#### Financial Results Highlights for the Three Months Ended March 31, 2015

- Approximately 220,000 policies in-force at March 31, 2015, of which approximately 74% were assumed from Citizens, 13% were assumed from SSIC and 13% were from voluntary sales
- Gross premiums written of \$134 million and total revenue of \$105 million
- Net premiums earned of \$101 million
- Net income of \$30 million
- Combined ratio of 65% on a gross basis and 56% on a net basis
- Cash, cash equivalents and investments of \$564 million, with total assets of \$669 million

#### Critical Accounting Policies and Estimates

When we prepare our consolidated financial statements and accompanying notes in conformity with U.S. generally accepted accounting principles (GAAP), we must make estimates and assumptions about future events that affect the amounts we report. Certain of these estimates result from judgments that can be subjective and complex. As a result of that subjectivity and complexity, and because we continuously evaluate these estimates and assumptions based on a variety of factors, actual results could materially differ from our estimates and assumptions if changes in one or more factors require us to make accounting adjustments. During the three months ended March 31, 2015, we reassessed our critical accounting policies and estimates as disclosed within our 2014 Form 10-K; we have made no material changes or additions with regard to such policies and estimates.

#### Results of Operations

The following table reports our results of operations for the three months ended March 31, 2015 and 2014 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2015	2014
<b>Revenue</b>		
Gross premiums written	\$ 133,968	\$ 68,903
Increase in gross unearned premiums	(7,967)	(8,043)
Gross premiums earned	126,001	60,860
Premiums ceded	(24,512)	(18,624)
Net premiums earned	101,489	42,236
Net investment income	1,633	618
Net realized investment losses	(3)	(42)
Other income	2,009	1,066
<b>Total revenue</b>	<b>\$ 105,128</b>	<b>\$ 43,878</b>
<b>Expenses</b>		
Losses and loss adjustment expenses	32,539	20,587
Policy acquisition costs	13,093	4,473
General and administrative expenses	11,204	6,997
<b>Total expenses</b>	<b>56,836</b>	<b>32,057</b>
<b>Income before income taxes</b>	<b>48,292</b>	<b>11,821</b>
Income taxes	18,236	3,933
<b>Net income</b>	<b>\$ 30,056</b>	<b>\$ 7,888</b>
<b>Ratios to Gross Premiums Earned:</b>		
Ceded premium ratio	19.5%	30.6%
Loss Ratio	25.8%	33.8%
Expense Ratio	19.3%	18.8%
Combined Ratio	64.6%	83.3%
<b>Ratios to Net Premiums Earned:</b>		
Loss Ratio	32.1%	48.7%
Expense Ratio	23.9%	27.2%
Combined Ratio	56.0%	75.9%



**Per Share Data:**

Basic earnings	\$	1.01	\$	0.48
Diluted earnings	\$	1.00	\$	0.42

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*Comparison of the Three Months Ended March 31, 2015 and 2014*

*Revenue*

Gross premiums written

Gross premiums written increased from \$68.9 million for the three months ended March 31, 2014 to \$134.0 million for the three months ended March 31, 2015. The increase in gross premiums written was due to the renewal of a significant number of policies previously assumed from Citizens and SSIC, the growing number of new voluntary policies written and the approximately 93% increase in premiums assumed from Citizens for the three months ended March 31, 2015 compared to the three months ended March 31, 2014. Of our \$134.0 million of gross premiums written for the three months ended March 31, 2015, \$101.5 million represented direct premiums written and \$32.5 million represented assumed premiums written. Personal residential business accounted for \$103.0 million and commercial residential \$31.0 million of the total gross premiums written for the three months ended March 31, 2015.

Gross premiums earned

Gross premiums earned increased from \$60.9 million for the three months ended March 31, 2014 to \$126.0 million for the three months ended March 31, 2015. Our premiums in force as of March 31, 2015 and March 31, 2014 were approximately \$533.0 million and \$261.0 million, respectively, resulting in the increase in gross premiums earned. Approximately \$25.7 million of gross premiums earned during the three months ended March 31, 2015 was attributable to commercial residential policies, of which we had none during the three months ended March 31, 2014.

Ceded premiums

Ceded premiums increased from \$18.6 million for the three months ended March 31, 2014 to \$24.5 million for the three months ended March 31, 2015. The increase in ceded premiums is primarily a result of the significant increase in the policies in force, partially offset by lower reinsurance costs due to favorable reinsurance market conditions and the availability of lower cost reinsurance related to \$200 million of Catastrophe (CAT) bonds issued by a third party as well as improved geographic spread of risk.

Net premiums earned

Net premiums earned increased from \$42.2 million for the three months ended March 31, 2014 to \$101.5 million for the three months ended March 31, 2015. The increase in net premiums earned in the comparable periods is primarily attributable to the increase in the amount of premiums in force at March 31, 2015, including the introduction of commercial residential business during the second half of 2014, as compared to March 31, 2014, partially offset by increased ceded earned premium.

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### Net investment income

Net investment income, inclusive of net realized investment gains and losses, increased from \$0.6 million for the three months ended March 31, 2014 to \$1.6 million for the three months ended March 31, 2015. The increase in net investment income is due to the significant increase in invested assets from \$151.1 million to \$402.7 million at March 31, 2014 and March 31, 2015, respectively. The increase resulted primarily from premium growth and \$90 million for our initial public offering.

### Other revenue

Other revenue increased from \$1.1 million for the three months ended March 31, 2014 to \$2.0 million for the three months ended March 31, 2015. The increase in other revenue between the comparable periods is primarily attributable to the policy fees generated by our growing portfolio of new and renewed policies, as well as, the rental income received pursuant to non-cancelable leases for our commercial property in Clearwater, Florida that we purchased in April 2013.

### Total revenue

Total revenue increased from \$43.9 million for the three months ended March 31, 2014 to \$105.1 million for the three months ended March 31, 2015. The increase in total revenue was due primarily to the growth in net premiums earned resulting from the significant increase in the amount of premiums in force at March 31, 2015 as compared to March 31, 2014.

## *Expenses*

### Losses and loss adjustment expenses

Losses and loss adjustment expenses increased from \$20.6 million for the three months ended March 31, 2014 to \$32.5 million for the three months ended March 31, 2015. The increase in losses and loss adjustment expenses resulted primarily from an increase in the number of policies in force between the respective periods, partially offset by a decrease in the loss ratio. Losses and loss adjustment expenses for the three months ended March 31, 2015 include losses paid of \$22.2 million and a \$10.4 million increase in unpaid losses and loss adjustment expenses, including the addition of \$4.5 million of IBNR reserves. Losses and loss adjustment expenses for the three months ended March 31, 2014 include losses paid of \$11.5 million and a \$9.1 million increase in unpaid losses and loss adjustment expenses, including the addition of \$4.6 million of IBNR reserves. As of March 31, 2015, we reported \$61.8 million in unpaid losses and loss adjustment expenses which included \$34.3 million attributable to IBNR, or 55.5% of total reserves for unpaid losses and loss adjustment expenses.

### Policy acquisition costs

Policy acquisition costs increased from \$4.4 million for the three months ended March 31, 2014 to \$13.1 million for the three months ended March 31, 2015. The increase is primarily attributable to the significant increase in new and renewed policies, which have associated commissions and administration fees paid to outside agents and administrators at the time of policy issuance, premium taxes and inspection fees, none of which are associated with policies assumed from Citizens prior to their renewal. In addition, \$1.9 million of the \$10 million SSIC policy acquisition fee was amortized during the three months ended March 31, 2015. At March 31, 2015 only \$0.6 million of the \$10 million acquisition fee remains as unamortized.

### General and administrative expenses

General and administrative expenses increased from \$7.0 million for the three months ended March 31, 2014 to \$11.2 million for the three months ended March 31, 2015. The increase in 2015 was due primarily to the increase in our bonus accrual as a result of the significant increase in year-to-date earnings in 2015, as well as stock-based compensation related to unvested options that were granted in 2014.

### Provision for income taxes

Provision for income taxes was \$3.9 million and \$18.2 million for the three months ended March 31, 2014 and 2015, respectively. Our effective tax rate for the three months ended March 31, 2014 and 2015 was 33.2% and 37.8%, respectively. The increase in the effective tax rate is due to our conversion from a limited liability company to a corporation on May 22, 2014 in connection with our initial public offering.

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### Net Income

Our results of operations for the three months ended March 31, 2015 reflect net income of \$30.1 million, or \$1.00 earnings per diluted common share, compared to net income of \$7.9 million, or \$0.42 earnings per diluted common share, for the three months ended March 31, 2014.

### **Ratios**

*Due to the impact our reinsurance costs have on net premiums earned from period to period, our management believes the ratios discussed below are more meaningful when viewed on a gross basis.*

#### Ceded premium ratio

Our ceded premium ratio decreased from 30.6% for the three months ended March 31, 2014 to 19.5% for the three months ended March 31, 2015. This decrease is due to lower reinsurance costs due to favorable reinsurance market conditions, the availability of lower cost reinsurance related to \$200 million of CAT bonds issued by a third party and improved geographic spread of risk, primarily as a result of the SSIC acquisition. Additionally, the growth in premiums assumed in the fourth quarter of 2014 and the first quarter of 2015, in which we incurred no additional reinsurance costs until June 1, 2015, significantly improved the ratio. Our ceded premium ratio in the first quarter of 2014 was also favorably impacted by similar growth from the fourth quarter of 2014 and first quarter of 2015.

#### Gross loss ratio

Our gross loss ratio decreased from 33.8% for the three months ended March 31, 2014 to 25.8% for the three months ended March 31, 2015, primarily due to favorable development on prior year losses, the introduction of our commercial residential business, which has a lower loss ratio than personal residential, and reserve strengthening that took place in the first quarter of 2014.

#### Net loss ratio

Our net loss ratio decreased from 48.7% for the three months ended March 31, 2014 to 32.1% for the three months ended March 31, 2015, primarily as a result of the items mentioned in the previous paragraph and the improvement of the ceded premium ratio.

#### Gross expense ratio

Our gross expense ratio increased modestly from 18.8% for the three months ended March 31, 2014 to 19.3% for the three months ended March 31, 2015. The increase in the ratio is primarily due to the amortization of SSIC policy acquisition costs, partially offset by a lower general and administration expense ratio, due to economies of scale.

#### Net expense ratio

Our net expense ratio decreased from 27.2% for the three months ended March 31, 2014 to 23.9% for the three months ended March 31, 2015. The decrease is primarily attributable to the improvement in the ceded premium ratio.

#### Combined ratio

Our combined ratio on a gross basis decreased from 83.3% for the three months ended March 31, 2014 to 64.6% for the three months ended March 31, 2015. Our combined ratio on a net basis decreased from 75.9% for the three months ended March 31, 2014 to 56.0% for the three months ended March 31, 2015. The changes in our combined ratio, on both a gross and net basis, are for the reasons explained above.

### **Liquidity and Capital Resources**

As of March 31, 2015, we had \$160.8 million of cash and cash equivalents, which primarily consisted of cash and money market accounts. We intend to hold substantial cash balances during hurricane season to meet seasonal liquidity needs and the collateral requirements of Osprey Re Ltd, our captive reinsurance company described below. We also had \$4.3 million in restricted cash to meet our contractual obligations related to the Catastrophe bonds issued by Citrus Re Ltd.

Osprey is required to maintain a collateral trust account equal to the risk that it assumes from Heritage P&C, less amounts collateralized through a letter of credit. In December of 2014, the FLOIR approved the removal of \$45 million from the collateral trust account following the end of the 2014 hurricane season. As of March 31, 2015, \$5.0 million was held in

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Osprey's trust account and an additional \$5.0 million was collateralized with a letter of credit. At March 31, 2015, the Company and the FLOIR deemed \$10 million to be sufficient to satisfy Osprey's reinsurance obligations from non-hurricane catastrophic events. Further, \$35.0 million of the \$45.0 million that was removed from the collateral trust accounts was contributed as paid in surplus, to Heritage P&C in December 2014.

Although we can provide no assurances, we believe that we maintain sufficient liquidity to pay Heritage P&C's claims and expenses, as well as to satisfy commitments in the event of unforeseen events such, inadequate premium rates, or reserve deficiencies. We maintain a comprehensive reinsurance program at levels management considers adequate to diversify risk and safeguard our financial position.

We believe our current capital resources, together with cash provided from our operations, will be sufficient to meet currently anticipated working capital requirements. We cannot provide assurance, however, that such will be the case in the future.

### Operating Activities

	Three Months Ended March 31,		
	2015	2014	Change
Net cash provided by (used in):			
Operating activities	\$ 72,363	\$ 24,011	\$ 48,352
Investing activities	(72,243)	(14,466)	(57,777)
Financing activities	212	88	124
Net increase (decrease) in cash and cash equivalents	<u>\$ 332</u>	<u>\$ 9,633</u>	<u>\$ (9,301)</u>

Cash provided by operating activities increased from \$24.0 million for the three months ended March 31, 2014 to \$72.4 million for the three months ended March 31, 2015. The increase in cash provided by operating activities reflects the growth of premiums in force, our improved ceded premium ratio and the timing of reinsurance payments.

### Investing Activities

Net cash used in investing activities increased from \$14.5 million for the three months ended March 31, 2014 to \$72.2 million for the three months ended March 31, 2015. The increase in net cash used in investing activities was primarily attributable to investment of cash attributable with the growth in our policy count.

### Financing Activities

Net cash provided by financing activities increased from \$88,000 for the three months ended March 31, 2014 to \$212,000 for the three months ended March 31, 2015.

### Seasonality of our Business

Our insurance business is seasonal as hurricanes typically occur during the period from June 1 through November 30 each year. With our reinsurance program effective on June 1 each year, any variation in the cost of our reinsurance, whether due to changes to reinsurance rates or changes in the total insured value of our policy base will occur and be reflected in our financial results beginning June 1 of each year, subject to certain adjustments.

### Off-Balance Sheet Arrangements

We obtained a \$5 million irrevocable letter of credit from a financial institution to secure Osprey's obligations arising from our reinsurance program. We collateralized this letter of credit facility with otherwise unencumbered real estate. The letter of credit terminates on May 31, 2015.

### JOBS Act

We qualify as an "emerging growth company" under the JOBS Act. Section 107 of the JOBS Act provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for complying with new or revised accounting standards. In other words, an emerging growth company can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have irrevocably elected not to avail ourselves of this extended transition period and, as a result, we will adopt new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies.

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We are in the process of evaluating the benefits of relying on other exemptions and reduced reporting requirements provided by the JOBS Act. Subject to certain conditions set forth in the JOBS Act, if as an emerging growth company we choose to rely on such exemptions, we may not be required to, among other things, (i) provide an auditor's attestation report on our systems of internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, (ii) provide all of the compensation disclosure that may be required of non-emerging growth public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act, (iii) comply with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements (auditor discussion and analysis), and (iv) disclose certain executive compensation-related items such as the correlation between executive compensation and performance and comparisons of the Chief Executive Officer's compensation to median employee compensation. These exemptions will apply until we no longer meet the requirements of being an emerging growth company. We will remain an emerging growth company until the earlier of (1) the last day of the fiscal year (a) following the fifth anniversary of the completion of our initial public offering, (b) in which we have total annual gross revenue of at least \$1 billion or (c) in which we are deemed to be a large accelerated filer, which means the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our prior second fiscal quarter, and (2) the date on which we have issued more than \$1 billion in non-convertible debt during the prior three-year period.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our investment portfolios at March 31, 2015 included fixed-maturity and equity securities, the purposes of which are not for trading or speculation. Our main objective is to maximize after-tax investment income and maintain sufficient liquidity to meet policyholder obligations while minimizing market risk which is the potential economic loss from adverse fluctuations in securities' prices. We consider many factors including credit ratings, investment concentrations, regulatory requirements, anticipated fluctuation of interest rates, durations and market conditions in developing investment strategies. Investment securities are managed by a group of nationally recognized asset managers and are overseen by the investment committee appointed by our board of directors. Our investment portfolios are primarily exposed to interest rate risk, credit risk and equity price risk. We classify our fixed-maturity and equity securities as available-for-sale and report any unrealized gains or losses, net of deferred income taxes, as a component of other comprehensive income within our stockholders' equity. As such, any material temporary changes in their fair value can adversely impact the carrying value of our stockholders' equity.

#### Interest Rate Risk

Our fixed-maturity securities are sensitive to potential losses resulting from unfavorable changes in interest rates. We manage the risk by analyzing anticipated movement in interest rates and considering our future capital needs.

The following table illustrates the impact of hypothetical changes in interest rates to the fair value of our fixed-maturity securities at March 31, 2015 (in thousands):

Hypothetical Change in Interest rates	Estimated Fair Value After Change	Change In Estimated Fair Value	Percentage Increase (Decrease) in Estimated Fair Value
300 basis point increase	\$ 318,361	\$ (46,535)	(13)%
200 basis point increase	\$ 333,874	\$ (31,022)	(9)%
100 basis point increase	\$ 349,386	\$ (15,511)	(4)%
100 basis point decrease	\$ 380,036	\$ 15,139	4%
200 basis point decrease	\$ 391,722	\$ 26,826	7%
300 basis point decrease	\$ 397,644	\$ 32,748	9%

#### Credit Risk

Credit risk can expose us to potential losses arising principally from adverse changes in the financial condition of the issuer of our fixed maturities. We mitigate this risk by investing in fixed maturities that are generally investment grade and by diversifying our investment portfolio to avoid concentrations in any single issuer or market sector.

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The following table presents the composition of our fixed-maturity portfolio by rating at March 31, 2015 (in thousands):

Comparable Rating	Amortized Cost	% of Total Amortized Cost	Estimated Fair Value	% of total Estimated Fair Value
AAA	\$ 93,920	26%	\$ 94,339	26%
AA+	\$ 30,666	8%	\$ 30,987	8%
AA	\$ 52,973	15%	\$ 53,582	15%
AA-	\$ 30,029	8%	\$ 30,435	8%
A+	\$ 33,040	9%	\$ 33,505	9%
A	\$ 39,994	11%	\$ 40,489	11%
A-	\$ 36,129	10%	\$ 36,784	10%
BBB+	\$ 30,040	8%	\$ 30,473	8%
BBB	\$ 7,597	3%	\$ 7,737	3%
BBB-	\$ 5,566	2%	\$ 5,615	2%
BB+	\$ 767	0%	\$ 787	0%
BB	\$ 43	0%	\$ 43	0%
B+	\$ 78	0%	\$ 77	0%
B	\$ 43	0%	\$ 43	0%
<b>Total</b>	<b>\$ 360,885</b>	<b>100%</b>	<b>\$ 364,896</b>	<b>100%</b>

### Equity Price Risk

Our equity investment portfolio at March 31, 2015 consists of common stocks and redeemable and non-redeemable preferred stocks. We may incur potential losses due to adverse changes in equity security prices. We manage this risk primarily through industry and issuer diversification and asset allocation techniques.

The following table illustrates the composition of our equity portfolio at March 31, 2015 (in thousands):

	Estimated Fair Value	% of Total Estimated Fair value
<b>Stocks by sector:</b>		
Financial	\$ 4,379	14%
Energy	15,296	49%
Other	11,811	37%
<b>Subtotal</b>	<b>\$ 31,486</b>	<b>100%</b>
<b>Mutual Funds and ETF By type:</b>		
Equity	216	0%
<b>Subtotal</b>	<b>216</b>	<b>0%</b>
<b>Total</b>	<b>\$ 31,702</b>	<b>100%</b>

### Foreign Currency Exchange Risk

At March 31, 2015, we did not have any material exposure to foreign currency related risk.

## Item 4. Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) that are designed to assure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

As required by Exchange Act Rule 13a-15(b), as of the end of the period covered by this Quarterly Report, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2015.

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**Changes in Internal Control over Financial Reporting**

As previously reported in our Annual Report for the Year Ended December 31, 2014, filed on March 18, 2015, we had material weaknesses in our internal control over financial reporting related to, among other things, accounting for stock-based compensation, equity transactions and income taxes. With the oversight of senior management, we have taken steps to remediate the underlying causes of these material weaknesses, primarily through the hiring additional finance personnel and additional review of certain more complex accounting matters by third party consultants. We have concluded that the steps we have taken to remediate the control weaknesses have been successful.

Except for the remediation efforts described herein, there has been no change in our internal controls over financial reporting during our most recent quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is a party to claims and legal actions arising routinely in the ordinary course of our business. Although we cannot predict with certainty the ultimate resolution of the claims and lawsuits asserted against us, we do not believe that any currently pending legal proceedings to which we are a party will have a material adverse effect on our consolidated financial position results of operations or cash flow.

**Item 1A. Risk Factors**

The risk factors disclosed in the section entitled "Risk Factors" in our Annual Report on Form 10-K filed on March 18, 2015 set forth information relating to various risks and uncertainties that could materially adversely affect our business, financial condition and operating results. Those risk factors continue to be relevant to an understanding of our business, financial condition and operating results. No material changes have occurred with respect to those risk factors.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

*None*

**Item 4. Mine Safety Disclosures**

*Not applicable*

**Item 5. Other Information**

*None*

**Item 6. Exhibits**

The information required by this Item 6 is set forth in the Index to Exhibits accompanying this quarterly report on Form 10-Q.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934 as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**HERITAGE INSURANCE HOLDINGS, INC.**

Date: May 8, 2015

By: /s/ BRUCE LUCAS  
Bruce Lucas  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

Date: May 8, 2015

By: /s/ STEPHEN ROHDE  
Stephen Rohde  
Chief Financial Officer  
(Principal Financial Officer and Accounting Officer)

**Index to Exhibits**

<b><u>Exhibit Number</u></b>	<b><u>Description</u></b>
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	101. SCH XBRL Taxonomy Extension Schema.
101.CAL	101. CAL XBRL Taxonomy Extension Calculation Linkbase.
101.DEF	101. DEF XBRL Taxonomy Extension Definition Linkbase.
101.LAB	101. LAB XBRL Taxonomy Extension Label Linkbase.
101.PRE	101. PRE XBRL Taxonomy Extension Presentation Linkbase.

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT**

I, Bruce Lucas, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Heritage Insurance Holdings, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) [omitted pursuant to Exchange Act Rules 13a – 14(a) and 15d-15(a)]
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the end of the period covered by this report; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal controls over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

Date: May 8, 2015

By: /s/ BRUCE LUCAS

Bruce Lucas  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT**

I, Stephen Rohde, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Heritage Insurance Holdings, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) [omitted pursuant to Exchange Act Rules 13a – 14(a) and 15d-15(a)]
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the end of the period covered by this report; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal controls over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

Date: May 8, 2015

By: /s/ STEPHEN ROHDE

Stephen Rohde  
Chief Financial Officer  
(Principal Financial Officer and Accounting Officer)

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT**

In connection with the Form 10-Q of Heritage Insurance Holdings, Inc. for the quarter ended March 31, 2015, as filed with the Securities and Exchange Commission (the Report), I, Bruce Lucas, the Chairman and Chief Executive Officer (principal executive officer) of Heritage Insurance Holdings, Inc. hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Heritage Insurance Holdings, Inc.

Date: May 8, 2015

By: /s/ BRUCE LUCAS

Bruce Lucas

Chairman and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT**

In connection with the Form 10-Q of Heritage Insurance Holdings, Inc. for the quarter ended March 31, 2015, as filed with the Securities and Exchange Commission (the Report), I, Stephen Rohde, the Chief Financial Officer (Principal Financial Officer and Accounting Officer) of Heritage Insurance Holdings, Inc. hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Heritage Insurance Holdings, Inc.

Date: May 8, 2015

By: /s/ STEPHEN ROHDE

Stephen Rohde

Chief Financial Officer

(Principal Financial Officer and Accounting Officer)

