

09-Nov-2016

Heritage Insurance Holdings, Inc. (HRTG)

Q3 2016 Earnings Call

CORPORATE PARTICIPANTS

Melanie Skijus

Director-Investor Relations, Heritage Insurance Holdings, Inc.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Stephen L. Rohde

Consultant, Heritage Insurance Holdings, Inc.

OTHER PARTICIPANTS

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

James Naklicki

Analyst, Citigroup Global Markets, Inc. (Broker)

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Heritage Insurance Holdings Third Quarter 2016 Financial Results Conference Call. My name is Denise, and I will be the operator today. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. Please note, this event is being recorded.

I would now like to turn the conference over to Melanie Skijus. Please go ahead.

Melanie Skijus

Director-Investor Relations, Heritage Insurance Holdings, Inc.

Good morning. The third quarter earnings release can be found in the Investors section of heritagepci.com. The earnings call will be archived and available for replay. Today's call may contain forward-looking statements. These statements which we undertake no obligation to update, represent our current judgment and are subject to risks, assumptions and uncertainties. For a description on the risks that could cause our results to differ materially from those described in the forward-looking statements, please refer to our Annual Report on Form 10-K and other filings made with the SEC from time to time.

With us on the call today are Bruce Lucas, Chairman and CEO; and Steve Martindale, Chief Financial Officer. Also on the call is Steve Rohde, Financial Consultant to the Company.

I will now turn the call over to Bruce.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Thank you, Melanie. I would like to welcome all of you to our third quarter 2016 earnings call. Before we begin a discussion of the quarterly results, I'd like to take a moment to reflect on the last few months and thank our employees for their unwavering dedication to our policyholders and the company.

After 11 years without a hurricane, Florida endured two hurricanes, Hermine and Matthew in little over a month's time. Our claims and remediation service teams worked tirelessly to reach out and respond to policyholders impacted by the storms. I am proud of our team's response times and the execution that we provided policyholders during and after both of these storms.

Our vertically integrated claims department has responded to roughly 3000 claims in total, many of which were addressed within hours and days of the storms. We believe our unique approach to managing and resolving claims benefits our customers and helps to deter fraud from Assignment of Benefits schemes.

Heritage has received 523 claims related to Hermine and we have recorded \$4 million in projected losses from these claims in the third quarter. I wanted to get out early on Hurricane Matthew with an estimate on projected losses, as the media was inciting panic in the days leading up to the storm's landfall in the U.S. and the estimated industry project the losses were fluctuating hourly, given shifts in Matthew's projected path.

I am happy to report that Heritage's losses for Matthew have materialized significantly less than we had previously estimated. As the storm track moved further east, projected losses diminished. We have had approximately 2500 Matthew claims to-date and we anticipate approximately 30 million in incurred losses.

Aside from our hurricane activity, our core business operations have been good. We received a 9.9% rate increase on our Citizens policies that will be effective on December 15. The primary driver of the rate increase is assignment of benefit and attorney-represented claims.

We'll now turn to the third quarter 2016. Despite Hurricane Hermine, which resulted in loss and loss adjustment expenses of \$4 million, we posted net income of \$10.9 million and return on average equity of 11.7% in the third quarter.

Other highlights in the third quarter are as follows: Gross premiums earned increased 28% year-over-year to \$165 million; policy count increased 36% year-over-year to 327,000 policies; stockholders equity of \$377 million increased 14% year-over-year; we repurchased 284,377 shares of common stock for a total of \$4 million; growth continued in voluntary personal lines, aided by expansion in North Carolina with 4,899 policies in force at September 30, 2016; we began writing policies in South Carolina with production showing steady growth month-over-month; Zephyr continues to perform well, and the integration into Heritage has been seamless.

I will now turn the call over to Steve to provide more detail on our financials.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Thank you, Bruce. Good morning.

Gross premiums written for the third quarter were \$147.2 million, down 1% compared to a year ago. Approximately 13% of the gross premiums for the quarter were written outside of Florida with 11% coming from Hawaii and 2% from North Carolina. The decrease in premiums written can be attributed to an absence of Citizens assumption activity in the third quarter of 2016 versus \$33 million in assumed premiums written in the third quarter of 2015.

Voluntary business written by Zephyr in Hawaii and by Heritage in Florida and North Carolina offset most of the decrease in policies assumed from Citizens. New business in North Carolina continues to show strength with \$3.3 million in direct premiums written during the quarter. Our total policy count at September 30, 2016 was approximately 327,000. The Heritage personal lines policy count was approximately 249,000.

Heritage voluntary personal lines policies increased by 4,300 policies from last quarter, largely due to new business written in North Carolina. Zephyr policies in force stood at 74,000, bringing us to a consolidated personal lines policy count of approximately 323,000. Our commercial lines policy count was approximately 4,000 at September 30, 2016.

Our total premiums in force at September 30, 2016 were \$646 million, an increase of 19% from a year ago and an increase of 9% from the end of 2015. Commercial residential premiums in force were approximately \$122 million. Gross premiums earned were \$165 million for the third quarter of 2016 compared to \$128 million for the third quarter of 2015.

Our ceded premium ratio was 38.4% for the third quarter of 2016 compared to 35.8% for the third quarter of 2015. This is in line with the 37% to 39% guidance range we provided during last quarter's earnings call. The increase in the ceded premium ratio is attributable to a shift in our mix of business to more commercial residential and wind-only policies, which have a higher catastrophe reinsurance cost and a lower attritional loss ratio.

Our loss ratio as measured against gross premiums earned was 32.7% for the third quarter of 2016 compared to 27.9% for the third quarter of 2015. The increase can be attributed to weather claims associated with Hurricane Hermine of \$4 million, coupled with reserve strengthening and adverse development totaling approximately \$2 million related to litigated prior-year claims.

Hermine added about 2.4 points to the gross loss ratio. On our first quarter earnings call, we provided guidance that our loss ratio excluding hurricanes would be in the 29% to 32% range for the remainder of 2016. Excluding Hermine, our loss ratio for the quarter of 30.3% was within our guidance.

IBNR represented approximately 58% of our total loss reserves at September 30 and a change in IBNR accounted for 2.1 points of the loss ratio for the quarter compared to 0.8 points for the third quarter of 2015. Our expense ratio as a percentage of gross premiums earned was 22.3% for the third quarter of 2016 compared to 20.1% for the third quarter of 2015.

The year-over-year increase in our expense ratio is primarily related to the larger benefit realized a year ago from assumed earned premiums from Citizens take-outs where there are no acquisition expenses associated with the premium. We provided guidance on last quarter's earnings call that an expense ratio ranging from 23.5% to 24% was reasonable going forward, without the benefit of assumed earned premiums from Citizens.

The benefit to our expense ratio from take-outs was 7/10th of a point in the third quarter of 2016 compared to 2.8 points in 2015. Our combined ratio as a percentage of gross premiums earned was 93.4% for the third quarter of 2016 compared to 83.8% for the third quarter of 2015.

Net income for the third quarter of 2016 was \$10.9 million compared to \$16.8 million for the third quarter of 2015. On the balance sheet side, stockholders' equity increased to \$377 million, an increase of approximately \$21 million from December 31.

During the quarter, the company repurchased \$4 million of its common stock for a year-to-date total of \$20.6 million resulting in approximately 1.4 million shares repurchased so far this year. Statutory surplus in our two insurance company subsidiaries at September 30 was approximately \$205 million and \$72 million for Heritage and Zephyr respectively.

Our invested assets at September 30 were approximately \$550 million, an increase of roughly \$150 million from December 31 with about half of the increase attributable to the inclusion of Zephyr's invested assets into our consolidated balance sheet. At September 30, our cash position was \$131 million and our total assets were \$1.1 billion.

Regarding Hurricane Matthew, we received approximately 2,500 claims and we have set initial reserves for virtually all of these claims. To-date, we've closed over 75% of Matthew claims, paid loss and loss adjustment expenses of more than \$6 million and incurred approximately \$12 million on a reported basis. Based on our historical loss development factors, we could expect to report incurred losses from Hurricane Matthew of approximately \$30 million in the fourth quarter of 2016.

With that, Bruce and I are now available to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question will come from Arash Soleimani of KBW. Please go ahead. Arash Soleimani, your line is open. You may be muted on your side.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Oh! Thanks. Good morning.

Q

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Hi, Arash.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Hi. So few questions. I think you had mentioned that \$2 million of the adverse development was from AOB. There was about \$3.2 million total of development. I was just wondering what the incremental amount over the \$2 million is?

Q

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Yes. There is \$2 million total. About \$3.2 million is prior year, so there's some favorable development on the first couple quarters this year. And that's the \$2 million. But it's all AOB-related.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. So there was some development – favorable development on prior quarters this year that would have benefited the -

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Right.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. But then – oh, go ahead.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah, we're talking about really small amounts on a large reserve. The development is less than 1%.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, okay. But the \$3.2 million of adverse from prior years – not from this – but from prior years, so that was all AOB-related or was there anything else in there?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

It's mostly AOB-related and about half of it is actual results coming in a little higher than expected results and then the other half is, that was actually increasing our loss development factors and strengthening reserves a little bit to make sure that we got it handled going forward.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, I think overall – or I think the take-away from my perspective is that really our loss development and adverse development from prior quarters has been pretty flat. You look at the size of our reserves, the size of our policy count et cetera, a \$1 million or \$2 million movement overall is extremely small. As Steve mentioned, it's less than 1% development.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. I guess the thing I was trying to back into, so if I take your gross loss ratio and I back out \$4 million of losses for Hermine, I back out the \$3.2 million of adverse, I get a, like a core gross loss ratio of 28.4% which is better than 3Q 2015's core gross loss ratio by about 140 basis points. So I guess I'm also trying to determine, what's driving that 140 basis point year-over-year improvement, especially just given that AOB this year is probably more of an issue than it was last year at this time?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah, that's right. Really, the better loss ratio this year is due to our mix of business, which includes more commercial residential and more wind-only business, which has a much lower attritional loss ratio.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

I'd also add that our loss ratios in North Carolina have been very good. And we got a quite a bit of policy count there in premium. And as mentioned previously, I think we're on track for a \$9 million to \$10 million a year in North Carolina and that book of business so far has performed incredibly well.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. That's great to hear. And then just kind of going – building on to that comment on new business, so can you talk about what the new business volumes were both in homeowners and commercial residential, and how that compared to the last year?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

So I can talk about – yeah. The volume is up this year compared to last year.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah. We are pulling all of our [ph] underwritings this year (16:04).

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Sure, no problem.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. So I mean, I can tell you, our in force business is up even quarter-over-quarter on the voluntary side.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

We look at it Arash, and say, you know on commercial residential for example, you really want to look at dollars that you – that in terms you write, You can't really look at the [ph] debt count (16:32). And I would think that the third quarter of this year in commercial residential was less than the third quarter of last year. And that really just reflects our view of risk in – some of the pricing that we've seen in the market from some of the other players, we want to make sure that we're approaching that business at the right combined ratio. Definitely on, I'd say personal lines side, obviously our policy count is pretty flat there year-over-year, which is in line with our expectations.

Stephen L. Rohde

Consultant, Heritage Insurance Holdings, Inc.

A

This is Steve Rohde. Our sales for the third quarter 2016 on the voluntary personal lines side were consistent with last year, but the difference is that we have more business being written in North Carolina and rest in the Tri-County. So we've shifted the mix of business away from the AOB-prone area of Tri-County and moved it into North Carolina. And the rest of the state is pretty flat from year-over-year.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah. And that's – to add to Steve's point there, I mean a big reason why you see voluntary production fairly flat, as he mentioned, an increase in North Carolina, but there are just wholesale areas in the Tri-County on a personal lines basis that we think are at this point in time uninsurable.

And so, therefore, we have really curbed that voluntary production down there quite significantly for I'd say the last six months. Until we see a fix on the legislative level to the assignment of benefit abuses taking place down there, we're really not interested in doubling down in the Tri-County at this point in time.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. So basically if we – [ph] you need to sort of (18:11) understand the key reason why gross premiums written were down modestly over here, that primarily just stems from your caution in Tri-County?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

That's right.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. That makes sense. And just along the same lines, what was retention in the – in each of your sub-segments, including organic business, Zephyr and take-out business?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, Zephyr is averaging a, probably around a 93% retention ratio. You guys got the number for Florida?

Stephen L. Rohde

Consultant, Heritage Insurance Holdings, Inc.

A

Florida, voluntary is running just under 80% and then Florida take-out is running just above 80%, and residential for the quarter was lower because of some risk -

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Derisking.

Stephen L. Rohde

Consultant, Heritage Insurance Holdings, Inc.

A

Derisking that we did in the Tri-County. So it was running closer to 70%.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

The 70%, is that [indiscernible] (19:14)?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

70% on commercial residential.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay, all right. And when you said derisking, you just mean policies that you yourself choose to either non-renew or...?

Q

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Correct – or we kind of looked at it and said, look, the pricing on these policies should be higher. Our belief is different from some of our competitors, I'm not really interested and expanding the top-line and sacrificing profit. I don't think that makes sense. I mean, we're operating in Florida. We all know the perils in Florida, especially with the cat risk. I believe you have to have a certain underwriting margin in order to operate here and to justify the risk that you take on a hurricane retention basis.

A

So we're not interested in adding top-line and running a 99% or a 100% combined ratio. That doesn't fit our business model. So we are going to make sure that we price the business to maintain a healthy and justified profit margin, and if we're not able to get that margin then we'll let somebody else take that risk and make little to no profit on it. That's just not business we're interested presently.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay, great. No, that makes a lot of sense. I think you mentioned already, but how many Matthew claims did you have, and from the total claims, how many have you closed?

Q

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Yeah. Right now, we have about 2,500 Matthew claims, about I'd say – I think the last report was, 76% of the claims have been closed. We've adjusted almost all of those claims. Right now, if you want to look at our incurred and reserves, I'd say Steve, about \$13 million or so -

A

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Yeah, in that range [ph] and that may (20:21) – yeah.

A

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Roughly.

A

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Yeah.

A

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

That's an approximate number in terms of where we are in losses. So obviously we've come out and said, losses could get as high as \$30 million, but we're going to use management's best estimate in the fourth quarter once we see what the actual paid are and see how many claims continue to come in. But right now claims are not really coming in at a big volume, they are kind of tailing off. And so there is a chance that we may do significantly better than the \$30 million in reserve. And so I'd like to highlight that, because right now based on what we're seeing, I mean that's very probable. But I think \$30 million is a good outside number for what ultimate losses could look like.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And you said you have \$13 million in case reserves now?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

\$13 million in incurred on a reported basis. So we paid – today it's about \$7 million. So – and then about \$6 million in case reserve, so for a reported incurred is \$13 million.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then how much more do you have in IBNR then?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

We have not set the IBNR for it yet. But I mean, the difference between the \$30 million and the \$13 million would be what we're thinking IBNR could be. Yeah.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then my last question, I just wanted to know, we talked about this a bit last – on the last earnings call for Q2. Just an update on rate increases and I think last time you also mentioned that in addition to potential rate increase, there was an alternative you were working on with the OIR, so just wanted to get an update on those items.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, so obviously our big policy count segment is the Citizens HO3 policy forms. I mean, that's a big component of our overall Florida policies in force. We did receive a 9.9% overall rate increase in the Tri-County. That's about 15% rate increase there. One of the alternatives that we are looking at with OIR is capping water claims at \$10,000. That is particularly true on older homes, say 40 years and over. We were able to get that approved. So that is a – I think a real benefit. I mean, policyholders still have a lot of coverage there, but on older homes, 40 years and up, just like many other of the Florida carriers, there is a \$10,000 cap per occurrence on for water and we have a pretty high percentage of our overall take-out portfolio in terms of HO3s that are over 40 years old and that number I believe is north of 50% I would say.

So this is going to have a meaningful impact on the loss ratio and that helps us to curb additional rate increases on innocent policyholders that would otherwise get a rate increase because of assignment of benefit fraud that is taking place in that area.

So this is a win-win for the consumer. It's a win-win for the company. Helps to control our loss ratios and we are very thankful for the OIR for all of their help and working with us on a good solution to help to address the assignment of benefit issues.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And you said the – I heard a 9% – 9.9% of that 15% can you clarify what were those numbers again?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, so the overall rate increase is 9.9%. And in Tri-County, the rate increase is capped at a maximum of 15% and pretty much most of the policies down there would generate roughly a 15% rate increase.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. So the 9.9%, that's the overall – is that across your entire personal residential portfolio, the 9.9% average [indiscernible] (24:57)...?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

The Citizens HO3 policy form.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. HO3. And what percentage of your business is that?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

The take-out right? Yeah. 75% of the take-out book is Citizens HO3 policy form.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And this 10-K cap, so is that basically language that gets applied at renewal or is that kind of effective as of a certain date for all the policies?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

It's available at – it gets put on automatically at renewal. The other thing that we are able to do is, we are able to offer our policyholders a \$10,000 cap on their water claim in exchange for roughly a 25% decrease on their AOP premium. And we think that is extremely important. So we can go to houses that are under 40 years old. We can approach the consumer and let them know that we can actually reduce their premium. And in exchange, they take a \$10,000 cap on their water coverage.

And so that is an effort that we have ongoing now, where we're reaching out to agents and consumers to try to save them some money on their premium and cap the dollar amount of the claims. And since the vast majority of our policyholders are fairly honest people and do the right thing, we do think that the response rate there will be pretty significant.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And so, you said this cap was on homes that are under or over 40 years old?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

So it's an automatic \$10,000 cap on homes 40 years and older and there is an optional cap of \$10,000 for homes 39 years and under.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. And this new language, is this specifically for the Tri-County or for the whole...?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

No, it's for all policyholders...

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Of the state.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And are you seeing any impact, positive, from the new Citizens language that you had implemented?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, it's too early to tell yet. I mean, the language certainly does help to cap the emergency restoration component of the claim until we have a chance to go in and adjust it. We were unique in that we were able to get language included that stated that there was, on reasonable delays in terms of letting us in to adjust the claim that the cap continues indefinitely.

So that language definitely helps our claims department address some of the abuses we've seen in the past where the contractor will go in, go report the claim, will be in there doing demo and remediation and they refused to let us in to inspect their house. That's an unreasonable delay and we're going to apply the caps. And that's fair.

And it's in our policy language, it's in our endorsement language. So that will definitely help us to curb some of the abuses that are taking place.

But it's too early to tell exactly what the impact of that will be, because in my opinion the language should go a lot further. And despite the language, there is nothing to stop the lawyers from coming in and filing the suit. So I think it will have some impact, but it's too early to tell really what the extent of that impact will be. But it is definitely a useful tool.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. And sorry, what was the effective date of the 9.9% increase in the 10-K cap?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

12/15.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, great. All right. Thank you very much for all those answers.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Thank you, Arash.

Operator: The next question will be from Mark Hughes of SunTrust. Please go ahead.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yeah, thank you. Good morning.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Good morning, Mark.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Could you give me some general thoughts when we think about the gross premiums written in the fourth quarter with Zephyr coming online, your take-out activity, the potential year-over-year change when we think about your new business production. How should we think about the gross premiums written in the fourth quarter? You were essentially steady in the third quarter. How is the fourth quarter shaping up or what are some of those dynamics we should consider?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Just on a general basis – and I'll let the Steves chime in. Definitely on the take-out side, we are not doing take-outs right now from Citizens and we've telegraphed that for quite some time now. Until we see assignment of benefit reform, we are not going to be assuming policies from Citizens. In fact, we had approval for example to take some wind-only policies, about 2,000 of them in October. We ran the numbers on that portfolio; didn't make sense. We didn't select one policy.

I believe that anybody that's assuming policies right now, particularly from the Tri-County which is where a lot of the policies are of Citizens, I think that they are just going to lose money on every one of them. Until we see bigger rate increases at Citizens and/or assignment of benefit reform – meaningful reform, I would not advocate assuming policies out of the Tri-County and Citizens, and that's where a lot of the policies are.

We've been focused on our voluntary side of it. That's why we diversified and bought Zephyr Insurance. So obviously that has worked out well year-over-year. We've seen an increase in gross premiums of about 28% year-over-year. We've seen a 36% increase in policy count year-over-year. It's worked out well for us. We're continuing to expand our voluntary production outside of Florida and the voluntary premium that we're writing in Florida is directed away from the Tri-County and areas of the state where we are profitable.

And that's going to be the overall thesis going forward. But I would think kind of fourth quarter numbers, we'd see it be barely flat, be my guess.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Right.

A

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Okay. Thank you for that. And then in North Carolina, you said on track for \$9 million or \$10 million this year. Will South Carolina ramp up at the same pace? I know you've got some – the partnership in North Carolina that helps. Anything in South Carolina?

Q

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

Yeah. Mark, we do not have a strategic partner in South Carolina. I would expect that production growth there would be much more modest. I think right now in terms of South Carolina, we don't really have a lot of premium there compared to North Carolina. About \$200,000 was written in the quarter in South Carolina. North Carolina, obviously the strategic partnership with National General has been instrumental to our market penetration there.

A

So we are incredibly appreciative of the partnership that we've developed over the last two years with National General. We are looking at expanding that partnership in other states. It's been very symbiotic for both companies and we do think that there are additional opportunities in the future to grow with National General and augment their need for a good homeowners' carrier in other states. So that's a process that we're undertaking right now.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

The G&A in the quarter was a little lower than we had looked for, lower than it was in the first six months. Was that – anything unusual there, or is that – kind of 8%, 9%, is that sustainable?

Q

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah, that's about where we're at now. We just – having reached some scale of economies here, we're able to kind of just stay flat on the expenses.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then the tax rate, as we think about that going forward, what's a good number?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

[ph] 38.5%. (33:05) Yeah.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then with the rate hike for Citizens, are you anticipating that we might see some loss of policies there, your retention might drop or nowhere else to go?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

In my opinion I am – it's hard to say Mark, but I would not expect a meaningful movement in terms of policy count down there. And the reason for that – and especially if you look at on a premium basis, I mean if you had a little higher attrition there, because you are getting a higher rate increase they kind of balance one another out. I firmly believe that you have to price for the risk. And we are doing that; we are pricing for the risk. And it's either going to be a profitable book of business or we will not write it.

So, if there is attrition in that book of business because there is a roughly 15% overall rate increase in the Tri-County, then there is attrition. And somebody else can take it up at a lower price and lose money on it. That'd be great for them and that's something that we're just not willing to do.

So there's a little bit of attrition there. We're okay with that. It's about bottom line profit; it's about making money and pricing for the risk and that's something that we've had as the core DNA of our business mentality since day one.

So that's okay with us. If we have fewer policies there, it will actually – if we're not getting the right rate, you could actually have fewer policies and make more money than you would having more policies and not getting enough rate. And that's really the focus that we have.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then a final question. Capital management, are you seeing M&A opportunities out there, and if not, what's your view on the share buybacks at this point?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, there are definitely M&A opportunities out there. But I'm also looking at this Mark, and saying, our share price right now is 10% below our book value. And we're not losing money around here; we're making money. So we're accreting to book value every quarter.

So the shares right now, from our standpoint, they are the cheapest they have ever been and I don't know if that's just a reaction to two hurricanes and what that does to our book value, but we're not seeing erosion in book value. And so at 0.9 times book, that's incredibly attractive point from our standpoint to increase the share repurchase program.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you.

Operator: And the next question will be from James Naklicki of Citi. Please go ahead.

James Naklicki

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Yes, thanks guys. My first question relates to the rate increase here. So if you look at the Citizens HO3 business, what sort of core loss trend has that business been producing this year? So, particularly like if you strip out the cats' for the year, what's been the core loss trend there?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

The loss ratio has been about 38%.

James Naklicki

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. But how about the loss trend that would sort of be comparable to the 9.9% rate increase you are going to get?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yeah, I mean – go ahead, Steve.

Stephen L. Rohde

Consultant, Heritage Insurance Holdings, Inc.

A

Yeah. We are looking at year-over-year – right now we're running, like Steve said, like a 38% loss ratio for our personal lines homeowners business in Florida. If you go back to the second quarter of 2015 before we started seeing the increase in AOB, that was running a 34% type loss ratio. And then prior, in 2014 we were running in the like 28% loss ratio.

So we've gone from a 28% loss ratio in 2014 to now like a 38% loss ratio in 2016. And that really started changing in that second quarter of 2015 when AOB became an issue. And again, we didn't realize that that the second quarter of 2015 is really when we got the development in fourth and the first quarter of 2016.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yes, so if you look at it, it's probably 10 points or so in terms of the increase in the loss ratio over a two-year period. So, if you average it out, maybe it's a 5 point per year average and we are getting 15 point rate increase there.

And we're just looking at this and saying, we've got to be ahead of the curve. And until the legislature in South Florida decides to get their act together and do something to curb the abuse, rates are going to go up on their constituency. And I see that some of these guys had a little trouble on their re-election last night. And I know that the rising insurance premiums were a part of it, and maybe they shouldn't have blocked AOB last year; they'd probably still be in office. So we're really looking at some substantive changes out of the legislature to address this.

I can tell you from speaking off the record to several leaders in both the House and the Senate, they are very, very much in support of comprehensive AOB reform this session. So, I'm glad to see that and we are cautiously optimistic that we may actually see a fix this session, but it's Tallahassee politics and until you get out there in the thick of things, you never know what's going to happen.

James Naklicki

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Got you. Thanks for that. And when you think of your pricing strategy, you know you are targeting some sort of combined ratio. So would it be – should we be assuming that there could be as much as a 10-point improvement in the combined ratio next year to something in the low-80s? Is that realistic or do you think that there is still going to be issues and it will be more like – it will improve, but not by that much?

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Yes, we've ran combined ratios in the past in upper-70s, low-80s because of the economic benefit of Citizens depopulations. And the way that works with the zero ceding commission and no expense ratio and no reinsurance cost et cetera, it does move that number down. And on a normalized basis, you are probably upper-80s, low-90s. [ph] That's what I say. (39:58) Guys, what do you think?

A

Our target is an 85% combined ratio when you look at all our products. This year we're closer to 90% because of the AOB issues as well as the hurricane issues as well. But with this rate increase, we would expect us to get back down to the – assuming no hurricanes in 2017 – of about 86%, 87% combined ratio.

James Naklicki

Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. Thank you very much.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

You're welcome.

Operator: And ladies and gentlemen, that will conclude our question-and-answer session. I would like to hand the conference back over to Bruce Lucas for his closing remarks.

Bruce Thomas Lucas

Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

I would like to thank everyone for joining our third quarter earnings call.

Operator: Thank you. Ladies and gentlemen, the conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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