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Heritage Insurance Holdings, Inc. (HRTG)

Q1 2017 Earnings Call

CORPORATE PARTICIPANTS

Melanie Skijus

Director-Investor Relations, Heritage Insurance Holdings, Inc.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Bruce Thomas Lucas

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

OTHER PARTICIPANTS

Matthew J. Carletti

Analyst, JMP Securities LLC

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning everyone, and welcome to Heritage Insurance Holdings First Quarter 2017 Financial Results Conference Call. My name is William, 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 that this event is being recorded.

And 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 first 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 speak only as of today and which we undertake no obligation to update, represent our current judgment, and are subject to risk, 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.

With us on the call today are Bruce Lucas, Chairman and CEO; Steve Martindale, Chief Financial Officer; and 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 first quarter 2017 earnings call. Before we begin the call, I'd like to thank all of our employees for their dedication to our company.

The first quarter was a great start to the year and we experienced significant improvements in several key metrics. Claims and loss ratios continued to trend favorably and year-over-year, our loss ratio improved 13.9 points. We previously provided some loss ratio guidance for the first quarter and I am pleased to report that we substantially beat our projections and ended the quarter with a 30.2% loss ratio.

The Tri-County continues to lead Florida in assignment of benefits and other abusive claims practices. We implemented new underwriting initiatives a year ago and we are beginning to see the positive results of those actions. Notably, our Tri-County claims dropped substantially in the quarter, resulting in a 30% reduction in Tri-County claims year-over-year.

This trend is very encouraging and helps to improve our underwriting profit, while decreasing costly AOB claims. We have also initiated two rate increases that are targeted towards the Tri-County. Initial results have been quite encouraging.

Although, we have had a slight decrease in retention in the Tri-County, average premium per policy in those counties is increasing and claims are down considerably. These results are helping to improve our loss ratio while making the company a more attractive risk for reinsurers.

On that topic, I'd like to point out that the company is nearly finished with the 2017 reinsurance treaty. We will not comment on the final terms until the placement is finished, but we are expecting additional reinsurance savings beginning on June 1.

On the production side, our voluntary production continues to grow. Voluntary policies written in the first quarter set a new record for the company. We continued to grow new business in Florida and production in the Carolinas and Georgia is ramping higher. All-in-all, we are off to a great start in 2017.

Some notable highlights for the first quarter are as follows: Gross premiums earned increased 2% for the first quarter of 2017 as compared to the first quarter of 2016. Our loss ratio improved 13.9 points in the first quarter 2017 as compared to the first quarter of 2016. Net income of \$6 million for the quarter, book value per share increased 6% to \$12.67 when compared to the first quarter of 2016.

Shareholders' equity was \$361 million at March 31, 2017. Capital returned to stockholders via a dividend of \$0.06 a share and we repurchased 361,211 shares for a total of \$4.5 million during the quarter.

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 first quarter of 2017 were \$142.2 million down 3% compared to a year ago. Direct premiums written for the quarter were \$142.3 million, up 4.2% compared to the first quarter of 2016. Assumed premiums written for the quarter were minus \$54,000 compared to \$9.1 million

a year ago. Approximately 13% of gross premiums were written outside of Florida with 10% coming from Hawaii and 3% from the Carolinas and Georgia.

For the quarter, we wrote approximately 24% of our direct new business premiums in the Carolinas and Georgia and approximately 2% in Hawaii. Our total policy count at March 31, 2017 was approximately 321,200. Our personal lines policy count was approximately 316,500 and our commercial residential count was 3,555.

Personal lines policy counts, by state, were approximately 233,000 in Florida, 73,300 in Hawaii and 10,200 in the Carolinas and Georgia. All commercial residential policies were written in Florida. Gross premiums earned for the first quarter were \$154.6 million compared to \$151.9 million a year ago.

First quarter 2017 gross premiums earned included a full quarter of Zephyr business which was approximately \$12.8 million higher than a year ago. The first quarter 2016 gross premiums earned included only 10 days of Zephyr business as the acquisition closed on March 21, 2016. Offsetting this increase was reduction in gross premiums earned, resulting from pricing and underwriting actions we've taken primarily in the Tri-County area.

Our ceded premium ratio, as measured against gross premiums earned was 40.3% for the first quarter of 2017 compared to 30% for the first quarter of 2016. Approximately 2.5 percentage points of the increase was due to a change in our business mix to include more commercial residential business and wind-only personal residential business, each of which has a higher catastrophe reinsurance cost.

The ceded premium ratio for the first quarter of 2016 was 5.8 percentage points lower due to the benefits of assuming policies from citizens during the fourth quarter of 2015 and the first quarter of 2016. The first quarter of 2017 ceded premium ratio was approximately 2 percentage points higher due to the decline in our gross premiums earned – noted previously.

Our loss ratio, as measured against gross premiums earned was 30.2% for the first quarter of 2017 compared to 44.1% for the first quarter of 2016. The loss ratio for weather claims for the first quarter of 2017 improved by 4.4 percentage points compared to a year ago. In addition, claims reported in the Tri-County region were down 30% for the quarter compared to the first quarter of 2016.

Our operating expense, which excludes interest expense as a percentage of gross premiums earned was 26.4% for the first quarter of 2017 compared to 21.4% for the first quarter of 2016. We recorded no benefit to the expense ratio in the first quarter of 2017 related to the assumption of policies from citizens where there are no acquisition expenses associated with the premium compared to a 2.3% benefit to the expense ratio a year ago.

In addition, the first quarter 2017 expense ratio included 1.6 points for the amortization of intangible assets associated with the purchase of Zephyr. Our combined ratio as a percentage of gross premiums earned was 96.9% for the first quarter of 2017, compared to 95.5% for the first quarter of 2016. For the quarter, our improved loss ratio offset most of the increases in the ceded premium and expense ratios as compared to a year ago.

Net income for the first quarter of 2017 was \$6 million compared to \$7.4 million for the first quarter of 2016. In addition to the changes noted previously in our ceded premium and loss expense ratios, interest and amortization of issuance cost totaling \$2.2 million associated with our senior notes issued in December of 2016 accounted for the change in net income for the quarter compared to a year ago.

On the balance sheet side, stockholders' equity stood at \$360.8 million at March 31, 2017 compared to \$358 million at December 31, 2016. We repurchased shares of our common stock totaling \$4.5 million during the

quarter and declared dividends of \$1.8 million. Invested assets stood at \$605.8 million at March 31, of which \$572.9 million was invested in fixed maturity securities with an average credit quality of AA at an average duration of 3.5 years. Our cash position was \$104.7 million and our total assets stood at \$955 million at March 31.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] And our first questioner today, it will be Matthew Carletti with JMP. Please go ahead with your question.

Matthew J. Carletti
Analyst, JMP Securities LLC

Q

Hey, good morning.

Bruce Thomas Lucas
Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Good morning, Matt.

Matthew J. Carletti
Analyst, JMP Securities LLC

Q

Couple of quick questions, first one just on the claim side, Bruce I appreciate your comments and glad to hear that you're seeing claims in Tri-County slowdown quite a bit. But, I was hoping you could help me kind of triangulate a few numbers and just understand what's going on.

So, claims are down, we see your reserves down about 6% sequentially, but at least in the public data, it looks like not just for you, but for everybody, lawsuits remain at pretty elevated levels each month and the new lawsuits coming in.

So, are you closing kind of the older claims at a pretty good clip and it's outpacing kind of the new lawsuits that's come in, as I'd imagine those are bigger claims and the non-attorney represented claims, could you just help me through kind of the moving pieces there?

Bruce Thomas Lucas
Chairman & Chief Executive Officer, Heritage Insurance Holdings, Inc.

A

Sure. Yes, I mean reserves were down slightly, but the number of open claims is down at a much higher percentage. One thing that we've been doing is closing our claims faster fourth quarter and first quarter, moving out some old inventory. So, our opens are down much more than any reduction in reserves.

And as I look at reserves, I mean just kind of comparing it to some of the other Florida publicly traded companies I don't think anybody has more loss reserves than us at least as of last quarter. So, we have I think our best estimate on reserves is I would say on the conservative end. And you could definitely see that despite comparing our loss reserves to the other publicly traded peer group.

And with respect to the number of open lawsuits out there, it really hasn't been accelerating I wouldn't say; it's been kind of steady. We've had months where it's really dropped down and some months where it went up. But I would say overall, I think we're trending lower the number of open lawsuits that we have right now really isn't that much different than where it was about a year ago.

We have, right now about 8 in-house attorneys, so we're handling a lot of these lawsuits ourselves to keep LAE low. I do see the trend is shifting in our direction, quite favorably. Any time, you can see a reduction in Tri-County claims year-over-year like we've had, while still having a pretty high retention on the policies that's impressive.

And I could tell you, just from fourth quarter to first quarter, the number of Tri-County claims was down about 20%. Right, so we're definitely trending in a very favorable direction here.

Matthew J. Carletti

Analyst, JMP Securities LLC

Q

Okay, great that's helpful. Thank you. And then one quick numbers question, if I could, just on the expense ratio; it popped up a few points in the quarter. Is that – are we at a reasonable run rate going forward or are there anything in the either policy acquisition cost or general expenses in the quarter that deserves calling out that might be more one time?

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

This is Steve. We had the acquisition – the amortization of some of the acquisition cost from Zephyr which will come down about 1.2 points going forward. So, we completed the amortization of our VOBA.

Matthew J. Carletti

Analyst, JMP Securities LLC

Q

Got you, all right, perfect that's very helpful, thank you. Congrats on nice start to the year.

Bruce Thomas Lucas

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

A

Thanks.

Steven Martindale

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Thank you.

Operator: And our next questioner today will be Mark Hughes with SunTrust. Please go ahead with your question.

Mark Douglas Hughes

Analyst, SunTrust RobinsonHumphrey, Inc.

Q

Yes thanks, good morning.

Bruce Thomas Lucas

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

A

Good morning, Mark.

Mark Douglas Hughes

Analyst, SunTrustRobinsonHumphrey, Inc.

Q

Bruce, I wondered if you could comment on any broader initiatives in Florida anything in the legislature, anything out of the OIR that might lead to some progress on the AOB issues?

Bruce Thomas Lucas

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

A

Yes. I don't think you're going to see anything out of the legislature, obviously the house passed their version of AOB reform. There's just too many trial attorneys in the Senate, I just don't see why they're going to end the fraud. There's just no way that's going to happen, I mean, that's how a lot of these guys are making the money. I've been saying it for over a year now it's not really an AOB issue as much as it is a trial attorney issue.

So, I don't really envision any legislative support here a session is winding down, I don't even think they're going to hear the bill that the House passed at all. And the Wall Street journal has been commenting on this quite a bit lately. So, there are some really good articles out there on the topic. I do have a lot of optimism that the Office of Insurance Regulation is going to take a more active role in helping consumers to fight this AOB fraud issue.

I don't speak for them, I'm not going to say with certainty that's something will or won't happen. However, I can tell you that they really have two choices and this is common knowledge. Choice one, let's just run up insurance rates on home owners in perpetuity and all the innocent actors who have done nothing wrong are going to pay the bill for people who are cheating the system.

Or option two, you can start to put some, let's just say some additional language in the policies that will help to go a long way to curbing the fraud abuse. And I think that the OIR and Commissioner Altmaier they're really looking at all the options right now to try to help consumers. And the best way to help them is to take action to prevent the fraud from taking place and that keeps rates low on everybody. And so, I am quite optimistic that we could see some real reform coming down the pipe.

Mark Douglas Hughes

Analyst, SunTrustRobinsonHumphrey, Inc.

Q

Right. Your voluntary – I don't know whether you shared specific voluntary production numbers if you have those available I would be interested to hear them. And then, do you think there is any competitive help from some of the capital discussion earlier in the year that Demotech wanted the people to have a more solid balance sheet do you think that helped your voluntary production at all?

Bruce Thomas Lucas

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

A

Yes, I do. So, to answer the first part of your question, the total voluntary production in the quarter was about \$17.2 million in premium. So, we have definitely seen increasing production in terms of our policy count. And I think that a lot of that – not some of that has to do with Part B of your question, which is Demotech kind of calling out since solvency issues from some of these kind of lower capitalized companies in Florida. It spooked a lot of agents, we had a lot of agents contact us for book roll opportunities, they're worried about their errors and omission policy if somebody goes insolvent, especially as we approach wind season.

And I think there is more of a flight to quality in the market right now. Why put your client with somebody who is 10% cheaper and has \$15 million of surplus and \$75 million of written and they haven't had an underwriting profit in 5 years.

That's a risky proposition for agents, I think what Demotech did rightfully so, was just to call out some of these issues, highlight concerns and I think that has helped to get through to agents so that they can start putting business with more quality companies with high levels of surplus.

When I look at our surplus level now, on a consolidated basis, we're number two and that's the last publicly available information I have – we have the second highest consolidated surplus of any of the Florida domestics. And we definitely highlight our financial solvency and I think agents are beginning to recognize that.

Mark Douglas Hughes

Analyst, SunTrust RobinsonHumphrey, Inc.

Q

And on net capital topic, any thoughts on capital management, share buyback upping dividend, how are you looking at that?

Bruce Thomas Lucas

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

A

Yes. I mean, listen I have been putting my money where my mouth is and I constantly believe our share prices is just ridiculously cheap and we are going to be active buyers at these levels. This is – that's no secret, I have been telegraphing that for a while. Me personally, I've bought about \$700,000 worth of stock over the past year continuing to add to my position I bought \$200,000 worth last quarter. I just view it as a good opportunity.

So, I view it that way personally, I think the company views it that way and we're going to continue to use our dollars to buy back stock when the stock is in our opinion significantly undervalued.

Mark Douglas Hughes

Analyst, SunTrust RobinsonHumphrey, Inc.

Q

Thank you very much.

Bruce Thomas Lucas

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

A

Thank you, Mark.

Operator: [Operator Instructions] And our next questioner today is Arash Soleimani with KBW. Please go ahead with your question.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks, good morning.

Bruce Thomas Lucas

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

A

Good morning, Arash.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

So, I think you had mentioned potentially last quarter the quarter before that, that you were offering discounts on homes over 40 in order to cap the [indiscernible] (20:14) losses at \$10,000 I was just curious if you are seeing that have a beneficial impact on your loss ratio?

Bruce Thomas Lucas

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

A

It's starting to trickle in, we started the water per occurrence cap at \$10,000 on the HO3 take out book and that went effective 12/15. So, as policies roll on to that new policy form and then submit a claim, you're going to see the – that's where you are really going to see the improvement. You got to remember our numbers right now are through March 31.

So, to the extent that yes, we've had policies renew on that book after 12/15 and submitted a claim? Yes, it has been a helper for the loss ratio, but it's pretty minor at this point.

You got to give it the full year to earn out. And we have the same exclusion on the voluntary book and that starts for new business 515 and renewal business 61. So, there is an additional impact coming down the pipe as well, which we think will be quite beneficial. About 35% to 40% of our takeout HO3 portfolio is plus 40 years, right so, we really should see a good impact on it as we move forward.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, great. And I was wondering if you could provide an update on commercial/residential; are you seeing more competition there or does it look pretty steady; what does the pricing environment look there and just any updates you can provide on that front?

Bruce Thomas Lucas

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

A

Yes, I do think the admitted carriers are feeling a little bit of a squeeze there. We definitely – we're down a little bit on premium written just – it was all really commercial residential because voluntary is accelerating. The department of financial services thought it would be a really smart decision to allow unregulated out-of-state companies to come in and take anything they want.

And it violates the statute that's in place in Florida. We have a new CFO coming in, I think that he's going to be – hopefully going to be more concerned about protecting Florida companies and Florida jobs.

And I do think that this kind of trend is going to – on an all likelihood reverse itself, if not I'm sure there will be legal action on it. But, it is creating a little bit of softness in the market, nothing devastating, but it's a little soft. But, I do think that, that trend will reverse second half of the year.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay great. Thanks very much for the answers.

Bruce Thomas Lucas

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

A

Sure.

Operator: [Operator Instructions] There look to be no further questions, so this will conclude the Q&A session. I would like to turn the conference back to management for any closing remarks.

Bruce Thomas Lucas

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

All right. Thank you to everyone for participating in our first quarter earnings call.

Operator: The conference is now concluded. Thank you all for attending today's presentation. You may now disconnect.

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