

05-Nov-2015

# Heritage Insurance Holdings, Inc. (HRTG)

Q3 2015 Earnings Call

## CORPORATE PARTICIPANTS

Melanie Skijus

*Director-Investor Relations, Heritage Insurance Holdings, Inc.*

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

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## OTHER PARTICIPANTS

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Samir Khare

*Capital Returns Management LLC*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning and welcome to Heritage Insurance Holdings' Third Quarter 2015 Financial Results Conference Call. My name is Chad and I will be the operator today. At this time, all participants are in a listen-only mode. [Operator Instructions] A brief question-and-answer session will follow the formal presentation. [Operator Instructions] Please note this event is being recorded.

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

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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](http://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 of 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 Rohde, Chief Financial Officer.

I will now turn the call over to Bruce.

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Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

Thank you, Melanie. I would like to welcome all of you to our third quarter earnings call. Before we begin the discussion of our quarter, I would like to take a moment to thank all of our employees for their relentless focus in driving our company forward and offering policyholders the best possible customer experience.

We had another strong quarter and in which we earned net operating income of \$16.8 million. Our business plan continues to produce strong financial results for our shareholders. Our gross written premium continues to steadily grow. Personal lines voluntary production increased 27% versus the third quarter of 2014.

Our commercial residential production, once again, outpaced our internal expectations. This trend has significantly increased at the start of the fourth quarter, as evidenced by record production in October, which, by itself, nearly doubled the new business premium win during the entire third quarter.

With respect to Citizens Insurance, the opt-out percentage in September was significantly lower than recent trends and expectations. In total, we assumed approximately 26,000 policies during the quarter, which represents approximately \$55 million in annualized premium.

Our integration of BRC Restoration is progressing very well. The acquisition will provide better customer service by allowing our in-house contractor to work directly with the insurer to repair their home with professionalism and expediency. This will help Heritage control claim expenditures by negating some of the assignment of benefit issues and performing the repair and reconstruction work at the appropriate price.

Our innovative approach to the claims process has been well received by our customers and agents and differentiates Heritage from our peers. During the third quarter, Heritage was licensed to write new business in North and South Carolina. And we have applications pending in Massachusetts and Rhode Island. And we additionally filed applications in Georgia, Alabama and Mississippi.

The company is in the process of filing the Form A with the Hawaii Department of Insurance in connection with our previously announced acquisition of Zephyr Insurance. The acquisition of Zephyr Insurance is expected to close in the fourth quarter of 2015 or the first quarter of 2016, subject to customary closing conditions and regulatory approvals.

We expect it will be accretive to our 2016 earnings as Zephyr's net operating income, without any reinsurance synergies, is expected to be approximately \$13 million. And we expect to achieve significant reinsurance synergies in addition to that amount. As previously mentioned, we do not intend to issue any equity in connection with the Zephyr acquisition. And we intend to pay for the transaction with existing cash on hand.

We continue to have tremendous success in growing the company, as evidenced by a 72% increase in gross premium written as compared to the third quarter of 2014; a 48% increase in net premiums earned as compared to the third quarter of 2014; a 40% increase in policy count as compared to the third quarter of 2014; net income of \$16.8 million, which is an increase of 69% as compared to the third quarter of 2014; our combined ratio of 83.8% for the quarter and 73.2% year-to-date.

Shareholders' equity increased 44% compared to the third quarter of 2014 and return on average equity year-to-date has been 32.8%. In closing, the team believes that through our proactive approach in the marketplace, we're better servicing our policyholders. We're excited about this quarter and results for the first nine months of 2015 and the progress we're making in our expansion initiatives.

We're focused on shareholder returns posting a return on average equity of nearly 33% year-to-date. I look forward to answering your questions at the end of our prepared remarks.

And I'll now turn the call over to Steve Rohde for a recap of our financial results. Steve?

## Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

Thank you, Bruce, and good morning. Gross premiums written for the third quarter were \$149 million, up 72% year-over-year, resulting from approximately \$116 million of direct premiums written and \$33 million of assumed premiums written. We participated in Citizens take-outs during July and September, resulting in approximately 26,000 policies assumed.

We netted approximately \$55 million of annualized premiums from these two assumptions, of which roughly \$39 million was from the September assumption. As a reminder, we only record the unwritten premium that is transferred from Citizens as assumed written premium. The opt-out rate of 45% for the September assumption was significantly better than what we had experienced.

The effective date of the September assumption was September 22. Therefore, only nine days of premiums were earned during the third quarter. The reinsurance associated with this, approximately \$55 million of annualized premium assumed from Citizens, will not need to be purchased until July 1 of 2016. Thus, we expect our operating results through May 2016 would be favorably impacted when compared to our third quarter results.

Our total personal lines policy count increased during the quarter to approximately 238,000 policies, an increase of approximately 19,000 policies from last quarter. Our voluntary personal lines policies increased by almost 4,000 policies during the quarter. Our total premiums in force at September 30 of 2015 were \$542 million, an increase of 68% from the same quarter one year ago and an improvement of 6% from last quarter.

Commercial residential premiums in force were approximately \$91 million, an increase of \$3.6 million from last quarter. This level of in force premium resulted in \$128 million of gross premiums earned compared to \$80 million for the third quarter of 2014. The significant growth in gross premiums earned was the primary reason for our growth in net income when compared to the previous year. Additionally, during the quarter, we generated realized capital gains of approximately \$1.9 million compared to \$80,000 during the third quarter of 2014.

Our ceded premium ratio was 35.8% for the quarter compared to 30.5% for the third quarter 2014. The increase in the ceded premiums ratio is attributable to our commercial residential business, which has a higher cost of reinsurance and, conversely, a lower loss ratio than personal residential business. In the third quarter of 2015, commercial residential represented approximately 18% of our gross premiums earned, while it represented only 2% in the third quarter of 2014.

Our loss ratios measured against gross premiums earned was 27.9% for the quarter, which was the same as the second quarter of 2014. The current quarter's loss ratio was favorably impacted by the inclusion of commercial residential business and favorable prior quarter development and was unfavorably impacted by weather-related claims in personal lines due to the heavy rainfalls in certain parts of Florida during the quarter.

Our reported loss ratio of commercial residential after one year of being in this line of business is in the low single-digits. During the quarter, we increased IBNR, our incurred but not reported reserves, by \$1 million to \$40.5 million. IBNR represent approximately 54% of our total loss reserves at September 30 and accounted for 0.8 points of the loss ratio for the quarter compared to 3.2 points for the third quarter of 2014.

Favorable prior quarter development in commercial residential accounted for the improvement of IBNR on the loss ratio. Weather-related claims impacted loss ratio for the third quarter by approximately six points compared to four points for the third quarter of 2014 and three points for the first half of 2015. Our expense ratio as a percentage of gross earned premiums was 20.1% for the quarter compared to 24.5% for the third quarter of 2014.

The year-over-year improvement in our expense ratio is primarily related to the Sunshine State Insurance Company policy acquisition fees amortized during last year's third quarter. All the fees associated with the SSIC acquisition were fully amortized as of June 30, 2015. Thus, there was no impact to the just closed quarter's ratio, while they increased the third quarter 2014 gross expense ratio by 5.6 points.

Also impacting expense ratios for both the third quarter of 2015 and 2014 were assumed earned premium from Citizens take-outs, while there are no acquisition expenses associated with the premium. This improved the Q3 expense ratios for 2015 and 2014 by approximately 2.8 points and 3.9 points, respectively. Our combined ratio as a percentage of gross premiums earned was 83.8% for the quarter compared to 82.9% for the third quarter 2014.

The third quarter is a quarter we typically see the smallest economic benefit from growth, particularly from assumed business out of Citizens. We believe our underlying base of profitable business, representing \$542 million of in force premium, positions us well for the coming quarters, particularly when factoring in the economic benefit we expect to achieve from the third quarter and fourth quarter take-outs.

On the balance sheet side, stockholders' equity increased to approximately \$332 million compared to \$255 million at December 31, 2014. Statutory surplus in our insurance company subsidiary at September 30 was approximately \$201 million. Our invested assets at September 30 were \$396 million with approximately \$364 million invested in bonds with an average credit quality of A. And with the capital gains that we took during the quarter, the duration was reduced to approximately 3.8 years, a move we felt prudent in light of the potential of a rising interest rate environment.

Our cash position was increased to \$201 million in anticipation of the closing of our acquisition of Zephyr Insurance Company as well as reinsurance payments due in the fourth quarter. And our total assets were \$855 million at September 30. Overall, we had an excellent quarter, one we're very proud of.

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

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. We will now begin the question-and-answer session. [Operator Instructions] First question comes today from Arash Soleimani with KBW. Please go ahead.

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

Thanks and congrats on the quarter. Just had a few questions here. In terms of your reinsurance synergies that you're expecting on Zephyr, so there's \$13 million of EPS accretion without any reinsurance synergies at all. And then what would you, I guess, conservatively say the reinsurance synergies could be?

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Yeah. Arash, this is Bruce. It's a little early for us to model those results. We would expect on the low end to be a couple of million dollars, potentially greater than that. We really need to see what the in force portfolio looks like towards the end of the first quarter after we close the acquisition. But I think that's a good conservative baseline.

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

Okay. And then in terms of – once you're ramped up in some other states – I know you mentioned a few licenses, what are your expectations for, like, for example, not in Hawaii, but North Carolina and South Carolina, those types of states for your voluntary production there? Is there any way we should be thinking about that?

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Yeah. I would think, right now, it's a little early to give a projection on 2014 (sic) [2016] voluntary production in those states. We are targeting a 1/1 launch date for new business in North Carolina. That would be the first state to come online. I believe South Carolina would be the second, now that we're licensed there. I would probably look at end of first quarter, early second quarter for that launch. But I would think in 2016 that the total new business would be fairly modest between \$5 million and \$10 million in the expansion states as we move forward.

We do have licenses or applications pending for Massachusetts, Rhode Island, Georgia, Alabama and Mississippi. Massachusetts and Rhode Island were filed maybe 60 days ago. And we're working with those departments and addressing any comments or questions they have. So, it's a little early to say when and if those programs would come online in terms of 2014 – or 2015 production (sic) [2016 – or 2017 production].

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

And is the National General partnership – is that North Carolina?

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Yes. That's correct. We also do business with them in Florida.

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

Okay. And then just more broadly in terms of organic growth in Florida. Are you seeing signs of positive organic growth there when you take into account attrition and mid-term cancellations? And if not yet, at what point do you think your – I guess the progress you've been making on the commercial front and on the voluntary personal residential front also gets you positive there?

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

A

Yeah. Arash, this is Steve. Commercial – we did go up about \$4 million in, in force premium over the quarter, resulting from about \$6 million of commercial residential new business during the quarter. And, as Bruce mentioned, October is a fantastic month. So we are gaining traction there going forward. And then on personal line side, after cancellations, we increased our policy count by about 4,000 policies. So we're at 36,600 voluntary policies in force. And that was at 32,700 at the end of the second quarter.

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

Thanks. And just last question. On the Citizens take-out that you had done, was there anything – I know September was the big month. Was there anything in October? And if so, how much time is left on the opt-out post-assumption there?

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Yeah. October would be a smaller assumption when compared to September. The first opt-out period for October has expired. I don't have that number in front of me. But I would think that we're probably in the neighborhood of 15,000 policies or so for October. And there is still another 30 day window here for policyholders to opt-out.

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

A

For comparable, into 30 days for the September, we're writing about 26,000 policies. So it's roughly 10,000 policies less at this point.

Arash Soleimani

*Keefe, Bruyette & Woods, Inc.*

Q

Okay. All right. Thanks for the answers.

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Thank you.

**Operator:** [Operator Instructions] The next question [comes from Samir Khare with Capital Returns Management.

Samir Khare

*Capital Returns Management LLC*

Q

Good morning. Congratulations on the quarter. I was wondering about the take-outs. If you can give us the number of commercial residential policies versus wind versus other and then the average premiums in each of those buckets.

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

A

Sure. Commercial, in September, accounted 33 policies with the average premium about \$49,000. And then, the wind-only policies, we assumed in September, was about 13,000 policies with an average premium of about \$1,750. And then – so then the remainder was about 13,000 policies. It had an average premium of slightly over \$2,000.

Samir Khare

*Capital Returns Management LLC*

Q

Okay. Great. And then the M&A pipeline – you guys talked about that in the press release a little bit. Can you just remind as to what you guys are looking for in terms of the profile of the company? And then what your budget is for such M&A opportunities? And what the resources you have?

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

A

Well, I think, Zephyr is a good comparable in terms of what type of profile we're looking for. I mean that's a multi-state diversification lottery insurance synergy. It has an excellent management team, very stable company that's been incredibly consistent over the years in terms of its production and profitably. We like that market a lot due to the non-correlated risk profile. So Zephyr, of course, really hit that sweet spot for us.

We will look at more companies that are outside of Florida and as we continue on this M&A track. And if there is good reinsurance synergies and a really good management team as well, that's, to us, equally important. That's something that we definitely look for because it gives us good diversification. And there are some companies in Florida as well that we think could be very compelling to us in terms of reinsurance synergies, top-line production and some back-office synergies that would result from the scale that you acquire.

So in terms of deal size – I'm not really going to put a number on that. I mean we have no intent really to go out and dilute shareholders. We've been saying that for quite a while now. We use cash on hand as our intent to close the Zephyr transaction. And as it stands right now, if we had another acquisition that we were to sign up and move forward with, we could look adding a little bit of leverage on to the balance sheet. We have none currently. We could do an equity raise, but my strong preference is to avoid any dilution to shareholders. And so, if we were to do an acquisition, I would be inclined to pursue the path where you're getting maximum shareholder appreciation.

Samir Khare

*Capital Returns Management LLC*

Q

Great. Okay. And just the storms in the quarter – I think you guys said that that was worth about 6 points. Two questions on that. Is that 6 points on the gross earned premium or the net earned premium? And then how many claims does that represent?

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

A

It was on the gross earned premium. I think I actually don't have it. It represented about an additional – the frequency increased, I would say, almost 2 points. We've been kind of averaging about 5% frequency. And then for the quarter, it was creeping towards 7%. Now a lot of those claims end up being closed without payment, because

we don't cover flood in a lot of – where it would have been flood related. We cover when the water comes through the roof. And -

Samir Khare

*Capital Returns Management LLC*

Q

Do you have an average severity for the -

Stephen L. Rohde

*Chief Financial Officer, Secretary & Treasurer*

A

It was about \$8,000 which is about \$2,000 less in our normal severity. So that's again an indication that a lot of these claims are closed without payment. But we did send out independent adjusters to do – scope the loss. So we did have some loss adjustment expenses associated with it.

Samir Khare

*Capital Returns Management LLC*

Q

Okay. Thank you.

**Operator:** [Operator Instructions] . This concludes our question-and-answer session. I would like to turn the conference back over to Bruce Lucas for any closing remarks.

Bruce Thomas Lucas

*Chairman & Chief Executive Officer*

I would like to thank everyone for their participation in our third quarter call.

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

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