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# EDITED TRANSCRIPT

HRTG - Q3 2019 Heritage Insurance Holdings Inc Earnings Call

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**Bruce Thomas Lucas** *Heritage Insurance Holdings, Inc. - Chairman & CEO*

**Kirk Howard Lusk** *Heritage Insurance Holdings, Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

**Frederique Suzanne Sleiffer** *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

**John Bakewell Barnidge** *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

**Matthew John Carletti** *JMP Securities LLC, Research Division - MD and Senior Analyst*

## PRESENTATION

### Operator

Good morning, and welcome to the Heritage Insurance Holdings Third Quarter 2019 Financial Results Conference Call. My name is Brandon, and I will be the operator today. (Operator Instructions) Please note this event is being recorded.

I would now like to turn the conference over to Arash Soleimani, Executive Vice President at Heritage. Please go ahead.

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**Arash Soleimani** - *Heritage Insurance Holdings, Inc. - EVP*

Good morning, and thanks for joining us today. We invite you to visit the Investors section of our website, [investors.heritagepci.com](http://investors.heritagepci.com), where the earnings release and our earnings call will be archived. These materials are available for replay or review at your convenience.

Today's call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on management's current expectations and are subject to uncertainty and changes in circumstances. In our earnings press release and in our SEC filings, we detail material risks that may cause our future results to differ from our expectations. Our statements are as of today, and we have no obligation to update any forward-looking statements we may make. For a description of the forward-looking statements and risks that could cause the results to differ materially from those described in the forward-looking statements, please refer to our annual report on Form 10-K, earnings release and other SEC filings.

With us on the call today are Bruce Lucas, our Chairman and Chief Executive Officer; and Kirk Lusk, our Chief Financial Officer.

I will now turn the call over to Bruce.

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Thank you, Arash. I would like to welcome all of you to our third quarter 2019 earnings call. Before we begin the call, I'd like to thank all of our employees for their dedication to our company.

Sales and earnings in the third quarter were strong, and all of our key internal metrics were well above plan. We continue to execute on our industry-leading diversification strategy that is focused on growing our footprint outside of Florida. And across our entire platform, 66% of personal lines new business premium was generated outside of Florida.

Similar to the second quarter, we are seeing strong sales across our footprint. In the Southeast ex Florida, new business premium increased 87% year-over-year. In the Northeast, new business premium increased 8% year-over-year. And in Florida, personal lines new business premium increased

22% year-over-year, an acceleration from a 7% decline in the second quarter of 2019. We also launched our Virginia operations and new product in Hawaii that are fueling growth in the future quarters.

New business sales in the third quarter was a new third quarter record for the company. Our new business sales continue to grow faster than prior expectations, and I believe growth will continue to be solid. While we have used our exported growth to offset strategic nonrenewals in the Tri-County, that will continue, but will likely not be as pronounced as in prior quarters and years. This is largely because our Tri-County de-risking strategy has been very aggressive in the last 3.5 years, and there is not nearly as much exposure to drop today. By way of example, at the end of the third quarter, our Tri-County TIV was 6.8% versus approximately 43% at the beginning of 2016 when our de-risking plan was initiated. As a result, we had positive top line premium growth in the third quarter and expect this trend to continue.

Claims and reserves are always paramount issues. I strongly believe that aggregation in Florida and in the Tri-County will continue to cause higher loss ratios and adverse prior year reserve development across our sector. I am, however, happy to report that we had favorable prior year reserve development for the fifth consecutive quarter, which continues to be the exception in the Florida market.

Our favorable reserve development is largely the product of 2 factors: First, we are known for being one of the best reserve companies in our sector. We are typically the first company to report and reserve for large weather losses and typically have more loss reserves than any other company in the peer group, despite being smaller and less concentrated in Florida and the Tri-County.

Second, we have led the industry in de-risking from the Tri-County over the last 3.5 years. Since that time, we have dropped approximately \$22 billion in TIV from the Tri-County. As we have dropped TIV, the percentage of new Tri-County claims and lawsuits has dropped significantly. The third quarter is the 12th consecutive quarterly drop in the percentage of litigated claims related to the Tri-County. And the percentage of litigated claims related to the Tri-County set yet another record low for the company. Since litigated claims are a major contributor to reserve development, having less of them helps our development favorably.

In light of a very strong third quarter, our book value increased to \$15.37. This represents an 8.8% compound annual growth rate since the end of 2018 and 10.5% in the third quarter. Despite some severe weather losses this year, our book value per share has increased significantly.

Our operating results have been very strong, and we intend to continue our share repurchase program. In the third quarter, we repurchased \$4.5 million of common stock at a 6% discount to third quarter book value, and we intend to continue retiring shares as long as we are trading below our fair value.

I will now turn the call over to Kirk to provide more details on our financials.

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**Kirk Howard Lusk** - *Heritage Insurance Holdings, Inc. - CFO*

Thank you, Bruce. Good morning. Net income for the quarter was \$8.1 million or \$0.28 per diluted share and was up from \$6 million or \$0.23 per diluted share reported during the third quarter of 2018. Gross written premiums increased by \$3.7 million from the third quarter of 2018, reflecting strong growth outside Florida of 7.9% or \$9.2 million of written premiums, with planned de-risking driving a decrease in Florida of 4.8% or \$5.6 million. Year-over-year, year-to-date growth outside of Florida was \$24.4 million or 7.7%, partially offset by a decrease in Florida of \$23.6 million or 6.1%. We continue to prudently evaluate our exposure in the Tri-County area. Based on underwriting and pricing actions taken since 2016, we expect the amount of de-risking to diminish in future quarters. .

Our growth strategy has been planned to position us for long-term growth, profitability and exposure management. An example of our balanced approach to growth can be seen by our growth in the Southern states outside of Florida, where we were able to exceed our expected TIV by over 31%, while at the same time, improving our risk aggregations and decreasing our 100-year PML in that area. As experienced in 2019, we expect our growth outside of Florida to continue.

Our retention has been strong at over 90% throughout our platform. Our Florida rate increases this year have averaged over 12%, with rate increases in the mid-single digits for business outside of Florida.

The ceded premium ratio was down from the third quarter of 2018 by 3 percentage points and down by 3.9 points from the second quarter of 2019. The decrease reflects the reinsurance synergies we described during the second quarter earnings call, along with the changes to the gross quota share treaty. 2019 Q3 net earned premiums are up 4.8% from the third quarter of 2018, reflecting the changes noted earlier.

Losses and LAE were up \$11.4 million from the prior year quarter. The net loss ratio was 56.6% for the third quarter of 2019 compared to 49.6% for the third quarter of 2018. Non-hurricane weather-related losses from multiple events impacted the net loss ratio for the quarter by 12.7 points and increased the quarter-over-quarter loss ratio by 7 points.

Our loss reserves remain in a solid position as we record the fifth consecutive quarter of favorable prior year development. Policy acquisition costs are virtually flat from the third quarter of 2018 and slightly down from a ratio standpoint.

General and administrative costs are down \$4.3 million from \$25.8 million at Q3 2018 to \$21.5 million at Q3 2019. The reduction from the prior year quarter is predominantly due to non-core business acquisition-related items booked during the third quarter of 2018, which were partially offset by a decrease in ceding commission income of \$0.8 million from the change in reinsurance structure.

The combined ratio for the quarter as a percentage of net premiums earned was 95.5%, which is up from 93.9% as of Q3 2018. The increase reflects the increase in the loss ratio being partially offset by a lower net expense ratio.

Due to the financing completed during the fourth quarter of last year. Interest expense for the third quarter of 2019 is \$2.8 million lower than in 2018 and lower by \$8.9 million year-to-date compared to year-to-date third quarter of 2018.

Shareholders' equity increased from year-end 2018 by \$19.9 million or 4.7% to \$445.2 million at September 30, 2019. Book value per share increased by 6.5% year-to-date and 2.5% from the second quarter of 2019. In addition, year-to-date, the company paid \$5.4 million to shareholders in dividends and also repurchased over 821,000 shares of stock at an average cost of \$14.47, which is 5.9% below the September 30, 2019 book value per share.

Of the \$50 million of stock buybacks authorized by the Board of Directors in August of 2018, just over \$38 million of authorization remains available for the purchase of stock. As of September 30, the company has over \$23 million of cash in nonregulated companies and also has \$40 million available on the loan revolver.

Bruce and I are now available to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from John Barnidge with Sandler O'Neill.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Congrats on the quarter. You talked on the 2Q '19 call that there might be a significant amount of reserve releases coming in the next few quarters from reserving for a surge in AOB claims, if it didn't turn out to be the case. Can you please provide your revised thoughts on that?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. Good question, John. And thanks for the comment. It's just too early to tell right now what we're going to do with the surge in AOB claims that have come through. Obviously, we're fighting a lot of those claims, and that is -- really, a surge just happened a few months ago, so it's really early in the cycle. But I can tell you that as we look at our reserves, we feel that we are more than adequately reserved. We're reserved actually above



the midpoint of our range. I think if you ask every other Florida company where they are, they wouldn't be that high. So we do feel pretty strong that we are adequately reserved and potentially have some cushion there. But as time develops, we'll know a little bit more about how those losses are maturing.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. I know as we think -- look back to Q4 '18, there was a benefit there from CAN. How should we be dimensioning and thinking about comparables on a net loss basis in 4Q '19?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. I mean, the issue with CAN is we're not really getting the repair opportunities that we've gotten in the past. The biggest bang for the buck on CAN was really in the Tri-County. If you get a water claim there, it's like 10x higher than anywhere else. And we were having a lot of success penetrating those claims and reducing our exposures as we've de-risked out of Tri-County. We're not getting that net-net benefit to the same extent that we've gotten in prior years. And so it's really a quite minimal impact at this point until things develop more in the Northeast.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. On the 2Q '19 call, when you're talking about the claims environment broadly in the industry, not necessarily Heritage-specific, you said it was getting worse and not better. Can you kind of provide your latest thoughts on fraud issues in Florida, please?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. Another great question. I do think things are getting worse, and you're seeing quite a bit of attorney, PA activity out there in the general market. AOB for us is down post-legislation, but my concern is they're just going to go to first-party direct lawsuits. And well, time will tell as to whether or not that happens. But I do think that the claims environment, especially in Southeast Florida, in Orange County in particular, I would call that the new quad county, I think that things there are particularly toxic and getting worse. And we are very grateful that we've dropped our TIV there to 6.8% versus 43% a few years ago when we started the process. But I don't see it slowing down anytime soon.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. My last question and I'll requeue. Can you dimension weather losses in the quarter and catastrophe losses in Florida versus ex Florida?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. The bulk of those are going to be in Florida for the quarter, about probably 90% in Florida. Yes. Dorian was a decent contributor as well, but it was relatively smaller than, I think, that's somewhere, -- correct me if I'm wrong, somewhere in the \$3 million range or so for Dorian. So we're taking a pretty conservative approach there. We haven't seen a lot of claims on Dorian. But overall, it's just a lot of rain events and some hail events that you get throughout the state.

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**Operator**

Our next question comes from Freddie Sleiffer with KBR.

**Frederique Suzanne Sleiffer** - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

Firstly, just wondering, what are your latest gross Michael and Irma losses? And how much IBNR do you have left remaining for each storm right now?

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**Bruce Thomas Lucas** - Heritage Insurance Holdings, Inc. - Chairman & CEO

Yes. They really haven't changed much for us. I mean we drew a lot of raised eyebrows when we put up some pretty decent numbers last year, but consistent with the way we reserve. We tend to reserve higher than those companies, and our thoughts were that people would eventually catch up. I think we're starting to see that now both on daily reserves and on cat reserves. Irma, total reserves are probably around a couple of hundred million or so with IBNR. I think it moved about \$15 million in the quarter, roughly, so not really that much of a move.

Michael is the one that I'm a little bit more concerned about, just seeing some of the claim activity up in the Panhandle. We're seeing a lot of PA activities, a lot of attorneys. A lot of AOBs are coming out of that event. Severities are very high up there, and there's been a lot of pressure put on Florida insurers to resolve all of their Michael claims and pay them out. Well, that makes it very difficult for us in the negotiation process. And I think that loss is somewhere in the \$60 million incurred range. So not a ton of movement, but we are seeing some decreased claim activity there.

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**Frederique Suzanne Sleiffer** - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

Okay. Got it. And then just -- I know it's probably a little too early on the upcoming reinsurance renewal, but do you think the recent elevated Japanese wind activity could have an impact? And also, given that your peers have reported some Irma and Michael loss creep recently, do you think that could impact the renewal in pricing?

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**Bruce Thomas Lucas** - Heritage Insurance Holdings, Inc. - Chairman & CEO

Not really. I can tell you. I just got back from PCI. We're in that with, I don't know, 40-plus of our reinsurance panel. And the issue in the market is not loss creep on Florence, Michael, Irma, Harvey. I think that stuff got priced in last year and no one's even talking about it this year. Same with the events in Japan. It was barely even mentioned in any of my meetings. The #1 thing that we are hearing is the lack of capacity potentially in the retro market and with the collapse of CATCo, things -- which was a huge supplier of retro capacity. We're hearing that in every single meeting, that there's a lot of concern around what retro capacity is going to look like.

Fortunately, for us, we've built a panel that is not very dependent upon retro. We think that helps us. And that was an issue that we saw again in 2019. There were some retro squeezes that were taking place in the market, but we were still able to buy to the highest return period in the company's history and save \$10 million because of the diversification of our footprint. We think that, that diversification trend, as it continues, will offset any potential, hopefully, reinsurance increases that could take place in 2020.

Kirk noted some interesting stats earlier in his portion of the call. Southeast ex Florida, for example, we were massively over TIV projections in those states, but it actually reduced our PMLs. So the synergies we're seeing from the multi-state footprint we've been growing for the last 3 years are really paying off on the reinsurance pricing.

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**Frederique Suzanne Sleiffer** - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

Okay. And then just quickly following up on some of the AOB comments you made. It sounds like Tri-County claims are down. And I might have missed it, but what are you seeing in your non-Tri-County claim counts? Are those down as much as Tri-County claims? And also, are you expecting any impact on the loss ratio or not at all, given your previous comments?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. That's a really good question as well. Yes, Tri-County claim counts and litigation counts are at, once again, new quarterly record. It's -- I think that's 12 quarters in a row. But that shouldn't shock anyone given the massive de-risking that we've done over the past 3.5 years in Tri-County. As a result of growing the footprint outside of Tri-County, the percentage of open claims and lawsuits, et cetera, have been growing ex Tri-County because we've been growing our footprint ex Tri-County. But I can tell you, those losses are a lot easier to resolve than the ones in Tri-County. So we are seeing favorable reserve development, I mean, 5 quarters in a row in the Florida market. It's pretty impressive. If I could just pat this team's back for a moment. We're not seeing that anywhere, any of the companies in Florida. A big reason for that, as I mentioned in my earlier statements, is the reduction in Tri-County.

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**Frederique Suzanne Sleiffer** - *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

Okay. And then just sticking with the core -- the net core loss ratio a bit. It was elevated over the last year. Should we be thinking about 51%, 52% as sort of a good run rate going forward and into 2020, given minimal benefit from CAN right now?

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**Kirk Howard Lusk** - *Heritage Insurance Holdings, Inc. - CFO*

Are you talking about net or gross loss ratio? You're talking about net?

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**Frederique Suzanne Sleiffer** - *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

Net core loss ratio.

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**Kirk Howard Lusk** - *Heritage Insurance Holdings, Inc. - CFO*

Yes. Yes, I'd say right around that area, a little bit less.

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**Frederique Suzanne Sleiffer** - *Keefe, Bruyette, & Woods, Inc., Research Division - Associate*

Okay. And just lastly, on capital management. It seems like share repurchases accelerated a bit this quarter over last quarter. So how should we be thinking about the pace of those going forward?

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Well, we're going to continue to pound it. And we believe that we are massively undervalued. It's pretty incredible. We're putting up great returns on equity. We're doing everything the right way on reserves, which I don't think a lot of people fully appreciate how meaningful that is to the financial wherewithal of the company. We're looking at great trends in reinsurance, top line growth across the board. And we're \$2 below book value? Yes, we're going to be buying back a lot of stock.

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**Operator**

Our next question comes from Matthew Carletti with JMP Securities.

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**Matthew John Carletti** - *JMP Securities LLC, Research Division - MD and Senior Analyst*

Most of mine have been answered on the past 2 lines of questioning, but I do have one left. Bruce, hoping you could update us on some of the partnerships that you have with other insurers, specifically, I think last we spoke, with National General. Alabama might have been in the works. And Safeco had just launched. I think you just dipped your toe in Connecticut. I was hoping you could update us with where those stand.

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**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. Well, that's a pretty legitimate question. And it is something that we spend a lot of time on is building the national relationships. We have them with GEICO, Safeco and National General, as you noted. I will not get into specifics on any one partner. We have an agreement with all of our partners not to disclose the amount of business that we're transacting together. We view that as something that's proprietary, and they prefer not to have that data released. So we're going to respect that.

I can tell you this, top line sales are up significantly, especially outside of Florida. And the #1 growth state in our portfolio right now in terms of percentage is Alabama. And that is an inland book of business that's been doing very well. North Carolina continues to just sizzle from our perspective. We're way ahead of expectations in every single state across the Southeast. Up in the Northeast, we're a little behind plan. And yet, it's more than made up by the additional business we've been writing across the Southeast and into Hawaii. So we're very happy with how the partnerships are progressing, but we can't give specific data about any one of them.

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**Operator**

(Operator Instructions) Our next question is a follow-up from John Barnidge with Sandler O'Neill.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Can you talk about your current thinking around the expense ratio? It ticked down in the quarter sequentially. Third quarter in row it did that.

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**Kirk Howard Lusk** - *Heritage Insurance Holdings, Inc. - CFO*

Yes. I think it's probably going to be -- probably stabilizing a little bit. And we really don't want to give a lot of guidance on the ratios, but overall, I mean, it's -- I think we're starting to stabilize. I think some of the actions we've seen have come through to the P&L. And so going forward, we're probably thinking about where it's going to be.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. Can you talk about other revenue and net investment income and kind of how we should be thinking about that going forward? Were the numbers we saw in 3Q '19 a level that we could consider run rate?

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**Kirk Howard Lusk** - *Heritage Insurance Holdings, Inc. - CFO*

Yes. Yes, I think that they're somewhat consistent with what we've been seeing.

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**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. And my last question. Can you kind of talk about the M&A environment and your interest in Florida and outside of Florida? I know previously there's been commentary in the industry about troubled insurers in Florida, so I don't know if that's something that would be advantageous to you, but also outside Florida.



**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

Yes. John, that's a really good question. And yes, there are a number of companies for sale right now that we're aware of. We'll never say no, but it has to be a really good fit for us to even consider it. A lot of what is out there is highly distressed, and there is no secret that there have been some failures in Florida. And I think all of those companies have been placed into insolvency, save one. Followed into the market after us. Timing is everything. They picked maybe not the best policies out of Citizens because there wasn't much left. Thankfully, we hit the break when we didn't see the credit quality. But there's some stuff out there that I think is struggling.

And there are some companies in Texas as well that have been on our radar from time to time, but we haven't seen any metrics out there that really justify an acquisition in Texas. We think it's a bad claim environment. And you don't got a reinsurance synergies off that portfolio. So for now, we're not looking to do M&A. It's not even on -- really on our radar at all. We're so focused on growing the book of business organically. We have record growth yet again. Top line is really going to start to move in the 2020, and we're going to focus on that because that has a lower acquisition cost.

**John Bakewell Barnidge** - *Sandler O'Neill + Partners, L.P., Research Division - Director of Equity Research*

Okay. And then are you seeing any opportunities in the Citizens book itself?

**Bruce Thomas Lucas** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

No.

**Operator**

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** - *Heritage Insurance Holdings, Inc. - Chairman & CEO*

We'd like to thank everyone for joining our third quarter 2019 earnings call.

**Operator**

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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