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# Heritage Insurance Holdings, Inc. (HRTG)

Q4 2019 Earnings Call

## CORPORATE PARTICIPANTS

**Arash Soleimani**

*Executive Vice President, Heritage Insurance Holdings, Inc.*

**Kirk Howard Lusk**

*Chief Financial Officer, Heritage Insurance Holdings, Inc.*

**Bruce Thomas Lucas**

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

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## OTHER PARTICIPANTS

**Matthew J. Carletti**

*Analyst, JMP Securities LLC*

**Paul Newsome**

*Analyst, Piper Sandler & Co.*

**Mark Hughes**

*Analyst, SunTrust Robinson Humphrey, Inc.*

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## MANAGEMENT DISCUSSION SECTION

**Arash Soleimani**

*Executive Vice President, Heritage Insurance Holdings, Inc.*

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 detailed 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 our 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**

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

Thank you, Arash. I would like to welcome all of you to our fourth quarter 2019 earnings call. Before we begin call, I'd like to thank all of our employees for their dedication to our company. The fourth quarter was another very strong quarter on all fronts including solid organic growth and underwriting margins, and another consecutive quarter of favorable prior year reserve development.

Gross premiums written grew 6.2% year-over-year to \$235.4 million, including 9.4% growth outside of Florida [ph] an (00:01:38) acceleration from 7.9% in the third quarter of 2019. I believe organic growth will continue to be strong for the foreseeable future as we benefit from our independent agency relationships, our auto carrier partnerships and the favorable rate environment. Our higher growth rate outside Florida reflects our continued shift to more stable and diversified markets.

Heritage is a super-regional insurer that is headquartered in Florida but that does not mean we are Florida carrier or heavily concentrated in Florida. It is easy to paint all Florida-based carriers with a broad brush but we look nothing like Florida companies that are extremely concentrated in Florida and Florida's Tri-County. At year-end 2019, approximately 30% of our consolidated TIV is in Florida, with only 6.4% of consolidated TIV in the volatile Tri-County region and I'm unaware of any peer carrier that has this advantage.

I received a number of inquiries about macro conditions in the Florida market and where we sit against this backdrop. First, the primary market in Florida is hardening at the fastest pace I've ever seen. Over the years, I've watched countless competitors suppress pricing to grow market share and many of these same companies have been understating loss reserves to support the growth. That certainly makes them look good in the short term but it is not a viable long-term business plan. Growing top line at inadequate rates only compound solvency issues, rate need and adverse reserve development. There are numerous companies that have only recently begun to address these issues by closing territories, not renewing agents and policies, taking very large rate increases, in some cases, large enough to require public rate hearings, and booking very large adverse reserve development charges.

I believe these trends will continue in 2020 as numerous companies continue to struggle with the compounded problem of fast growth and inadequate pricing and reserves. Recently, it isn't unusual to see a Florida carriers seek rate increases between 20% and 40% and post large adverse development charges. In stark contrast to this trend, Heritage was a first-mover and began to address these foreseeable issues as early as 2016. Since the first quarter of 2016, we have consistently taken meaningful rate increases in Florida, particularly in the Tri-County, while virtually shutting off new business in troubled regions in the state.

Since the first quarter of 2016, we dropped \$23 billion in Tri-County TIV, massively reduced our Florida concentrations, and substantially increased our loss reserves. In very simple terms, we saw the trends early and took bold action to mitigate their impact whereas most of our peers are struggling to manage these issues which are far more pronounced today. Unlike some of our peers, many of our key metrics have been improving as a result of the prudent steps we've taken and we believe that, today, we have a better spread of risk, a stronger balance sheet, more adequate reserves and more conservative financial leverage.

Top line growth has returned and is accelerating while our premium mix continues to shift outside of Florida. Favorable, not adverse, reserve development is becoming the norm for Heritage. While it is impossible to always have favorable development, we have managed an impressive six consecutive quarters of favorable reserve development, and we have done that while substantially increasing our non-cat reserves since 2016.

Claim trends continued to improve and the percentage of litigated non-hurricane claims stemming from the Tri-County region in Florida declined by 830 basis points year-over-year. I am unaware of any Florida-based carrier that can make these statements. [ph] If they existed, (00:05:40) they would disclose it to their shareholders.

While we still have work to do, core metrics related to growth, underwriting quality, reserve development, diversification and national partnerships look very favorable at this time. And although there's a lot of noise in the

Florida market, I want our investors to know that I believe our proactive response over the past four years has addressed most of these issues, and the results are apparent in our earnings numbers.

I'm sure I will get questions related to reinsurance renewals at June 1. While I won't comment on specifics at this time, I will state that, so far, the process has been very orderly and not contentious. We have built significant reinsurance relationships from the outset of our company. We have approximately 60 trading partners on our catastrophe program alone and many of our largest trading relationships and well beyond our excess of loss program.

Reinsurers respect the results we have delivered versus our Florida-only peer set. We have reduced our Tri-County Florida exposures by \$23 billion, since the first quarter of 2016, we have achieved diversification through intelligent organic growth outside of Florida and through strategic acquisitions, and now have less than 30% of our TIV in Florida.

We are a US super regional insurer now with nearly 500 employees, including sizable legal and claims groups, and not just a Florida specialist or takeout insurer. We have a strong capital position with \$449 million of GAAP equity. Again, reinsurers respect these core differences and we believe that reinsurers will differentiate diversified insurers, such as us, from the Florida insurers that have failed to diversify.

To the extent that our rates are higher this year, we will file for a limited reinsurance rate increase that will likely begin in September. This will significantly mitigate potential reinsurance rate increases albeit with a slight lag.

Moving on to the financials. In light of a very strong fourth quarter, our book value increased to \$15.66. This represents an 8.5% growth rate relative to year-end 2018. 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 fourth quarter, we purchased \$4.3 million of common stock at a 12.5% discount to fourth quarter 2019 book value per share, and we intend to continue retiring shares as long as we are trading below what we believe to be fair value.

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

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## Kirk Howard Lusk

*Chief Financial Officer, Heritage Insurance Holdings, Inc.*

Thank you, Bruce. Good morning. Net income for the quarter was \$12.8 million, or \$0.44 per diluted share, and was up from \$3.9 million, or \$0.15 per diluted share, reported during the fourth quarter of 2018. As Bruce mentioned, we've had strong organic growth in the fourth quarter 2019. And for the full year of 2019, gross written premiums increased by \$14.6 million or 1.6% year-over-year. The growth includes 8.1% growth outside Florida, partially offset by 3.9% decrease in Florida from planned de-risking in the second and third quarters.

We indicated during the third quarter call that we expect the amount of de-risking to diminish in future quarters. This can be seen by the growth in all states experienced during the fourth quarter and with \$13.7 million of our full-year growth of \$14.6 million being achieved in the fourth quarter. We continue to prudently evaluate our exposures in all geographies and take the necessary pricing and underwriting actions to ensure long-term rate adequacy and strong underwriting margins.

We continue to get rate increases in excess of expected claims trend. The ceded premium ratio was down from the fourth quarter of 2018 by 5.3 points and down 2.5 points for the third quarter of 2019. The decrease reflects reinsurance synergies and the elimination of the gross quota share of our Northeast business, which was partially offset by the purchase of more cat XoL to replace gross quota share.

2019 Q4 net earned premiums were up 2.7% from the fourth quarter of 2018, reflecting the changes just mentioned. Losses and LAE were up \$7.1 million, or 3%, from the prior year quarter. The net loss ratio was 51% for the fourth quarter of 2019 compared to 50.3% for the fourth quarter of 2018. The increase relates to lower income from vertically integrated operations and higher current accident year non-weather losses partially offset by lower weather losses. Since we did our in-depth reserve review in mid-2018, we continue to show favorable prior year reserve development which reflects our prudent reserving process. For the full year of 2019, favorable prior year development was \$3.7 million.

The net expense ratio was 38.3% for the fourth quarter of 2019 compared to 36.1% for the fourth quarter of 2018. The variance was driven by an increase in licenses and fees coupled with the timing of variable compensation accruals. The net combined ratio for the fourth quarter of 2019 was 89.3% which is up from 86.4% in the prior year period. The increase reflects the items just noted.

Interest expense was down \$2.6 million and other non-operating losses are down by \$11 million, both reflecting the refinancing which was completed in the fourth quarter of 2018. Shareholders' equity increased from year-end 2018 by \$23.5 million to \$448.8 million at December 31, 2019. Book value per share increased by 8.5% year-over-year.

In addition, for 2019, the company paid \$7.1 million to shareholders in dividends and also repurchased over 1.1 million shares of stock at an average cost of \$14.26 which is 8.9% below the December 31, 2019 book value per share. Of the \$50 million of stock buybacks authorized by the board of directors in August of 2018, over \$33 million remains available.

As of December 31, the company has over \$34 million of cash in non-regulated companies and also \$40 million available under its revolver. We are pleased with the results of the fourth quarter and even more pleased with how the company is positioned for 2020. We are positioned for a solid organic growth, rates are continuing to favorably impact the P&L, and our reserve position is strong.

Bruce and I are now available to take your questions.

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**Operator:** Before we begin the session, I'd like to turn the conference back over to Bruce Lucas for closing comments.  
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## Bruce Thomas Lucas

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

Thank you. Before we move to Q&A, I'd like to comment on recent market activity. Over the past week, global markets have experienced significant declines based on coronavirus fears. Whether the fear of SARS, coronavirus or other catalysts, panic tends to wash over markets on a macro level and everything moves lower. This has certainly been the case for Heritage and other stocks in our sector. Once the panic subsides, and it always does, investor focus returns to fundamentals.

One excellent reason to own our stock in the long term is that our fundamentals are not impacted by events like coronavirus. We are not in the travel and hospitality sectors or other sectors that feel an impact from these types of events. We are a homeowner's insurance company and if you own a home, you're going to buy homeowner's insurance regardless of macro events like coronavirus.

I'm confident that when the fear trade subsides, our fundamentals will be given fair value by investors. In the interim, we intend to use this opportunity to repurchase our shares at these levels because it will generate an outsized return for our shareholders. Kirk and I are now available to take analyst questions.

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## QUESTION AND ANSWER SECTION

**Operator:** We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Matt Carletti of JMP. Please go ahead.

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**Matthew J. Carletti**

*Analyst, JMP Securities LLC*

Hey, thanks. Good morning.

Q

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**Bruce Thomas Lucas**

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

Good morning.

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**Matthew J. Carletti**

*Analyst, JMP Securities LLC*

Hey, Bruce I was hoping you could update us a little bit just on – you have, I think, the three partnerships, Liberty Mutual/Safeco, National General and GEICO, just kind of where each of those stand and how they're progressing.

Q

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**Bruce Thomas Lucas**

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

Yeah, that's a great question and I do get that question a lot from various shareholders and analysts. And what I can tell you is I can't comment on specifics per my agreement with all three of those partners, so I can't get into production levels or states where we're partnering in. I can tell you that these relationships are material. They are a large driver of our growth, especially ex-Florida. We do value these relationships. We worked hard to earn them and, other than that, I really can't comment on specifics.

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**Matthew J. Carletti**

*Analyst, JMP Securities LLC*

Okay. One other question for you just brought broadly on capital, can you just talk a little bit about, you know, you're returning to growth so maybe what sort of growth you think it could support on your current capital base. And then alongside that, to the extent there's excess capital, you have been buying back stock but how would you think about M&A in this environment, whether that be kind of whole companies or if books become available or otherwise?

Q

**Bruce Thomas Lucas**

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

A

Yeah. Our capital position – another great question – our capital position's pretty strong. We've got the lowest underwriting leverage of any of the so-called Florida peer companies. We're about, on a net ceded basis, we're about 1 times [ph] GAAP equity, (00:16:10) which is by far the lowest.

So, we've got a lot of room in the capital stack for growth. We do not think that we need any capital for the foreseeable future to sustain that growth. And our target internally is to reach upper single-digits, low double-digits growth at this point in time. The sales numbers are just massively accelerating. We saw that trend in third quarter. It went up 300% or so fourth quarter. It's up again in the first quarter. We like where we stand in terms of the growth and we know that we have enough capital to sustain that growth.

With respect to M&A, which was the second part of your question, I never say never. I mean, we've definitely led the Florida market in terms of our M&A activity and we've done several of them, Zephyr and Narragansett Bay, Sawgrass, Sunshine State and others. I can say this, with respect to Florida, we're going to be very conservative. And we've worked incredibly hard over the last four years to change the mix of our portfolio, to be more diversified and less dependent on the volatility in the Tri-County region in the Florida market in total.

That doesn't mean that we have no room for growth in Florida. In fact, we are anticipating growth in Florida in 2020. It's just that it needs to be the right type of growth. And I've seen several opportunities recently, companies that are looking to sell or divest their portfolios. I can tell you, we haven't seen one acquisition prospect in the Florida market that looked appealing to us. So we'll keep our power dry. We'll be opportunistic if the right transaction comes our way. Until then, we're going to keep going with the organic growth because it's accelerating and it's far cheaper versus an acquisition.

**Matthew J. Carletti**

*Analyst, JMP Securities LLC*

Q

All right. Thanks. Appreciate the answers and the best of luck in 2020.

**Bruce Thomas Lucas**

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

A

Thank you, Matt.

**Operator:** Our next question comes from Mark Hughes of SunTrust. Please go ahead.

**Mark 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 Hughes**

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

When we think about the loss ratio in 2020, could you give us some sense of, one, what you feel like a good underlying loss ratio is? Obviously, it's going to be dependent on the weather et cetera, but kind of where should this business be operating? And then how is that influenced by the Florida/outside of Florida mix? Is the loss ratio appreciably different, one or the other?

**Kirk Howard Lusk**

*Chief Financial Officer, Heritage Insurance Holdings, Inc.*

A

Okay. Yeah. I mean, as far as, like, the overall loss ratio, I think in the low 50s is kind of where we look at where we want to operate. When you look at 2019, even though there really wasn't a lot of hurricane activity, the other weather activity we had on the full year basis was much more severe than we'd experienced in the last several years. We have an estimate of what we think the "non-hurricane" cat should be in any given year and 2019 definitely exceeded all those expectations. So it actually even kind of made up for the difference of not having a cat this year. So really when we look at it going forward, I think that's probably where we should be pegging it.

**Bruce Thomas Lucas**

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

A

And I'll comment too. Ex-Florida loss ratios tend to run higher. And that's because reinsurance costs are lower. And so I've had questions in the past with people saying, oh, your loss ratio or gross reserves are up. Yeah, well, of course they are, our book is expanding outside of Florida and the loss ratios there tend to be higher because the cat costs are so much lower.

**Mark Hughes**

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

Understood. How about – I think you had talked about the percentage of litigated non-hurricane claims in Tri-County is down. How about when you look at your litigated claims count overall, what do you see there?

**Bruce Thomas Lucas**

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

A

It's also down. You just get less litigation frequency when you move away from the Tri-County. So where you tend to see it is just throughout the state of Florida and then, ex-Florida, you just don't see it. It's the exception to have a lawsuit outside of Florida. Usually, those get resolved pretty easily. It doesn't mean we don't have a handful of them, we do, but nothing that even remotely approaches the stratosphere of numbers you see in Florida, which is why we like the continued diversification trend to our 15 other states of operation.

**Mark Hughes**

*Analyst, SunTrust Robinson Humphrey, Inc.*

Q

And then your latest thought on AOB reform, how meaningful that is as you sit here today.

**Bruce Thomas Lucas**

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

A

Yeah. We've actually seen a big reduction. We're down over 70% year-over-year on AOBs. That is pretty material. Some of that, I'm sure, is driven from the fact that we've had an increase in non-Florida business and a reduction in a lot of areas within Florida, particularly the Tri-County where you see a lot of these AOBs. But even assuming those factors into the equation, we have seen a very, very large reduction in AOBs coming in the front door. That is really, really good for us and the rest of the market.



The main reason for that, Mark, is when you have a direct lawsuit with an insured on a loss, it's one lawsuit. When you have an AOB, usually, there's 4, 5, 6, sometimes 10 AOBs on one particular claim, and so you end up with 4, 5, 6, 10 lawsuits. And so, having a big reduction in AOBs on the front end means that you're going to have a big reduction in the litigation expenses and litigation activity on the tail end.

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**Mark Hughes**

*Analyst, SunTrust Robinson Humphrey, Inc.*

Thank you.

Q

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**Bruce Thomas Lucas**

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

Thank you, Mark.

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**Operator:** [Operator Instructions] And our next question will come from Paul Newsome of Piper Sandler. Please go ahead.

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**Paul Newsome**

*Analyst, Piper Sandler & Co.*

Good morning. Thanks for the call. Could you touch a little bit upon what you think of claims inflation on an underlying basis is outside of Florida? Obviously, lots of concern in the market in general about things like social inflation and other impacts that seem to be hitting everyone.

Q

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**Bruce Thomas Lucas**

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

Yeah. That's a really interesting question. We don't really see it. I mean, it's there. There is insurance fraud everywhere. You can't escape it. But we do not see it hitting our numbers in a big enough way where we can actually quantify it. It tends to be a one-off issue whereas in Florida, it's just more commonplace to have AOBs and claim inflations and you get the so-called storm chasers that go and knock on your door and give you a free roof. And that's a big scam hitting Central Florida right now, by the way. We don't really see it. By comparison, it pales to the extent that it's so small we really can't even quantify it. But I'd say within Florida, it's probably responsible for tens and tens of millions of dollars of losses on an annual basis.

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**Paul Newsome**

*Analyst, Piper Sandler & Co.*

And then maybe probably more of a review, but could you walk us through how we should think about the impacts of rate going through with the possible offset of reinsurance costs? I would assume, and please correct me if I'm wrong, you've got a fair amount of rate coming through, as we speak right now, that would affect, I guess, second quarter.

Q

And then, maybe there's a change because of reinsurance and then there's an offset. How is that – I sort of envision sort of sine wave here in terms of impact. Is that the right way to think about it, or how should we think about it from an income statement perspective as opposed to actual rate taking at the moment?

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**Bruce Thomas Lucas**

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

A

Right. Yeah. You are correct in that we do have some pretty decent-sized rate increases coming to the system. Over the years, and you could go back, I don't care what year it is, we have always tried to grab double-digit rate, especially starting kind of 2015 to 2016 when we saw the problems the market is choking on today, we saw them then, and we've been taking 14-plus percent rate increases virtually every single year across the line. And we've been hitting Tri-County for the last three years with 25% rate increases across the board. And so, we do have a lot of rate coming through. That means our rate need is now lower than what it has been in the past as the rate has flowed to the book and the portfolio has shifted.

That brings us then to what happens with reinsurance pricing now. We don't know where pricing is going to end up. It was not some doomsday event for us last year. We actually saved \$10 million last year over the prior year and bought a bigger tower. I'm not saying it's going to happen this year, but it is a hard market out there. But our diversification is a big factor for us in hedging against those rate increases.

And to the extent we get it, the process works as follows. We lock in our pricing. We then file for a limited reinsurance rate filing. By statute, in Florida, the regulators have 45 days to get that rate approved and then it's about 45 days thereafter, we're charging the higher rate to our customers on a per policy basis. So the lag, roughly, is about three months before you start recouping those additional dollars, but the other rate increases that we have in the system are still playing their way through, and so that helps to blunt the impact during that three-month gap.

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**Paul Newsome**

*Analyst, Piper Sandler & Co.*

Q

Right. Thank you very much.

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**Bruce Thomas Lucas**

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

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Thank you, Paul.

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

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**Bruce Thomas Lucas**

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

I want to thank everyone for joining our fourth quarter 2019 earnings call.

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

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