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Heritage Insurance Holdings, Inc. (HRTG)

Q2 2018 Earnings Call

CORPORATE PARTICIPANTS

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Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Bruce Thomas Lucas

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OTHER PARTICIPANTS

John Bakewell Barnidge

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Matthew J. Carletti

Analyst, JMP Securities LLC

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Heritage Insurance Holdings Second Quarter 2018 Financial Results Conference Call. My name is Nicole, and I will be the operator today. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. Please note this event is being recorded.

I would now like to turn the conference over to Joe Peiso. Please go ahead.

Joseph R. Peiso

Vice President, Compliance, Heritage Insurance Holdings, Inc.

Good morning. We invite you to visit the Investors section of our website, heritagepci.com, where the current quarter 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. 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.

Also, during the course of today's call, our Chairman and CFO will be discussing one or more non-GAAP financial measures defined in this quarter's earnings press release, along with the SEC-required disclosures, including reconciliations to the most compatible GAAP measures.

With us on our call today are Bruce Lucas, our Chairman and CEO and Kirk Lusk, our Chief Financial Officer. I will now turn the call over to Bruce.

Bruce Thomas Lucas

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

Thank you, Joe. I would like to welcome all of you to our second quarter 2018 earnings call. Before we begin the call, I'd like to thank all of our employees for their dedication to our company. The second quarter was marked by unmodeled severe weather events across our portfolio with losses in excess of \$14 million. These additional losses were the primary driver of our reduced earnings this quarter.

Additionally, we strengthened loss reserves by \$12.6 million, primarily related to litigated claims in light of the Federated National and Homeowners Choice decisions regarding attorney fee multipliers. We take a conservative view of loss reserves and are typically one of the first companies to react to adverse changes in the Florida claims environment. Absent severe weather losses and a one-time increase in reserves, we were on track for a very solid quarter well ahead of expectations.

I have several positive developments to report. Two-and-a-half years ago, we decided to de-risk from the Tri-County region, given the growing water fraud crisis in that area. Our TIV has considerably decreased over this time and the Tri-County personal lines represents only 6% of consolidated total insured value. Heritage is well-diversified and only has approximately one-third of our total consolidated TIV in the Florida market.

As we have moved away from the Tri-County, the number of newly reported claims and losses has steadily declined. Current claim and lawsuit inventories are at three-year lows and the percentage of these claims and lawsuits related to the Tri-County are at all-time lows. As our Tri-County policies in force are reduced, our open claim and litigation inventory will continue to trend lower and reduce reserve volatility. We believe that we have worked through a lot of the claims tail related to Tri-County claims that began in early 2015 and we believe that our loss ratios will continue to improve.

We had another strong sales quarter. During the quarter, 47% of new business policies were originated outside of Florida. Our footprint continues to expand away from Florida, which should help to reduce claims volatility and reinsurance pricing. Policy sales continued to grow at record numbers and increased 54% year-over-year. The increase in sales correlates to an increase in premiums in force, which jumped 66% year-over-year to \$930.5 million. We also plan to implement two new strategic relationships this year, which we believe will meaningfully increase revenue.

Finally, our Contractors Alliance Network is now operational in the Southeast and Northeast and will be operational in Hawaii this year. CAN will now be able to respond to catastrophe events in all three geographic zones and reduce our retained losses.

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

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Thank you, Bruce. Good morning. Net income for the quarter was \$2.4 million and was down from \$6.6 million reported during the second quarter of 2017. The main driver of the variance and also the deviations from expectations are due to weather losses and reserve strengthening. Due to the significant impact that these items had on the quarter, I would like to address them first.

The net loss ratio was 59.3% for the second quarter of 2018 compared to 50.9% for the second quarter of 2017. The impact of the weather-related losses and reserve strengthening impacted the net loss ratio for the quarter by

14.8 points. The loss ratio was partially mitigated by profitability arising from the utilization of our vertically integrated affiliate, Contractors Alliance Network. We have a geographically diversified portfolio that yields many advantages. However, with that diversification, we will occasionally be hit by severe isolated storms.

With respect to reserve strengthening, we have continued to evaluate our reserves to ensure that they are adequate and appropriate. One area that we have continued to focus on and to evaluate on an ongoing basis is litigated claims in the state of Florida and, in particular, the Tri-County area. Although we believe that we have the fewest litigated claims amongst our peer group, we felt that it was necessary to increase our reserves due to the judicial environment in the state.

Of the prior period development taken during the second quarter, about 90% was due to litigated claims. We have taken and continue to take actions that we believe will mitigate the future detrimental impact that litigated claims have upon the company. Those actions include the reserve strengthening in the quarter as well as our hiring of 16 attorneys to bring all litigated claims in-house.

In addition, we took actions in 2016 to reduce our exposure to the Tri-County area, which typically comprises approximately 80% of the litigated claims. We will continue to evaluate our exposures and reserve position and to take the steps necessary to limit the impact on future periods. Operating income was \$8.2 million for the quarter, which was down from \$13.1 million as of the second quarter of 2017.

Looking at the top line, gross premiums written are \$264 million, which is an increase of 66% or \$105 million from the second quarter of 2017. \$89 million of the increase was from NBIC and \$15 million was from the legacy Heritage portfolio. Gross premiums earned were \$231 million, which was up \$79 million year-over-year.

Net premiums earned increased from \$90 million at 2Q 2017 to \$111 million at the second quarter 2018, which is a year-over-year increase of 23%. Ceded premiums increased from \$62 million to \$120 million, reflecting the addition of the catastrophe reinsurance programs for NBIC and the various quota share programs on its portion of the business.

Correspondingly, the consolidated ceded premium ratio, as measured against gross premiums earned, increased to 51.9% from 40.6% in 2Q 2017 and from 41% from year-end 2017. Excluding NBIC, the ceded premium ratio was 37% and down from the prior year of 41%. This reduction in ceded premium reflects the reinsurance synergies related to portfolio diversification and exposure management.

The net expense ratio decreased year-over-year from 41.8% at 2Q 2017 to 39.4% at the second quarter 2018. Ceding commissions of \$18 million were offset against acquisition costs and operating expenses in proportion to the expenses associated with the production of business. Our combined ratio for the quarter as a percentage of net premiums earned was 98.7%, which is up from the 92.7% as of Q2 2017. The increase reflects the losses, as previously discussed.

Moving to the balance sheet, shareholders' equity at June 30, 2018 increased to \$386 million from \$380 million at the end of 2017. The change predominantly reflects the year-to-date net income, offset by the tax-effected change in net unrealized investments, dividends to shareholders, and repurchase of a portion of the convertible notes.

Book value per share is \$14.98 per diluted share, up from \$14.67 per share at year-end. Total invested assets increased \$22 million for the quarter, mostly driven by the receipt of reinsurance recoverables related to Hurricane Irma claims.

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] Our first question comes from John Barnidge of Sandler O'Neill. Please go ahead.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Thanks. And I dialed in like a minute late, so I apologize if you already said this. But what were cats and reserve development independent of one another? I know in the press release it's at \$14 million, but could you break that out cats and then development and then geographically where were your cats located?

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

A

Yeah. The cat portion was about \$14 million and primarily related to hail events, some development up in the Northeast on winter storms. The development – not really development, it's really reserve strengthening as we view it just kind of looking at what the litigation environment looks like in Florida, we want to be ahead of that. We added about \$12.6 million in additional reserves.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Okay. And then, with Narragansett being added on, there's more scale that's obviously going to be occurring over time, but your expense ratio sequentially actually bumped up almost 7 points or right around there on a net basis. Can you talk about maybe what you're seeing there? On a gross basis, it was up 4 points.

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

A

Yes. Yeah, there's three items, in particular, I'd like to address there. One is there was one-time personnel related charges of about \$3 million in the quarter. There is about \$1.5 million worth of expenses associated with volume and bringing in personnel and you'll see this, our written premium is up associated with that. And then the other, it really has to do with some of the personnel we're bringing in to handle litigated claims, boosting the claims operation and the integration aspects with NBIC. So, that's about \$2 million right there.

John Bakewell Barnidge
Analyst, Sandler O'Neill & Partners LP

Q

Okay. Non-other operating expenses, we hadn't seen that in a while and it showed up, \$542,000 in the quarter, what was that about?

Kirk Howard Lusk
Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Oh, yeah. That's the debt on the extinguishment of some convertible debts.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Okay. Last question and I'll re-queue. With shares trading where they are, I know the previous quarters you have been pretty active buyers of your own stock, but weren't this quarter that I at least saw. Can you talk about that maybe?

Bruce Thomas Lucas

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

A

Yeah. We were not terribly active in buying back the stock during the quarter because we've retired \$10 million of the convertible bonds that were outstanding. We look at the convertible bond as an unfortunate feature of the bond when you're in the money on the option. As your share price goes up, there is a short interest that grows against the share price that caps you. So, you actually get better long-term value retiring the coupon, getting rid of that principal amount and having the short covered. And so we did allocate \$10 million and rather than put it into a share repurchase, we did it in the form of a bond repurchase.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Okay, great. I'll re-queue. Thank you.

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

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yeah. Thank you. Good morning.

Bruce Thomas Lucas

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

A

Good morning, Mark.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Of those expense items, the \$1.5 million related to the new premium. I presume that sticks around if you continue to grow the top line, is that fair?

Bruce Thomas Lucas

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

A

Yes.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then the \$2 million for, I guess, the new legal staff, that sticks around as well, is that correct?

Bruce Thomas Lucas

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

A

Yeah. A portion of that will, yes. There's a portion of it that will not, but the good portion of that will, yes.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. And then could you talk about your reinsurance program, what do you anticipate in terms of cost on the new program and how did it come together compared to what you had targeted with the NBIC acquisition?

Bruce Thomas Lucas

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

A

Do you have those numbers?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

The cost came in – and first of all, the synergies came in in line with our expectations, it was about \$15 million of reinsurance synergies that were realized on the 2018 program. We weren't really sure how to put in the cost going into 2018 for reinsurance. There was a lot of speculation that rates would go up 20%, 30%, some people said flat. We actually came in risk adjusted for 2018 at about a 0.4% decrease in costs. So, we did pretty well in the diversification and our program helped that out tremendously. If you're looking for a net spend, then I'm sure we can get you that dollar amount.

Bruce Thomas Lucas

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

A

Yeah. And again, it's reflective of the – when you look at the ratios dropping from 41% ceded down to 37%, that really is indicative of the savings that we're seeing. If you were to back out the net and gross quota shares from NBIC, which have a tendency to distort that ceding commission, it's going to be right around the 37.5%, 37% range. So, therefore it's going to be in line with that. So, that gives you an idea of what the savings on that reinsurance program is for the synergies.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

You got something in terms of dollar spend annually or sort of on a quarterly basis, your reinsurance costs are \$120 million roughly in the last couple of quarters. Is that going to change much on a go-forward basis?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. It'll drop a little bit over where it was previously.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Maybe \$115 million?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Just hold on a second, I will get you the number.

Bruce Thomas Lucas

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

A

Hold on a second while he scrolls to that page.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. And then I think you said \$15 million of the increase in gross premiums written was in the legacy Heritage portfolio. Could you talk about your voluntary production trends?

Bruce Thomas Lucas

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

A

Yeah. So, we are seeing increased production across the Heritage portfolio. We are launched in the Southeast. We're in Georgia, Alabama, North and South Carolina and Florida. Production increases have been pretty steady across the board. We are hitting record new business volumes in Florida and that new business by the way is outside of the Tri-County, and that's the key with us.

I mean we really looked at where the AOB problem is, where it's going and that analysis actually started before we even founded the company. We were one of the first companies to predict it would be an issue. It certainly blew up a lot more than us and others thought it would. But once we saw that increase in 2015 in AOB, AOB lawsuits, et cetera coming out of the Tri-County, we reacted immediately. We shut down production two-and-a-half years ago.

We've been heading that book of business with some pretty significant rate increase. We've been doing some selective non-renewals. We've been dropping our TIVs in force there. And that has an overall impact on your top line premium because those are the highest premium per policies in our portfolio. But despite that, we've been growing outside of the Tri-County in record numbers offsetting a lot of that attrition that we've been getting.

So, it's worked well from a top line number for us. We're getting a nice hedge in production elsewhere, a good diversification for us, but most importantly, Mark, it has helped us to get way ahead of the Tri-County fraud tail, and every company in Florida whether they're going to tell you this or not, they have a big tail in their book related to Tri-County claims and adverse development. Our approach to it is a lot different. We looked at it and said, stop the problem now, two-and-a-half years ago, don't write any more business, leave that book off and let's get ahead of this issue.

So, we're sitting here today with a open inventory of claims in the Tri-County that are at three-year lows when the problem first started. We are at an open inventory in lawsuits that are down 60% year-over-year and are also at three-year lows. And then the percentage of open claims that we have in Tri-County are at record lows, which tells me that we are much closer to resolving the tail of these claims that come through than other carriers in Florida. And so to be able to grow the top line the way we've done it and reduce the claims that we see there has been – I think is incredibly positive for the company.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then a final question, what do you see in terms of potential rate increases both in Florida and the NBIC footprint?

Bruce Thomas Lucas

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

A

NBIC rates are pretty stable. I think we have a rate increase coming through roughly of a couple of percent, maybe North Carolina goes up upper single-digit kind of range. At Heritage kind of legacy portfolio in Florida, we applied for and received 14%. And those are in place and being renewed with pretty sticky retention rates. That's the one good thing I can say about the Florida market is that, you are able to get rate here, and that does help counteract some of the volatility you're going to see in claims in future quarters.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Thank you.

Q

Bruce Thomas Lucas

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

Thanks, Mark.

A

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

I think you can look at the ceding commissions being about \$115 million.

A

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Okay. Thank you very much.

Q

Operator: Our next question comes from Matt Carletti of JMP. Please go ahead.

Matthew J. Carletti

Analyst, JMP Securities LLC

Hey, thanks. Good morning.

Q

Bruce Thomas Lucas

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

Hey, good morning, Matt.

A

Matthew J. Carletti

Analyst, JMP Securities LLC

Bruce, I – good morning. I just wanted to follow up on a comment you made in your opening remarks. I think I heard you right that you mentioned some point coming up two new strategic relationships that will significantly increase revenue and while I know you can't tell too much, can you give us a little bit of color on what the nature of those might be? Where they might be located, kind of the magnitude of volume that's associated with them? Or did I just not hear you right?

Q

Bruce Thomas Lucas

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

No. You heard me right. We do have two new strategic relationships. We will announce them as soon as we buy in the first policy. I can tell you that one of the relationships is, let's say, a top one or two auto writer in the United

A

States, and the other one is probably top five. And so, I don't want to get too far ahead. I want to make sure that any comments we make are approved by our partners before I make them.

But the upside potential on these is massive. It's bigger than anything else we have in our portfolio. So, we're really looking forward to these new partnerships that are launching this year and we've already got training in place and launch date's kind of set. And it looks like they're going to launch here in the third quarter. These are going to be big drivers of growth for us for future years.

Matthew J. Carletti

Analyst, JMP Securities LLC

Q

Okay. Given kind of how you describe those will be right to think of these as national or multi-state sort of relationships or would they be more [indiscernible] (22:14).

Bruce Thomas Lucas

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

A

Yeah, multi-state relationships.

Matthew J. Carletti

Analyst, JMP Securities LLC

Q

Multi-state relationships.

Bruce Thomas Lucas

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

A

Yeah, multi-state relationships for sure. And there's a third one we're close to as well, but that one hasn't been inked yet.

Matthew J. Carletti

Analyst, JMP Securities LLC

Q

Got you. Great. All right. Thank you for the color, and best of luck.

Bruce Thomas Lucas

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

A

All right. Thank you, Matt.

Operator: Our next question comes from Arash Soleimani of KBW. Please go ahead.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. Just wanted to continue on Mark's question on the rate increases, so I know you have the 14% in Florida, but to the extent that you're getting more renewals outside the Tri-County, is the effective rate increase coming in actually below 14% since I'm assuming the higher rate increases are in Tri-County?

Bruce Thomas Lucas

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

A

No. We spread it across the board. Actually, the Tri-County rate increases were fairly consistent with the rest of the state. So, you've got to remember we've been extremely proactive over the last two-and-a-half years in increasing rates in Tri-County because we predicted that the AOB problem would worsen.

A lot of people kept their rates low and continued to buy in policies and to this day are still doing that, if you can believe that. So, the fact that we raised rates so much down there over the past couple years means that the rate gap on this last filing was sort of in line with the rest of the portfolio. That's a good trend. We like that sign.

The only thing that we don't like is the litigation environment. And if you look at some of the decisions against some of our peer carriers where you can go to court on a \$19,000 roof claim and end up paying cost and attorney fees of \$700,000 or \$800,000 to the plaintiff counsel, there is something incredibly upside down with what's going on in the legal environment in Florida.

We view that as the number one risk factor in the Florida market, end of story. What investors in my opinion should be looking at more than any other metric, number of open lawsuits and number of open lawsuits in Tri-County and then just number of open claims in Tri-County. Those three stats will tell you whether that company is going to outperform or underperform for the next five years.

And our strategy is to get ahead of these things to resolve these lawsuits, resolve these claims quickly, problems don't age well, and our actuaries will tell you that as well. And when you see a sudden change in the legal environment like we saw recently on those two decisions that came through, you have to make adjustments to your portfolio and get ahead of that. And that's what we did. It's painful, it sucks to have a quarter where you're coming in way below what your own internal guidance was.

Had it just been the increase in reserves primarily related to 2Q, that would be one thing if the miss wouldn't be that great, but when you couple it with some cat losses, I mean that's just a one-two punch that unfortunately hurt our earnings a lot, but yet I'm not going to sandbag the reserve analysis to try to get a better quarterly number. I'm just going to do what I can to get ahead of the problem, so that we're through the tail and moving forward. And I think that's the best long-term play. It's a lot better than putting up lawsuits with almost no reserves and acting like the problem doesn't exist.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And can you remind me when the 14% went into effect? And then looking ahead, do you anticipate taking another sizable rate increase? And if so, do you expect the regulators to be on-board with that as well?

Bruce Thomas Lucas

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

A

Yeah. I mean the – my hat's off to the Florida regulators. They're doing an incredible job. They're doing everything they can to help companies. They're aware of the problem. I mean there's limitations to what they can and can't do. I think they're little overly criticized in my opinion. But the one thing that they've been good at, they have not taken a hostile approach to required rate increases and they've been focusing on insurance company solvency.

So, our rate increases on the voluntary side, roughly 14%, that effective date was August 1. And then we had roughly a 14% rate increase on the take-out business and that effective date was 05/15 of this year. So, that's already well in place right now. And I can't tell you about future rates because we haven't done the actuarial analysis yet.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then just some questions on gross Irma losses, can you remind us what the original gross loss was and where it stands today?

Bruce Thomas Lucas

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

A

Yeah. I think we've put a number up without any claim experience. We just took an average of AIR and RMS and that was somewhere in the upper-500 millions. And today it's between \$700 million and \$800 million.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And you have the number of claims to date and how many of those are paid versus unpaid?

Bruce Thomas Lucas

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

A

Yeah. Our open claim count is somewhere in the neighborhood of maybe a couple of thousand claims, it's pretty much close and that's probably on a top line number of 34,000, 35,000 claims. And we do not count reopens as a separate claim where a lot of companies do. So, if you had 10,000 reopens, for example, in a hypothetical, we'd actually have 45,000 claims related to Irma, but we only reported as one claim even if it reopens. So, if you want to go look at it kind of apples-to-apples with how a lot of other players do in the market, I'd say we closed 98% of our claims, something like that.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And are you still seeing a lot of claims coming in and if so, are most of those – do most of those have attorney involvement at First Notice of Loss?

Bruce Thomas Lucas

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

A

Yeah. We're still seeing some new claims come in and that tail trickles off over time. Right now, the attorneys are out trying everything in their power to mine claims, they're going door to door, they're advertising everywhere. It's quite the racket. So, yeah, new claims are coming in, you do get reopens and you – what we have seen is that a lot of the new and reopened claims that are coming in are related to Tri-County.

And I looked at a stat, it's a few months stale, so I don't have an updated number for you. But call it three, four months ago, I looked at all claims reported and what percentage by county was represented by a PA or an attorney and Dade and Broward were like, 35% to 40% of all claims were reported by a public adjuster or an attorney and the rest of the state was like 5%.

So, it tells you where the problem is. You're seeing the same fraud on reinsurance-related recoveries that the Florida market has been seeing on water-related claims, but the numbers continue to trickle down. That's a good thing. And the fact that we started de-risking two-and-a-half years ago in the Tri-County means tail problem on this won't be as big as a lot of other players.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And in terms of the reopens, do you have any stats for what percentage of claims are reopening or any...

Bruce Thomas Lucas

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

A

Yeah. I mean, the problem with tracking reopens that way is that you could reopen for an administrative reason. You could reopen to drop an estimate into a claim. You could reopen to reissue a check that had expired. I mean there's hundreds of reasons why a claim would technically reopen. We just track them [ph] as reopened (30:19). So, I don't – I can't give you a good number right now. I'd have to actually spend a lot of time digging through the data to figure out the cause of the reopen, but we've probably had a couple thousand maybe real reopens, 1,500, that's just a guess.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And can you provide by any chance the average severity for claims closed with payment?

Bruce Thomas Lucas

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

A

I don't have that in front of me. And we have commercial residential and it skews the number quite a bit.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. That's fair. In terms of – I know you guys use the CAN network obviously to help generate some extra income there. When you have the discussions with the reinsurers, do you get any pushback from them or is it positive feedback? I'm just curious how they look at that.

Bruce Thomas Lucas

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

A

Yeah, I mean, we've got nothing, but positive feedback. I mean, CAN is going in and doing repair work at a substantial discount to what an AOB would be. And if you can get out to a claim quickly and get the customer signed up into the repair program, you're going to save a lot of money. You're going to save a lot of AOBs and PAs, and attorney's fees and where you also see a corresponding reduction in loss adjustment expense.

I guarantee you would – I'd put \$1,000 on it. We have the lowest loss adjustment expense in Florida. We are under 10%. I had some Lloyd's syndicates come through here the other week, I asked them what they're seeing as the average LAE ratio in Florida, and it's like 25% to 30%. So, CAN saves a lot of money on these cat costs.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And are you able to disclose in the quarter the impact that any kind of – any work that CAN performed related to Irma? To what extent it benefited the loss ratio this quarter?

Bruce Thomas Lucas

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

A

Yeah, I mean on – we don't really break down those types of numbers because we do guard CAN quite a lot because it's the one thing that we have that nobody else does. But I can tell you that repair work on CAN actually – I mean it's in a trickle mode at this point. I mean Irma was 10 or 11 months – 11 months ago now. So, most of that repair work related to Irma has kind of washed through where we're seeing benefits today or on – the repair side is on the daily claims. And that's just something that we do systemically.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And in terms of the growth outside Narragansett and the legacy Heritage book, to what extent was that exposure was rate driven?

Bruce Thomas Lucas

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

A

You had some rate-driven changes, but you also had – because we did get rate increases like everyone else. But you got to remember we lose a tremendous amount of top line revenue because we're not writing in the Tri-County and we continue to de-risk there. We dropped 17% year-over-year in TIV in the Tri-County alone.

And the average premium down is a \$3,000, maybe even \$3,500 of policy whereas if you're writing a policy in Jacksonville it's probably around \$800. So, the fact that our top line continues to increase despite de-risking in the Tri-County is pretty impressive and it just goes to show you how diversified the footprint is becoming and it's accelerating in all of our new states in the Southeast.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And what's driving that acceleration because I know the new partnerships you're talking about haven't gone into effect yet, so what's the main driver in 2Q, for example?

Bruce Thomas Lucas

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

A

Well, I mean, it takes time in new states to get your ground game in place to market to agents. I know that our new system enhancements have been really critical. It makes it easy to buy in the policy, buy in the policy with us in under a minute. And so, the agents do love that. We rolled out Georgia. We rolled out Alabama, South Carolina. Those things are helping to drive growth.

In North Carolina, we're absolutely killing it. And the beauty of North Carolina is we're not really writing a whole lot on the coast. Its inland business and everyone said that would be impossible. But I mean the ratios inland to coastal, I mean inland premium is like five times higher in terms of volumes. So, we're dialed in. Our rates look good. Our system's good. We've got our ground game in place. It's working very well for us. And we're gaining a lot of traction in other areas of Florida that are just far away from the Tri-County.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And in terms of the reserve strengthening, which accident years were those from?

Bruce Thomas Lucas

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

A

A lot of those related to 2Q, right?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah, that was 2Q, it actually was throughout predominantly 2015, 2016.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And in terms of the – I apologize if you mentioned this already in the prepared remarks, but in terms of the quota shares, did you make any changes to Narragansett's quota share?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yes. We dropped the gross quota share from about 10%, so that will have an impact on the ceding commission and also on the ceding premium.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And just given the cats this quarter, I mean does that change the way you think about reinsurance? Would you want to, I guess, implement like an ag cover or anything to reduce the volatility there? Just curious how you're thinking about that.

Bruce Thomas Lucas

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

A

Well, we do have an ag cover at Heritage, but these were – none of them pierce through the retention. And so, yeah, we're going to think about – I mean, this is unusual. I think the most we've ever had in cat losses in the second quarter is usually we're seeing a couple million bucks. And so you get a couple of hail events and you've got a portfolio there, it's going to hit you. There's just nothing you can do about that.

We have a pretty robust net gross quota share program in place in Narragansett Bay along with an aggregate program that's very robust, but it's not going to pick up all the losses and remember first quarter losses were records. And there is sliding scales in the quota shares et cetera. So, I mean you have really, really tough weather events in the first quarter. It responds really well to it and it did certainly last quarter.

But you're not just going to get dollar for dollar coverage for all these losses and if things escalate and get a little bit worse, you're going to have to – it goes toward your retention amount. That's the one thing you get when you have a diversified portfolio, you're more open to frequency events. But overall, when you compare the reinsurance savings that you get by being diversified, less risk, less volatility that you typically get over time versus isolated severe convective events, it's definitely better to be diversified than to have all your eggs in Florida, particularly in the Tri-County.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Exactly. And to what extent does your retention change given the quota share change that you made in Narragansett?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

10 points.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay. And can you – and I think you had mentioned some comments in terms of additional legal fees and such, what about with the integration of NBIC? I think Kirk said that was \$2 million. So, is that something that will be a recurring, I guess, expense for a few quarters or how does the integration cost work going forward?

Q

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Yeah, yeah, a good portion of that will continue for a period of time and then again some of it is actually staffing, so that will continue also.

A

Bruce Thomas Lucas

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

We have big growth plans for NBIC and you're going to grow it, including new states and new partnerships. We launched some new lines that just went live recently up in the Northeast. You got to have the bodies to generate the growth and there is a lead lag to staffing and production. If you try to get the production before you get the staffing, you're going to fall flat on your face.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay. So, you're basically just putting the infrastructure in place for the future growth, so that you're...

Q

Bruce Thomas Lucas

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

Yeah, [ph] we will (39:16). Yeah. And we've been – remember we've been expanding Contractors Alliance Network up there, et cetera, so there is G&A expenses that come along with growth, but then you get the return for it in future quarters.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay, perfect. And maybe just a comment on your M&A thoughts and any kind of change in your M&A appetite or what you're looking at going forward.

Q

Bruce Thomas Lucas

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

Yeah I mean we did look at an M&A transaction, I'm under an NDA, so I can't disclose names or anything like that. We walked away from it. We were just not – we just didn't feel comfortable with the purchase price versus what we saw. And the sellers on their part weren't comfortable with where our purchase price came in.

A

So, the two parties just couldn't align on that; that happens all the time. I've probably looked at 20 or 30 different M&A opportunities, we have done two. And so we're going to be pretty selective. We got a model, the model

works. We're going to stick to it and if something comes along in the future that kind of fits within that box so be it and if it doesn't, I think we have to be disciplined.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. Perfect. I know I asked a lot of questions, so thanks for all the answers.

Bruce Thomas Lucas

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

A

Of course. Thanks, Arash.

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

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

I would like to thank everyone for joining the second quarter earnings call.

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

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