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Heritage Insurance Holdings, Inc. (HRTG)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Joseph R. Peiso

Vice President, Compliance, 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.

OTHER PARTICIPANTS

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

James Naklicki

Analyst, Citigroup Global Markets, Inc.

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 First Quarter 2018 Financial Results Conference Call. My name is Andrea, 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's 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 comparable 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 first quarter 2018 earnings call. Before we begin the call, I'd like to thank all of our employees for their dedication to our company. I am very pleased with the progress we are making on our consolidated business plan.

We began an initiative several years ago to expand our geographic footprint, which is producing excellent results. During the first quarter, 46% of new business policies were originated outside of Florida. Heading into the 2018 hurricane season, only 31.8% of consolidated total insured value is in Florida versus 70.1% in the first quarter of 2017. The diversification of our multi-state expansion enables the company to hedge risk and earnings volatility. Our conservative reinsurance program further helps the company to hedge risk. This was particularly true in the first quarter.

NBIC's portfolio in the Northeast was significantly impacted by severe winter storm activity. The gross loss on these storms totaled over \$56 million; however, the net pre-tax retention at NBIC was reduced to just \$9 million after reinsurance recoveries. Despite record winter storms, we were able to produce a solid \$14.8 million in net income and \$24.8 million in operating income.

We continue to see improved operating metrics across the company. Our net combined ratio declined to 82.2% compared to 94.8% in the first quarter of 2017. Book value per share increased 19.1% quarter-over-quarter to \$15.9 per share. Policy sales continue to grow at record numbers and increased 50% year-over-year. The increase in sales correlates to an increase in premiums in force, which jumped 48% year-over-year to \$923.3 million.

Finally, despite persistent AOB fraud, our consolidated gross loss ratio declined to 23.4% versus 30.2% year-over-year. The decrease in the loss ratio reflects the effectiveness of our vertically integrated claims network and our decision to diversify away from the Tri-County area of Florida, where AOB fraud is particularly prevalent. We are laying the foundation for further expansion of Contractors Alliance Network in the Northeast, Southeast and Hawaii, and anticipate additional benefits once the network is operational in these areas.

The company has completed its 2019 reinsurance program. On the prior earnings call, I was optimistic about our early reinsurance placements. As noted, our loss adjustment expense ratio is believed to be the lowest in the Florida market and approximately one-third of the average expense of our peer composite.

Our unique approach to handling claims reduced expenses, which facilitated the placement of our program. We also have meaningful multi-year reinsurance coverage, which further help to keep our reinsurance costs under control. Year-over-year, our consolidated reinsurance purchase only increased less than 1% on a risk-adjusted basis. This is a tremendous result for the company.

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

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

Thank you, Bruce. Good morning. Net income for the quarter was \$14.8 million, reflecting an increase of a 148% over the first quarter of 2017. Operating income increased to \$24.8 million for the quarter, reflecting an increase of a 108% as compared to \$11.9 million for the fourth quarter of 2017.

Operating income, excluding operating income generated by NBIC which was acquired in November of 2017, was \$15.9 million for the quarter, an increase of 34% compared to \$11.9 million in the prior year period. The increase in earnings reflects the acquisition of NBIC as well as the strength of the vertically integrated business model, the geographic diversification of our portfolio, and the breadth of our reinsurance program. The net income for Q1 translates to an earnings per basic share of \$0.58, which is an increase of a 176% from the \$0.21 per share earned in Q1 of 2017.

Looking at the top-line, gross premiums written increased year-over-year by \$62 million, reflecting an increase of \$70 million due to the acquisition of NBIC, offset by an \$8 million decrease in the legacy portfolio. The decrease was almost exclusively in the commercial property portfolio. As previously communicated, management has taken actions to reduce its commercial residential exposure, and, in particular, in the counties of Miami-Dade and Broward. Gross premiums earned were \$227 million at Q1 2018, a 47% increase over Q1 of last year.

NBIC contributed \$81 million to the increase for the quarter. Excluding NBIC, gross premiums earned decreased by \$8 million, reflecting the de-risking in the commercial portfolio mentioned previously. New business production for the quarter was at one of the highest levels for the company with over \$20 million of new business premium generated in the quarter.

To provide a perspective on the shift to our geographic diversification, at the end of Q1 2018, 45.5% of the policies in force were in Florida, down from 73.7% at Q1 2017. Policies in force in the Tri-County area also dropped from 24.3% to 12.3% of the overall portfolio. Ceded premiums increased from \$62 million to \$121 million, reflecting the addition of the cat program from 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 53.3%, up from 40.3% in Q1 of 2017 and 41% as of year-end. Excluding NBIC, the ceded premium ratio was 38%, down from 40% in the prior year period. Net premiums earned increased from \$92 million at Q1 2017 to \$106 million at Q1 2018, which is a year-over-year increase of 15%. NBIC contributed \$16 million to the increase in net earned premiums.

Loss and loss adjustment expenses were \$53.1 million for the first quarter of 2018. The losses include \$9 million of incurred net losses from winter storms and \$1.9 million of prior year adverse development. Both the gross and the net loss ratios decreased from the same quarter last year. The gross loss ratio was 23.4% for the quarter, down from 30.2% in the prior year period. And our net loss ratio was 50.0%, relatively consistent with a 50.6% in the prior year period.

Excluding NBIC, Heritage's net loss ratio, as measured against net premiums earned, was 42.6%, reflecting the underwriting actions and the positive impact from CAN on loss ratio performance.

The net expense ratio decreased year-over-year from 44.2% at Q1 2017 to 32.2% at Q1 2018. Ceding commissions of \$19 million were offset against acquisition costs and operating costs in proportion to the expenses associated with the production of the business. We have received approval for rate increases in Connecticut, Massachusetts, and for the voluntary HO3 business in Florida.

Our combined ratio for the quarter as a percentage of net premiums earned was 82.2%, which was down from 94.8% as of Q1 2017 and down from 94% at year-end 2017. The decrease reflects a slight improvement in the year-over-year losses for the quarter and a drop in the year-over-year expense ratio of 12 points.

Moving to the balance sheet. Shareholders' equity increased to \$389 million from \$380 million at the end of 2017. The change predominantly reflects income for the quarter offset by the tax effective change in net unrealized investments, dividends to shareholders, and the repurchase of 115,200 shares of our common stock during the quarter.

Total invested assets decreased \$64 million for the quarter, mostly driven by the use of funds for payment of Hurricane Irma claims pending reinsurance recoveries. Reinsurance recoveries received to-date post quarter end approximate a \$109 million. The investment portfolio remains very conservative to minimize the investment risk of the portfolio.

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

QUESTION AND ANSWER SECTION

Operator: [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

Thank you, and congrats on the quarter. The ceded premium ratio of 53.3% in the quarter was higher than we're expecting. I know there are some wonkiness in 1Q, 2Q this year because Narragansett is not on the Heritage reinsurance program. But what are your thoughts on the ceded premium ratio going forward? Do you see it leveling off closer to 40% to 45% in the balance of year?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

This is Kirk. I think that probably the ratio is going to be relatively consistent quarter-over-quarter. It could because of the way that the cat XoL is coming in could have a slight reduction in it, but it's going to be minimal throughout the rest of the year. So, it's going to be I would say fairly consistent.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Okay. A real positive in the quarter seem to have been the expense ratio decline driven by the policy acquisition cost ratio being 11.5% on a net basis. What's going on there and how sustainable is that?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yes. Expense ratio, yes, it's driven a lot by the ceding commissions that are coming through. We do allocate those between the policy acquisition costs and the G&A. So, that is impacting that. Looking forward, we think that the expense ratio is probably going to be – you could uptick a little bit, but it's going to be relatively, I think, consistent for the year also.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Is there any way you could quantify the level of net premiums earned contribution from Narragansett Bay in the quarter?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Net premiums earned?

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Yeah.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. It's relatively small, \$16 million.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Okay. And then the last question and I'll re-queue. I noticed wind-only for Zephyr and Hawaii. But just to confirm in case anyone is concerned, you have no exposure to the volcano, correct?

Bruce Thomas Lucas

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

A

That's right. No exposure at all.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

All right. Thank you. I'll re-queue

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Thanks, John.

Bruce Thomas Lucas

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

A

Thank you.

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

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

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

So, the ceded premium ratio low-50s, is that what you're suggesting?

Bruce Thomas Lucas

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

A

Yes.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yeah. And then, how successful were you in generating synergies with the combined reinsurance program?

Bruce Thomas Lucas

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

A

Yeah. We were definitely successful in generating some synergies on a combined basis with NBIC. As stated, at the time of the acquisition, it'll take us two full treaties to get a 100% of the synergies because NBIC buys approximately 50% of its XoL treaties on a multi-year basis.

Those numbers are baked in. It was a great tough environment this year. I'm sure a lot of the primary companies are going to report increases in adjusted pricing year-over-year. For us, it remained relatively flat, while there is some price pressure in the market, we did have good synergies that helped to counteract that and kept our increases under control.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Right. So does the risk adjusted 1% include the synergies?

Bruce Thomas Lucas

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

A

Yes, it would.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. And then, the Contractor Network, how much of follow-through you're getting or did you get in Q1 related to the storm? Is there some element of that which you would consider nonrecurring that as we think about subsequent quarters probably some of that benefit drops off?

Bruce Thomas Lucas

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

A

Yeah. I would say probably as you get into the third and fourth quarter, you're going to see that benefit drop off unless there's another storm. But we were pretty successful in getting out to policyholders. There's a tail to that business, which is positive for us. I would expect to see that tail, kind of, wind its way down in the second quarter. I think that's probably about the right timeframe.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

And then, any numbers you care to throw with that, kind of the magnitude of the extra benefit you might say?

Bruce Thomas Lucas

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

A

No. As we said on other calls, this is our trade secret. This is what separates us from everybody else in the market. We spent five years developing it, building it, did \$100 million in revenue last year in this division. We'll let our competitors try to figure it out on their own.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Then, final question, I think you had suggested \$20 million of new business generated in the quarter. Could you give us some context for last few quarters, a year ago quarter, how that stack up?

Bruce Thomas Lucas

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

A

Yeah. We're pulling the numbers now. Those are tough tasks. I would have to get back to you on premium levels. I've got test levels. If you look at test, that was generated a year ago, it was just under \$10,000. If you look at it this year, kind of year-over-year comparison, it's over \$15,000, so up about 50% plus. So, a pretty big increase.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yeah. Is that NBIC, is that the bigger driver of that?

Bruce Thomas Lucas

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

A

Yeah. That's going to be a fair amount of it, because we obviously didn't have them in the portfolio a year ago. However, I can tell you that our Southeast sales are trending well above expectations. We're getting – absent NBIC, we are hitting record sales numbers yet again, it's been multiple quarters in a row and we don't see that trailing off at all.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you very much.

Bruce Thomas Lucas

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

A

Thank you, Mark.

Operator: Our next question comes from James Naklicki of Citi. Please go ahead.

James Naklicki

Analyst, Citigroup Global Markets, Inc.

Q

Yes. Thank you. So you had a little bit of improvement in the loss ratio year-over-year, about 40 basis points; you're getting a pretty big rate increase on the Citizens Property book, around 14%. Can we expect some improvement over the balance of the year in that loss ratio?

Bruce Thomas Lucas

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

A

It depends on weather, but we hope so. But we have it down to a pretty low level. I'm not really aware of other Florida carriers that have been consistently over five, six quarters now showing a downward trend in loss ratio. It's really a testament to our diversification strategy, the effectiveness of our claims handling divisions. They are definitely paying dividends. We hope for additional improvement, and that's particularly true once we get Contractors Alliance Network online in all of the jurisdictions where we write business.

James Naklicki

Analyst, Citigroup Global Markets, Inc.

Q

Got you. And then, on the new reinsurance contract, is your retention still going to be \$20 million?

Bruce Thomas Lucas

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

A

Yes.

James Naklicki

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thank you very much.

Bruce Thomas Lucas

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

A

That's for Heritage P&C. It's a lower number for Narragansett Bay.

James Naklicki

Analyst, Citigroup Global Markets, Inc.

Q

Got you.

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

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. Good morning.

Bruce Thomas Lucas

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

A

Good morning.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Just wanted to first confirm a couple of numbers questions. Did you say the cats were \$56 million gross, \$9 million net?

Bruce Thomas Lucas

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

A

Yes. For Narragansett Bay in the first quarter, correct.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And as Contractors Alliance, is that currently Florida-only?

Bruce Thomas Lucas

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

A

Yes.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And in the release where you said that the loss ratios would have been up if not for Contractors Alliance. So, was that a meaningful contributor or was it just like a marginal contributor and...

Bruce Thomas Lucas

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

A

It's pretty meaningful, Arash. I mean, the work that we do in Contractors Alliance Network really does help us control costs considerably and that in terms of claims handling. So, really, Contractors Alliance Network is a meaningful contributor to our loss ratio performance every quarter, it's a substantial part of our business.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then the next question I had in terms of policy acquisition cost. Can you break that down into what it was at each of the subsidiaries like Heritage, Zephyr and Narragansett?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. No, we look at it as one segment, so we don't break it down by those individual businesses.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then how – in the release, you had split \$14.3 million and \$4.7 million into policy acquisition costs and G&A, separately.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Correct.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

What determines – like, how do you allocate it between those two?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

It's almost like you can look at it – at this for example right now is about 75%-25% split for the total, it has to do with the policy acquisition costs within that entity and also the G&A percentage. So, it really is allocated in proportion to the expenses that are utilized to generate it. So, you look at expenses, our commissions, premium taxes, supplemental, all those items into the policy acquisition costs and then the G&A piece. So, it's about 75%-25% split.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And why is it that – excluding the ceding commission benefit, why is it that the G&A would be so elevated without that?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Well, part of it is – it's tough a little bit and part of it is, there are continuing investments. So, for example, Bruce mentioned the fact that we're expanding the CAN network in the Northeast. We're looking at adding some additional products up there. There are some additional expenses associated with those. So, as we go throughout the year, there will be additional investments to continue to generate additional profits and revenue going forward.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Understood. Does that suggest that like if we look at 2019 or 2020, that there would be, kind of, a decent drop in the expense ratio as some of those investments roll off or is this, kind of, like a multi-year process that we should expect to continue in terms of the investment?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. I would expect it probably to drop off some next year 2018 as they ramp up year for us where we're expanding into new stage, new products, rolling out CAN in different territories. So, there is some ramp up. I would have to look through the numbers, Arash, and try to get a firm understanding of what that projected decrease would be. And to be honest with you, I just don't have that level of detail with me right now.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Sure. Not a problem. And in terms of the Sawgrass policies that haven't been renewed yet, do those have an acquisition cost associated with them?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

No.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And in terms of the reinsurance, what was the XoL premium and the quota share ceded premium for NBIC in 1Q 2018?

Bruce Thomas Lucas

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

A

[indiscernible] (23:12) ceded premium ratios.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. Ceded premium ratios, again, like, for NBIC, it's typically up around 80% in total, that's going to include both quota shares and the cat portion, so then you can, kind of, get to where – where we get to the 53%.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

So, what was the 80% representing?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

NBIC's ceded premium ratio.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And you said the 53% was the quota share...

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

It's total. Yes, in total,

Bruce Thomas Lucas

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

A

Consolidated.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Consolidated.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And in terms of the Florida non-renewing exposure management process you've had in place, should we expect that to continue or is that process basically done at this point?

Bruce Thomas Lucas

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

A

Arash, we are – we firmly believe that AOB is not going anywhere. And I'm pretty adamant on this and have been for years. I think other carriers that are just aggressively writing in that market are making a monumental mistake. We are not writing in Dade and Broward. We do a little bit in select areas in Palm Beach [indiscernible] (24:27) but not much.

The trend in AOB is here until there is a real legislative fix and that will take years, so we are continuing to take rate increases. That does increase attrition a little bit down there, but we're seeing a remarkably high percentage of our policies sticking despite the rate increases. So, it's going to be a trickle in terms of our downward exposure. But from a risk management standpoint, it stabilizes earnings, it stabilizes reinsurance spend, it takes a lot of volatility out of the financials, and it makes us a much more stable company in the overall picture of how we're managing risk. I do believe that there is going to be some additional downward erosion in that program in the Tri-County area. And we're pretty comfortable with that. We're building our projections around that.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And does this include both commercial residential and homeowners in the Tri-Country exposure?

Bruce Thomas Lucas

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

A

Yeah. So, yes, Arash, it does. In particular, we had some incredibly high TIV policies in commercial residential that were located in the Tri-County, and I think one was Southwest. We looked at those and just said that is a lot of concentrated risk there. If one of our competitors wants to pick them up, they can have it. And so, we did let those policies go. To my knowledge, we didn't even quote on them. And so, it's just a risk management perspective.

Do I really want to have a commercial residential policy with \$700 million in TIV right down the street from another one with \$500 million in TIV, which is next to one with \$300 million in TIV? Not really. If a tornado were to spun off, off of a cat down there and hit that area, that could be pretty devastating. So, somebody else feels comfortable with that risk. I wish them the best of luck. But for us, we just reevaluated things post Matthew and Irma.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

So, is this something in terms of the premium effect like we should expect until kind of the end of 2018? Or like when do you think the exposure reduction gets to a point where you're kind of comfortable to leave the book at like a kind of run rate level?

Bruce Thomas Lucas

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

A

On commercial residential, we're there. We're comfortable with the run rate level. In Tri-County, it's really a balance of rate increases versus attrition. And if you go up 15% in rate and your attrition is [ph] axe (27:02), I mean, it's the absolute margin between it, plus you have inflation guard on that portfolio as well, it helps to kind of stabilize the premium numbers. We saw the biggest drop in Q4 and Q1, mainly because we not renewed some extremely large commercial residential policies.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And I just wanted to touch based on Sawgrass again. How much Sawgrass business from last year is still in force as of Q1?

Bruce Thomas Lucas

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

A

Let's see if we can pull that for you. \$28 million, we have about \$28 million of in force which is pretty close to what we assumed.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And the reinsurance costs, I know you've provided some detail on that. Did you say what the actual dollars in terms of the costs would have been for the new program?

Bruce Thomas Lucas

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

A

We have not. And in fact, we literally just closed on that program. So, we're going through the net costs right now that are associated with placement fees, et cetera. So, we should have better updates on what that actual spend is fairly soon. But we have given some consolidated ceded premium ratios for reinsurance. So, I think, those are pretty safe numbers to use right now.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. And then that contemplates that spend.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. Can you remind me what...

Bruce Thomas Lucas

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

A

And you know Arash, I'm a little – I don't want to make it too evident for our peers what exactly we spend versus what our tower looks like because I do believe we got best-in-market pricing, better than anyone. And the reason for that is the way we handled our cat. And our loss adjustment expense ratio to our knowledge, absolutely the lowest in the state of Florida. Then, I look at things like increased litigation in the first quarter.

There was a Sun Sentinel article that came out, that really compared the top 10 Florida writers, the average increase in first quarter litigation. We were the only one that was almost up single-digits. And if you look across that group of other top nine carriers, I'm going to say the average was around 50% to 75% increases in litigation.

So, we're handling the cat the right way on the front end, reducing the litigation, keeping LAE under control, fixing houses, keeping costs in check. That translated to – I wouldn't be surprised to see best in market pricing, I really wouldn't.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

And can you remind me what the ceded premium guidance was for the program that you put out?

Bruce Thomas Lucas

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

A

I don't think we gave it. I don't know that we give guidance. We didn't give guidance on that, Arash. We just gave guidance on the net income number.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Okay. And on the balance sheet, you guys have this line there now, accrued compensation, what's that related to exactly, I haven't seen that line before?

Bruce Thomas Lucas

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

A

It's just an accrual for payroll.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay.

Bruce Thomas Lucas

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

A

Yeah. It's just due to a timing issue.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And aside from what Kirk mentioned earlier when I asked about the ramp-up expenses with the CAN network, is there any other one-time G&A expense this quarter or is it just related to that?

Bruce Thomas Lucas

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

A

Not really. I'm struggling to think of any significant one-time G&A in the quarter. Yeah. Nothing material.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And Bruce, you've mentioned before that, obviously, you're always looking for M&A opportunities. Post-Narragansett, do you still have an appetite for M&A? And what exactly are you kind of looking for, if so?

Bruce Thomas Lucas

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

A

Yeah. We do have an appetite for M&A. And the entity that we'd look for is an entity that is providing some sort of synergy for the organization on the whole, whether that'd be a hedge against certain exposures or a production – source of production hedge, reinsurance synergies, G&A synergies, et cetera.

We are in the market and there's no doubt about that we have continued appetite to grow top-line and bottom-line of the organization. And we did a \$1 billion, zero to a \$1 billion in the first five years of operations. I have my sight set firmly on being \$2 billion in top-line in the next five years. So, we have a lot of work ahead of us. We like to set our goals very high. We've hit them consistently for years. And I like the trend of where we are right now. So, short answer is yes, but it has to be the right fit at the right price.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And last quarter, you had mentioned in terms of CAN that you'd ultimately want to try to sell that. Any progress on that front and/or...

Bruce Thomas Lucas

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

A

Yeah. Just to clarify there, Arash. What I had mentioned in the last quarter was not that I ultimately wanted to sell it, but that if the right offer did come about, we would at least entertain it. Now, CAN is a material contributor to the success of our organization. And you can credit the management team for being outside the box on how we handle claims. It's paying big for us where other people just missed it.

It would have to be a high multiple for me to sell that division, incredibly high. It's just that valuable for us in terms of hedging risk and cash flows. So, it's not that I'm looking to sell, but I've had competitors come or other companies come and ask if we would entertain offers, I've had multiple large shareholders ask the question about potentially divesting that asset. So, given the crossroads of those two, I just wanted to mention that.

We believe it has a high intrinsic value. We see it in our operations every day. We would entertain an offer if it was the right offer, but we are not actively looking to sell it because of the benefits that it provides to us currently.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

All right. Thanks. And just last question, can you remind me what the prior year development number was. I think you mentioned it earlier in the call.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

\$1.9 million.

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Q

Was that favorable or adverse?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

That was adverse.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay. And was that just accident year 2017?

Q

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

No. It actually – yeah, the majority of that had to do with Matthew and Hermine.

A

Arash Soleimani

Analyst, Keefe, Bruyette & Woods, Inc.

Okay. All right. Perfect. Thanks for the answers, guys.

Q

Bruce Thomas Lucas

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

Sure thing, Arash. Thank you.

A

Operator: Our next question is a follow-up from John Barnidge of Sandler O'Neill. Please go ahead. Mr. Barnidge your line is open.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Yes. Sorry. I was on mute. The tax rate came in a bit higher than 24% that we were expecting. Does this seem reasonable to just assume ballpark 24% going forward or should be a bit higher?

Q

Bruce Thomas Lucas

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

No, I think it's going to be higher. I would say that I think the 25.8%, 26% probably range is probably going to be pretty close.

A

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Okay. Great. And could you expound maybe on some new distribution opportunities both in NBIC Property as well as Heritage PCI, please?

Q

Bruce Thomas Lucas

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

Yes. So, John, we are filing new state applications as we speak in kind of mid-Atlantic areas. We're rolling out our commercial residential product in New York fairly soon. We are looking at some new state applications for Heritage that would partner up with some additional – our existing sources of production. We've added a lot of new independent agents into our network across the East Coast. We do expect an uptick in production as a result of those relationships.

A

On every front, we are definitely ramping up our production. 2018 will be the predominance of the buildup in terms of G&A and operations, et cetera, [ph] Asian plants (35:31), increasing that footprint. 2019 would be the big kind of growth push in terms of earned premium. We are also licensing Narragansett Bay as E&S carrier in the State of Florida. We think we can come to market with some unique products to handle the water fraud situation on an E&S basis. So, that's a process, that's well under way. It's really a multipronged approach to what we're building here.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Okay. Thank you. And then, the other revenue line item, it declined quite a bit year-over-year. Can you tell me kind of what's in there and what's a reasonable run rate to assume? And I think that's all my questions. Thank you.

Bruce Thomas Lucas

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

A

Yeah. I think probably be the current run rate is going to be pretty good. I think there was a true-up last year, which had a little bit of impact. And then, there's also, when you look at the issue this year is that the big drop is the evaluation of the equity securities, the new ASU guidance, where we do have to revalue the equities. And so, that actually impacted that number by about \$800,000.

John Bakewell Barnidge

Analyst, Sandler O'Neill & Partners LP

Q

Great. Thank you.

Operator: Our next question is a follow-up from Mark Hughes of SunTrust.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yeah. Thank you. I'm sorry. Did you say the current, that \$2.8 million is a pretty good run rate for the other revenue?

Bruce Thomas Lucas

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

A

Let me see here. Looking...

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yes. The one-time change there, the \$800,000 is a one-time event based upon what the equity is going to do. So, when you look at, we would think that it would be flatter excluding that one-time item.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

So, does that say mid-3s?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Yes. Okay. And then, if you do get these growth initiatives up and going, what is your target say for an organic growth rate in terms of premium if we look at 2019?

Bruce Thomas Lucas

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

A

Yeah. That's a good question, Mark. And there's a lot of variability in that. We had been working on kind of forward projected numbers as we look at new state expansion, et cetera. I mean, you just never know what you're going to get in a new market. I can tell you markets like North and South Carolina for us, we came in way above projections. So far, Georgia and Alabama have been a little below projection. So, it's hard to say it's a legit question. And I think we've got more work right now before we formally give guidance as to what that projected number would be. So, unfortunately, I just can't give you the detailed clarity that you're asking for right now, it's a work-in-process.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah. Then, there's a lot of factors we're trying to calculate there as far as looking at what is the impact in each of the geographies, in each one of the products and also what we think is the anticipated take-up rate. So, you were the process that you're kind of putting that all together so.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. Then, one final question. When we think about the gross premiums written in seasonality in the business, I think, we've got a historical track record on Heritage when we think about NBIC. How much of their gross premiums usually come in Q1 versus other quarters? Just kind of a refresher on the seasonality on written at NBIC?

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

The written NBIC, it actually is not that different than Heritage from a trend standpoint. It's probably a little bit lower in the second quarter, then ticks up in the third and fourth quarter where I think Heritage kicked up a little bit earlier in the year in the second quarter.

Bruce Thomas Lucas

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

A

But they're pretty close.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah.

Bruce Thomas Lucas

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

A

The percentages are pretty close.

Kirk Howard Lusk

Chief Financial Officer, Heritage Insurance Holdings, Inc.

A

Yeah.

Mark Douglas Hughes

Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. Thank you very much.

Bruce Thomas Lucas

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

A

Thank you, Mark.

Operator: This concludes our question-and-answer session. The conference has also now concluded. Thank you for attending today's presentation. You may now disconnect.

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