**Heritage Insurance Holdings, Inc. [HRTG]**
**Third Quarter 2022 Earnings Conference Call**
**Wednesday, November 9, 2022 9:00 AM ET**

Company Participants:
Ernie Garateix, Chief Executive Officer
Kirk Lusk, Chief Financial Officer

Analysts:
Mark Hughes, Truist Securities
Paul Newsome, Piper Sandler

**Presentation:**

Operator: Good day, and welcome to the Heritage Third Quarter 2022 Earnings Call. (Operator Instructions). After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Ernie Garateix, Chief Executive Officer. Please go ahead.

Kirk Lusk: Good morning, and thank you for joining us today. We invite you to visit the Investors section of our website, 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 upon management's current expectations and subject to uncertainty and changes in circumstances.

In our earnings press release and our SEC filings, we detail material risks that may cause our future results to differ from our expectations. Our statements are as of today, and we have no obligation to update any forward-looking statements we may make. For a description of the forward-looking statements and 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, earnings release and other SEC filings.

Our comments today will also include non-GAAP financial measures. The reconciliations of, and other information regarding these measures, can be found in our press release.

With me on the call today is Ernie Garateix, our Chief Executive Officer. I will now turn the call over to Ernie.

Ernie Garateix: Thank you, Kirk, and thank you for joining the call today. We'll discuss our third quarter 2022 results during this call. I will provide overview of our strategic initiatives, Kirk will provide an update on key financial performance metrics, and then we will open the call for Q&A.

Our thoughts continue to be with all those impacted by Hurricane Ian, which made landfall in Florida on September 28. We remain committed to assisting our policyholders, and I'm proud of the hundreds of employees we've mobilized and deployed to respond to this event.

Our customers have been loyal to us based on a promise to deliver service in their time of need. We are committed to fulfilling that commitment by providing timely payments of valid and covered claims. Our experienced claims team has deep catastrophe handling experience, which includes distinguishing causes of loss from wind versus flood.

We continue to execute strategic initiatives that will enable Heritage to achieve consistent, long-term quarterly earnings and drive shareholder value. Our initiatives, which are described in our earnings release, include rate adequacy and selective underwriting, product selection and capital allocation and diversification of our portfolio policies throughout 16 states.

Getting appropriate rates for our coverage offer is paramount. We continue to take rate in all our markets to keep up with the reinsurance, higher frequency of weather events and higher repair and replacement costs, driven by inflation of products and services. These higher rates are the primary driver of our 13.6% increase in the average premium per policy throughout the book. And we expect this trend to continue. We continue to derisk and diversify our policy mix outside of Florida. These efforts have led to the growth of premiums in force in all states outside of Florida. In addition, total shared values outside of Florida represents approximately 75% of our portfolio, up from 71% at this time last year.

Our underwriting continues to be more selective, and we continuously evaluate coverage changes, so our product serves our markets, but also produced margin. A considerable market disruption has caused us to tighten our underwriting criteria, while also restricting new business in our over-concentrated markets. Even with the tightening of our criteria and limiting new business, our premiums in force are a historic high of 1.24 billion at the end of the quarter.

We seek to align our capital with our products and geographies that maximize long-term returns. Correspondingly, we will exit products in states that we don't believe can generate long-term returns, or have limited upside potential. I am pleased with our progress in this area. However, we continue to evaluate our portfolio, and expect to make more changes going forward as we focus on both the short and long-term returns.

Reinsurance capacity and pricing is a factor in how we allocate capital by product and state. The cost of reinsurance is expected to increase, and capacity constraints are on the horizon. We appreciate our reinsurance trading partners, with whom we have developed a long-term, consistent relationship. Given the expecting pricing capacity for catastrophe reinsurance going forward, we will continue to evaluate and adjust our portfolio to manage exposure concentration. This includes the amount of new business we expect to write and the amount of existing business we may renew while maintaining compliance with individual state regulations.

Product selection is also key to our long-term success. As we reduce business and products or geographies that don't provide sufficient margin, we are entering markets we believe offer opportunity for our company and our customers. For example, we entered the California and Florida markets on an excess and surplus lines basis, which allows us to be nimble and responsive to pricing and product offerings. We continue to analyze and evaluate the challenging markets in which we operate, and will look to expand our excess and surplus line capabilities in other states and markets.

Despite the negative impact Hurricane Ian had on our third quarter 2022 results, we are pleased with the progress we continue to make towards sustainable profitability. Rate increases continue to meaningful benefit written premiums throughout the book of business. And we remain committed to proactively and appropriately raising rates to offset higher cost for reinsurance, as well as higher loss costs. We are taking underwriting actions to improve profitability.

This concludes my remarks. Let me now turn things over to Kirk Lusk for a review of the results in the quarter with key financial performance metrics.

Kirk Lusk: Thank you, Ernie. Good morning, everyone. The third quarter net loss totaled $48.2 million or $1.83 per diluted share, compared to a net loss of $16.4 million or $0.59 per diluted share in the prior-year quarter. This loss is primarily attributable to a $40 million net retained loss for Hurricane Ian that previously was announced on October 13, and without which our net loss and LAE for the quarter would've declined by $14.8 million or 10.6% from the prior-year quarter. The company has received close to 14,000 claims associated with Hurricane Ian, and we project ultimate gross losses, including loss adjustment expense, of $655 million. At this level, we expect that ultimate loss from Hurricane Ian will remain well within the second layer of our cat exit Bell Tower.

The third quarter was also impacted by a $10.7 million tax valuation allowance related to Osprey Re and its Internal Revenue Code Section 953D election, for which we are able to recover the valuation allowance as Osprey generates future net income.

As Ernie mentioned, in-force premiums are at their highest level at $1.24 billion, up 5.8% while policies in-force are down 6.9% and CID is up 2.1%. The increase in premiums and decrease in policy count reflects the amount of rate earning to the portfolio and tightening underwriting. In-force premiums in all states other than Florida grew by 14.4%. Policies in-force decreased by 18.8% for Florida admitted personal lines policies, while personal line Florida in-force premium was down 7.8%, we grew our commercial lines premium by 18.2% over the prior-year period. The increase in our commercial portfolio, while decreasing our personal portfolio in Florida, results from our effort to shift capital to those lines of business and geographies that generate sufficient returns, and away from lines that do not.

Total revenue for the quarter declined 1% from the prior-year quarter, reflecting the increase in ceded premium of 12.4%, exceeding the increase in gross earned premiums of 4.2%. The ceded premium ratio ended the quarter at 48.1%, up 3.3 points from 44.8% in the prior-year quarters. The increase primarily stems from higher costs of our 2022 to 2023 catastrophe excessive of loss program. The increase in this program was driven by higher rate online, as well as higher total insured value.

In addition, other income is down due to reduction policy (inaudible) associated with fewer policies in-force, which is partially offset by an increase in investment income with higher interest rates.

The net current accident year weather losses of $63.8 million ended the quarter at 24.2% from $51.4 million in the prior-year quarter. As mentioned, current accident catastrophe weather losses included $40 million of net current accident quarter catastrophe losses attributable to Hurricane Ian, up 150.5% from $16.0 million in the prior-year quarter, and $23.8 million of other weather losses down 32.8% from $35.4 million in the prior-year quarter. Attrition losses were also up slightly in the quarter, most notably in the Northeast.

Expenses are up due to acquisition costs related to the increase in gross written premium, with a net expense ratio driven higher by reduction in net earned premium.

The net combined ratio for the quarter was 133.3%, up 20.8 points from 112.5% in the prior-year quarter, driven by higher net loss ratio and net expense ratio just mentioned.

Our focus on profitability will continue to drive reductions in policy counts, along with rate increases anticipated to line with inflation, reinsurance and loss costs.

Abuse of litigated claims practice as inflation continued to be our primary concern for first lines business in Florida, and we have taken underwriting actions aimed at reducing the adverse impact of market challenges and inflation. We're also restricting underwriting to address the surge in policies as certain markets are becoming more dislocated. We're also including inflation guard on all states.

Our book value per share is $4.54, but when adding back the unrealized losses in the investment portfolio, the adjusted book value is $6.65. With over $297 million in cash and cash equivalents, we don't anticipate a need to sell any of these investments in advance of maturity with the abundant cash held outside our investment portfolio.

Our duration is short at 3.4 years and the average credit rating on our invested fixed asset income portfolio is A-plus. As such, we expect the unrealized losses to decline as investments mature.

We operate by design into very challenging markets, and are focused on generating an underwriting profit and remain unfettered in that pursuit. We will continue to analyze and evaluate our portfolio and optimize returns and reduce volatility. We are dissatisfied with our stock price, and do not believe that it reflects the true value of the company.

We firmly believe that each of our current operating companies are worth more than the total market capitalization of the company. Management Team and the Board are committed to providing shareholder value, and will take the steps necessary to drive that value. We remain focused on sustainable profitability and long-term shareholder returns. As I have stated before, we will consider all options to realize the value of our entities, and will also take the actions necessary to improve margins.

That concludes our prepared remarks. Operator, we are ready to begin the question-and-answer portion of the call.

**Questions and Answers:**

Operator: Thank you. We will now begin the question-and-answer session. (Operator Instructions). Mark Hughes from Truist.

Mark Hughes: Kirk, how much did you say how much cash is the holding company?

Kirk Lusk: $30 million.

Mark Hughes: And then what is the surplus within the insurance operations?

Kirk Lusk: Yes, the total surplus is between all entities is $261 million.

Mark Hughes: Then how do you look at the capital adequacy in terms of underwriting leverage? $261 million, how much more business would you put on, or the idea from here that you can taper? I guess you've continued to grow premiums, so continue growing commercial in Florida. How do you view that capital adequacy?

Kirk Lusk: Yes, I think when we look forward, our [PIP] count, we anticipate that is going to continue to decrease. And we are taking substantial rates on top of our inflation guard factors, and that really is what's driving our premium increase. When we look at going forward, we actually think that our PIP count is going to continue to decrease. And I think our exposures are probably going to be leveling off a little bit.

Mark Hughes: And then for reinsurance, refresh me on how much multiyear reinsurance you have in place. How much of your tower will you have to buy this year and next year?

Kirk Lusk: Yes, we do have a cat bond for the Northeast tower, and that would be the extent of our multiyear.

Mark Hughes: So most of your spend will be -- you'll hit the market in --

Kirk Lusk: Yes.

Mark Hughes: -- for the (inaudible)?

Kirk Lusk: Right.

Mark Hughes: And then anything -- any expectations for the Florida legislative session? Any particular fixes or strategies under discussion, as far as you're aware?

Ernie Garateix: So we have been discussing with legislators the one-way fee [statue] and doing something on the cat fund. They're all considering all those items, but those items are being discussed now, being strategized for a special session at this point.

Kirk Lusk: Yes, I just think on just going back to the reinsurance piece is we did defer on the [wrap] program last year. So that is available for us this year, which would assist below the FHCF. Keep in mind the FHCF accounts for almost 50% of the reinsurance program.

Mark Hughes: Thank you.

Operator: (Operator Instructions). Paul Newsome from Piper Sandler.

Paul Newsome: Did you talk at all about -- or say what the RBC ratios were in the subs, or did I miss that? I apologize if I did.

Kirk Lusk: Yes, at year-end, RBCs for HBCIC was just a little over 310; Zephyr was in the 440 range; and NBIC was in the 420 range.

Paul Newsome: And that's as of last year's year-end times and --

Kirk Lusk: That's as of year-end. It is calculated kind of on an annualized basis based upon -- it's a 12-month rolling basis. So that's why we look at where it was versus the surplus.

Paul Newsome: Right. But presumably, those numbers will be different in the fourth quarter, given the losses?

Kirk Lusk: Yes, given the losses, we anticipate -- Zephyr is still going to be well above 400; NBIC and Heritage, we are looking to provide them with some additional cell phone or expense forgiveness in the fourth quarter. So that is already planned and in our expectations.

Paul Newsome: Could you talk about what would happen if Hurricane Nicole ends up being a significant from a reinsurance perspective? Is it very much the same as what happened under Ian, or does it have other changes?

Kirk Lusk: Yes, I think from a retention standpoint, our retention, [max] retention on a second event would be $32 million. Anything over $20 million, we basically have it covered, it's $0.40 on the dollar. So even at a -- $30 million, it would 26; $40 million it would be 32, and that would be the extent of our retention, so depending upon the severity of that particular storm.

Paul Newsome: Great. Did you talk at all about the difference in profitability between Florida and non-Florida? How much of a difference is it in profitability?

Ernie Garateix: Yes, we're talking about -- we look at ourselves as a single segment from a reporting standpoint, so therefore, kind of look at it in totality. I'd tell you that our objective is to become rate-adequate across the footprint, and that is in every state, every jurisdiction and every product. And so that's when you look at the extensive amount of rate we've been taking both in the Northeast and the Southeast, and also a little bit in Hawaii. That is reflective of that goal to basically focus on rate adequacy.

Paul Newsome: Any thoughts -- I'll let this be my last question -- about what level you're currently getting in terms of rate respectively versus what you think the claims inflation is on the business? It seems like there hasn't been a lot of makeup in the difference, but inflation's been remarkably higher than from these price increases in the last couple of years. So where are you, in your view, in terms of what you think the underlying claims inflation is versus the (inaudible)?

Kirk Lusk: Yes, we actually think it would be -- when we look at the underlying claims inflation, we think it is running a little over 10%, maybe even over a little 11%. That is baked into our pricing, and then we also have inflation guard on top of that. When you look at when we start taking rate and then the compounding of that is that the initial catching-up, I think, with inflation was a little -- was slow.

But we're starting to pick around it, and when we look at the amount of rate earning through the portfolio year-over-year, it increased in 2022 from 2021. And then going into 2023, it actually is increasing substantially more than it did over the last several years. So it's really -- a lot of that rate we've been taking is starting to take effect into 2023, and actually into 2024.

Paul Newsome: Thank you all. I'll let some other folks ask questions, but always appreciate the help.

Operator: (Operator Instructions). There are no more questions in the queue. This concludes our question-and-answer session.

I would like to turn the conference back over to Ernie Garateix for any closing remarks.

Ernie Garateix: We thank everybody for joining the call today, and hope everyone has a great day.

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