Heritage Insurance Holdings, Inc. [HRTG]
Q4 2022 Earnings Conference Call
Friday, March 3, 2023, 9:00 AM ET

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

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

Presentation:

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

I would now like to turn the conference over to Kirk Lusk, Chief Financial Officer for the company. Please go ahead, sir.

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 all for joining us today. I will provide an overview of our strategic initiatives for the fourth quarter 2022. Kirk will provide an update on key financial performance metrics, and then we will open the call for Q&A.

We are pleased to announce that we returned to positive adjusted net income in the fourth quarter. We are encouraged by the strategic initiatives that we believe will enable Heritage to achieve consistent long-term quarterly earnings and drive shareholder value. These strategic profitability initiatives include rate adequacy and selective underwriting, product selection and capital allocation as well as diversification of our portfolio of policies throughout 16 states. We remain encouraged by our improving metrics and the long-term positive impact we believe it will have on our underwriting income.

We took significant rating actions throughout the book of business this quarter, resulting in an increase in average premium per policy of 18.1% over the prior-year quarter and 5.6% over third quarter 2022. These higher rates are the primary driver of our 15.5% increase in gross premiums written, and we expect this trend to continue.

Our underwriting continues to be more selective and we continue to evaluate coverage changes, so our product serves our markets, but also produces margin. The considerable market disruption this past year has sharpened our focus on timely rate actions, tightening underwriting criteria and expanding restrictions on new business written and over concentrated markets or products.

Even with the tightening of our criteria and limiting new business, our premiums in-force are up 9.6% at a historic high of $1.3 billion at the end of the year, while policy count is down.

We continue to align our capital with the products and geographies that maximize long-term returns. These efforts have led to a reduced policy count for Florida personal lines business by 16.2% as compared to the prior-year period. Our disciplined underwriting and rating actions have reduced our Florida personal lines total insured value by 11.1%, while driving a 1.9% decrease in premiums in force. This disciplined underwriting approach resulted in a policy count reduction of 2.5% in other states, while generating an 11.9% increase in premiums in force. We will continue to reduce our exposure in products and geographies that we don’t believe will generate long-term returns, or have limited upside potential in compliance with regulatory requirements.

Our focus on maintaining a balanced and diversified portfolio this quarter resulted in our top five personal line states representing 79.2% of all TIV at fourth quarter 2022, compared to 79.8% of all TIV at fourth quarter 2021. This was further evidenced by the fact that our top four states grew TIV by an average of 2.2%, while the smallest five states grew by 56.7%, with no state representing more than 26% of our total insured value.

Product selection is also key to our long-term success. As we reduced business in 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, in addition to the California market, we entered the Florida market last quarter on an excess and surplus lines basis, which we believe allows us to be nimble and responsive to pricing and product offerings.

We have since evaluated an expansion of E&S policies to include South Carolina, where we anticipate offering E&S policies in the second quarter of 2023, while we continue to analyze and evaluate E&S offerings in other states and markets.

We are encouraged by our improving metrics and the long-term positive impact we believe they will have on our underwriting income. We believe this discipline also better positions Heritage for the upcoming June reinsurance season.

Speaking of reinsurance season, reinsurance capacity and pricing is a factor in how we allocate capital by product and state. As we discussed in last quarter's call, the cost of reinsurance is expected to continue 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.

The higher reinsurance cost will be partially mitigated through participation by our Florida affiliate in a program created by the Florida legislature last year, which will provide us with some reinsurance limit at no cost to the company. We also expect to have the ability to access the capital markets through Citrus Re, which provided a $100 million limit on last year's Northeast CAT XOL program.

Given the expected pricing and capacity for catastrophe reinsurance going forward, we will continue to evaluate and adjust our portfolio to manage exposure concentration, which can drive up reinsurance costs. This includes limiting 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. We are also exiting relationships with agents who are not producing good business for us.

We are pleased with the progress we continue to make towards sustainable profitability. Rate increases continue to meaningfully 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 as well as taking underwriting actions to improve profitability.

Before turning the call over to Kirk, I wanted to express my encouragement for the recently-passed Florida Senate Bill 2A during the December Special Session of the Florida legislature. I am cautiously optimistic that it will accomplish the goals of the legislature, our governor and the state CFO to stabilize the Florida property insurance market and curtail abusive claim practices. Our strategy will remain unchanged until we see the impacts of the legislative changes in our results.

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

Kirk Lusk: Thank you, Ernie. Good morning, everyone. Fourth quarter net income was $12.5 million or $0.48 per diluted share, and up from a net loss of $49.2 million or $1.79 per diluted share in the prior-year quarter. This represents a return on average equity during the quarter of 40% annualized.

Our in-force premiums are at an all-time high of $1.3 billion, while policies in force are at the lowest level since the third quarter of 2019. Our average premiums increased 18% from the fourth quarter of 2021, and of that increase, 9.7% out of it occurred in the last 6 months and 8.6% of it in the fourth quarter alone. This shows the impact of the continued rate increases in the portfolio as well as the inflation guard factor. We expect rate increases to continue and potentially accelerate throughout 2023.

We did see an opportunity in the commercial residential market to capture profitable premiums and expand that product line. Commercial residential in force premium increased 41% year-over-year, while the policies in force increased by less than 1%.

In addition, we see opportunities in the E&S market, and are now offering E&S homeowners policies in Florida, which we expect to expand into other states. We've been writing E&S business in the State of California for several years, and it has been a profitable product due to our specific underwriting criteria and the ability to change forms and adjust rates as needed.

Gross written premiums are up 15.5% and gross burn premiums are up 8% year-over-year. Net premiums earned are only up 3.9% compared to the last year's fourth quarter due to the increase in ceded premium. The increase in ceded premium is primarily driven by the increase in the 2022 to 2023 CAT XOL program, as well as a higher ceded premium on our net quota share program in the Northeast.

Total revenue for the quarter increased 4.7% from the prior-year quarter, reflecting the increase in net earned premiums just mentioned, and higher investment income due to an increase in return, partially offset by lower other revenue, which is driven by lower policy fees associated with the lower policies in force.

Net loss and LAE for the quarter was $103.8 million, which was an increase of 4.8% over the prior year. Losses for the quarter included $10.3 million in losses from Hurricane Nicole and prior adverse development of $2.2 million. The adverse development includes net losses of $14.1 million related to Hurricane Irma. We re-estimated our ultimate losses for Hurricane Irma in the fourth quarter, recognizing most of the open claims are late reported litigated claims. As a result of that re-estimation, Heritage has exhausted the private layers of reinsurance that has 40% participation in the FHCF limit remaining. The increase in losses caused an increase in the net loss ratio of 50 basis points.

Expenses are up due to higher policy acquisition costs related to the increase in gross written premiums and benefits costs along with investments in IT. The impact of the increase in cost has increased the expense ratio by 2.3 points, of which 1.4 points relates to policy acquisition costs.

The net combined ratio for the quarter of 2022 was 96.1%, up 2.9 points from 93.2% in the prior-year quarter, driven by a higher net loss ratio and net expense ratio just described.

Book value per share is $5.13, but when adding back the $53.6 million unrealized losses in the investment portfolio, the adjusted book value is $7.23. With over $280 million in cash and cash equivalents, we don't anticipate a need to sell these investments in advance of maturity. Our duration is a short 3.2 years, and the average credit rating on our invested fixed income portfolio is A-plus. As such, we expect the unrealized losses to roll off as investments mature.

Our focus continues to be on profitability, and we expect to continue to drive reductions in policy count to manage our TIV and CAT XOL reinsurance costs, which are expected to rise. Despite the recent favorable legislative changes in Florida, we don't expect to shift our strategy of reducing exposures until we see meaningful improvements in our loss results and metrics. We expect rate increases to exceed inflation and loss cost, and will take the steps necessary to adjust rates as soon as possible to reflect any increase in reinsurance costs.

We include inflation guard in our pricing for all states to address rising loss cost due to material and labor. We continue to restrict underwriting across the portfolio to avoid unprofitable business, especially in dislocated markets, and also to keep our exposures relatively flat, given the expected tight reinsurance capacity of our CAT XOL renewal in the spring.

Our focus is on rate adequacy efficiency of CAT XOL reinsurance program, underwriting integrity, providing the right product for the market and a balanced portfolio and operational and efficiency and effectiveness. We will focus on these initiatives to provide our policies holders with the service they expect, and to provide consistent returns for our shareholders. We will continue to analyze and evaluate our portfolio to optimize returns and reduce volatility.

We remain dissatisfied with our share 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, particularly given the statutory surplus of each of the insurance companies are worth more than the total market capitalization of the company. Management 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). Paul Newsome with Piper Sandler.

Paul Newsome: Congratulations on the profit in the quarter, that's wonderful. Can you walk us through what actually is going to get renewed for reinsurance over the course of the year? I think it's not everything, right; it's a part of pieces. But there is also that quota share in there. Maybe if you can just kind of walk us through exactly what's going to be renewed and what would potentially face higher prices?

Kirk Lusk: Yes, well, the two largest ones are the net quota share, which is a 12-31, so that's already been renewed for the bulk of the year. And the other real large one is the CAT XOL, which is a 6-1.

Ernie Garateix: And as part of that CAT XOL, there is a CAT bond for the Northeast, which is already in place from the previous year. It's a multiyear.

Paul Newsome: Right. Is it the entire XOL that contributed, or just part of the [company]?

Kirk Lusk: It's the entire CAT XOL is on 6-1 --

Paul Newsome: Got it. Got it. And then --

Kirk Lusk: -- excluding the CAT bond portion, yes.

Paul Newsome: Excluding the CAT [one]. The net quota share, was there any changes in the economics of that that we should have put into our models [retrospectively]?

Kirk Lusk: Yes, yes, the net quota share, we did drop that slightly from a percentage standpoint, although the cost was up. So from a ceded frame standpoint, it's probably going to be a slight increase.

Paul Newsome: Great. And then maybe you could just address kind of your view of what on the margin you're getting with rate versus claims inflation, particularly in Florida, but maybe even more broadly, given the book isn't just Florida?

Kirk Lusk: Yes, well, claims inflation, as we've seen, that actually dropped recently. We're still looking at it in the high-single-digits, low-double-digits. And what we have is we have an inflation guard factor of 7.5% in the Northeast and then 10% in the Southeast, California and Hawaii. And on top of that, I would say the bulk of our rate increases almost across the footprint, are double-digit rate increases this year. So when you look at it as the difference there, again, because of some of the claims inflation we've seen in the past, you can expect that probably the difference between the current claims inflation and that rate is going to be close to double-digits.

Paul Newsome: Great. And then one more question unless somebody else asks. Any update on RBC ratios and capital levels in the various subsidiaries at year-end?

Kirk Lusk: Yes, each of our subsidiaries, the RBC, particularly at Heritage, is going up from last year; NBIC is down slightly, but it's still well over 350%; and then Zephyr actually increased also, it was 440 last year, and it's up. Last year, Heritage was 311; we expect that number to be actually in the 330 range this year, so again, improvement in our RBCs. And so we feel pretty good as far as where each of the statutory entities is from a capital standpoint.

Paul Newsome: Fantastic. I will let some other folks ask questions.

Operator: (Operator Instructions). Mark Hughes of Truist.

Mark Hughes: How was the weather this quarter? Was this an unusually good weather quarter, or was this normal weather quarter? Just sort of thinking certainly of seasonality, but is this kind of run rate, or was this something unusual?

Ernie Garateix: Are you referring to the fourth quarter or the first quarter? Fourth, right?

Mark Hughes: Fourth quarter, but you can talk about first quarter too if you want.

Ernie Garateix: (Laughter). If you want us to, yes.

Kirk Lusk: Yes, the fourth quarter was almost about what you would expect from a -- when you look at the non-cat weather, the non-hurricane cats and then the hurricane cats, it was very comparable to last year. So I would say it was about kind of a flat year.

Mark Hughes: Yes, okay. And then anything you want to say about the first quarter?

Ernie Garateix: No. This year, so far, the first quarter is kind of mirroring what we gave seen in the past and so --

Mark Hughes: Okay. So normal, similar to the fourth quarter seasonality adjusted?

Ernie Garateix: Yes, yes.

Mark Hughes: You have mentioned pricing, you expect to continue and perhaps accelerate. With the rate actions you are taking, will that kind of keep this pace of rate increases going? I am thinking to accelerate, do you need to see what happens with the reinsurance renewals, and then that would drive the acceleration, or how are you thinking about that?

Ernie Garateix: So there is definitely a component with the reinsurance, right? As we mentioned over with Paul, CAT XOL was placed 6-1. Once we have what that pricing would be, then we would kind of evaluate that. And obviously, rates would be adjusted accordingly to that piece. So in some areas of our portfolio, you might see rates go up further because of the increase in reinsurance from that perspective.

Kirk Lusk: Yes, and I think it’s a good question. We do expect reinsurance rates to continue to go up. Last year, they went up rather substantially. And so that is actually contributing to the some of the substantial rate increases that we are taking, and I think that that is probably going to continue. And we will actually be looking at each state to see what we need to do based upon those reinsurance rates because, yes, unfortunately, I think that the overall market is going to see increases across our footprint, even despite some of the positive recent legislative actions, which we are very pleased about. But I don’t think that that’s going to ease reinsurance rates at this point.

Mark Hughes: What was the dollar amount of that CAT XOL spend last year roughly, just so we can sort of get a sense of what the base is when we think about potential increases?

Kirk Lusk: Yes, that net spend was -- I will confirm that number up and it was around -- one second -- yes, about $370 million.

Mark Hughes: Okay. And then the E&S in Florida, what was that bringing for you? When did you say you started offering E&S policies? And then is that driving business that you feel is adequately priced?

Ernie Garateix: So it definitely is adequately priced. We have been in the Florida E&S business for a little bit over a year. As we saw some of the conditions in the market, we basically paused or suspended the admitted. So we will continue focusing on the E&S with select agents in the area, but it is adequately priced. We do have the flexibility there, as market conditions change, to make those pricing changes accordingly.

Mark Hughes: And then the commercial business, what gives you confidence that you are getting reasonable pricing there? How open is that market for additional growth?

Ernie Garateix: So a couple of things there on the commercial. Each risk is modeled individually, and we do have some flexibility on the pricing side with an IRPN factor that we can adjust accordingly to make sure that again, we are adequately priced to the market conditions, even for the Crest residential piece.

Mark Hughes: Yes, I assume you are making some assumption about what your reinsurance costs are going to be looking like if you are still growing that commercial piece?

Ernie Garateix: Correct. That is a correct assumption, yes.

Kirk Lusk: Yes, well, and also I think when you think about that commercial portfolio, it did grow last year. Premiums were up substantially. Actually, our policy count was down, but premiums were up substantially. I would expect that growth to slow, to be flat, this year as we manage our exposures for the reinsurance process. So I think that the growth we had last year is probably not going to repeat itself in 2023.

Mark Hughes: Okay, great.

Kirk Lusk: Yes, the other thing on the commercial is we do write just the garden style, of course, habitational. So from an underwriting standpoint, we are not going to deviate from that to actually getting more premium also.

Mark Hughes: Let me ask one more. The California E&S, how much are you leaning into that market at this point?

Ernie Garateix: We are not leaning heavily. Again, we do think that's a long-term play. It is a small portfolio. It's a disciplined underwriting approach and I guess on an E&S basis. So we do have our toe in the water there. It is a profitable business that we are writing out there. And we will kind of see long-term where that plays out.

Mark Hughes: Maybe an estimate on what you think the reform in Florida could mean? I have heard 10 points on the loss ratio. What do you think of that number?

Ernie Garateix: I don't think we have a number at this point. I think it's early. I think we are looking at all the metrics and the trends to kind of see where this will eventually end up. Am I cautiously optimistic that it is going to stabilize the property market in Florida? Absolutely. But until we have a little bit more time and data, I think we kind of refrain from exactly what that would mean. But everything that was passed by the legislature in December is absolutely a promising sign for the Florida market.

Mark Hughes: Yes, okay. Thank you very much.

Operator: Paul Newsome with Piper Sandler.

Paul Newsome: So are you seeing any regulatory pushback with some of your rates? It feels like it sounds like Florida is very accommodating, but obviously, California is much in the news. And I think even New York has been in the news with being resisting some of these rate increases. What's your perspective on it? And what has your experience has been so far?

Ernie Garateix: So what I would say is that we have a very good relationship with each of our regulatory environments. And we are always proactive to provide them information of what's going on. So a case in point, as we go out and are placing our reinsurance, we are not waiting until the reinsurance is placed to have the discussions. We are giving them some insight as to what's going on and working with them on that piece.

So again, everything from a rate perspective is backed up actuarially, right? We are not looking at numbers and saying, this is what we think. This is based on metrics that are coming in from loss costs, reinsurance pricing that the actuaries put together and then make the case on that piece. So I think we will continue those conversations with them proactively in front, so they understand what is happening in the marketplace and why these rates are necessary.

Kirk Lusk: Yes, and I would say, it does vary by state, but in general, they are seeing the reality of the reinsurance rate increases. And I would say the bulk of them understand the situation, and so therefore, are understanding how we are approaching it.

Paul Newsome: This is also last question. We appreciate the help as always.

Operator: And ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to the management team for any final remarks.

Ernie Garateix: Thank you. We would like to thank everyone for joining the call today and appreciate the interest in Heritage. We are encouraged by these fourth quarter results and look forward to the balance of 2023, as we continue to execute against our strategic profitability initiatives to achieve consistent long-term quarterly earnings and drive shareholder value. Thank you, and have a great weekend.

Operator: Thank you. This concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.