# Raising HCI to a Buy Based on Exceptional Premium Growth

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**Conclusion:** We are recommending the purchase of HCI Group, Inc. (HCI) because our work suggests net earned premium growth combined with a shrinking loss ratio will lead to much stronger than consensus earnings.

**Price Target:** We derive a one-year price target of $68.62, which is 27% above Friday’s (10/6) close of $54.11, by applying a 13% discount to the market multiple to our $4.43 FY’25 EPS estimate.

**What’s Changed:** Our view regarding premium rate increases on takeout policies and loss ratio reductions due to legislative reform motivates us to raise our FY’25 EPS estimates to $4.43 compared to consensus’ $1.99 FY’25 EPS, putting us 123% higher than consensus.

**Research:**

* We anticipate a 32% increase in net earned premiums for FY'24, followed by a 1% rise in FY'25. Net earned premium growth is a result of both policy growth and premium rate increases. Ultimately, this growth can be attributed to the ongoing consolidation within the Florida homeowners' insurance market prompted by the departure of several major insurers and the collapse of numerous smaller carriers in the aftermath of Hurricane Ian. The current market conditions remain uncertain, with the possibility of additional carrier failures potentially resulting in an even more constrained market.
* We project that recent and ongoing acquisitions of competitors’ portfolios will result in 75,000 takeout policies for HCI. When accounting for churn, we arrive at a 15% increase in policies in force by year end 2024. The financial challenges faced by several competitors have presented HCI with unique opportunities to acquire assets at deeply discounted price-to-book values. In some cases, HCI has acquired books at a 99% discount to their market value.
* We project a 15% increase in homeowners' insurance policy rates over the next twelve months (5% increase in EPS). We concluded this by conducting a Florida policyholder survey to estimate 2024 rate increases. These responses indicate that consumers expect a 15% rise in their homeowners' insurance rates in the upcoming year. Given the fact that insurance policies are renewed over the course of a year, we are inclined to believe that a significant portion of these consumers possess accurate pricing estimates.
* We estimate a 5% reduction in the loss ratio due to recent Florida insurance industry litigation (6.5% increase in EPS). This view is grounded in discussions with industry experts including both a former HCI executive and a reinsurance analyst. The former executive, responsible for overseeing HCI operations, confirmed that 2022's legislative reforms are set to bolster the robustness of well managed carriers. Concurrently, the reinsurance analyst emphasized the predicted stability of the reinsurance market, which will further enhance HCI's loss ratio. Highlighting the positive ramifications of recent regulatory changes, the analyst aligns with our projections for near-term loss ratio reduction.

**Quantifying the Impact:** Specifically, we forecastpremium rate increases will result $130M higher net earned premiums than consensus for FY’24. Our current estimate is for rates to increase by 15% but could be as high as 30% if our more aggressive survey results prove indicative. In terms of loss ratio, we anticipate decreases in loss ratio will result in $25M lower losses than consensus. Our current estimate is for the loss ratio to decrease 5% but could reach as high 10% if recent litigation yields more favorable loss development outcomes than anticipated.

**How We Differ:** Our areas of differentiation from consensus come down to a few key factors. The first is litigation changes. While the 2023 litigation changes are public, many analysts are unsure exactly how this will affect the loss ratio in the near term because a storm has not hit a major city since the new laws have passed, which would reveal the litigations effectiveness. The next area in which we differ is net earned premium growth. With the market consolidating as carriers continue to leave the state, the remaining insurers gain pricing power. Utilizing a survey that targeted policyholders, we forecast premiums per policy in force to grow 15% next year. The combination of incremental policy growth and premium rate increases results in 32% growth in net earned premiums after premiums ceded to reinsurance is considered. Throughout sell-side reports, analysts have stated that after the last few years of 100%+ combined ratios, they are cautiously optimistic when it comes to HCI’s profitability. The analysts are waiting to see repeated quarters of reduced loss ratios and litigation effectiveness before revising their estimates upwards, this inaction provides us with a window to get ahead of consensus.

**Where we Could We Be Wrong:** We have a modest degree of conviction in our call due to the many factors that go into forecasting a P&C insurer's profitability. Starting at the top with gross premium growth, if the consumer survey overstated the upcoming premium increase, then overall profitability will take a hit. Furthermore, if reinsurance costs (premiums ceded) continue to rise then revenue growth will suffer as a result. While reinsurance costs remain elevated, we are confident in our assumptions after speaking with a reinsurance industry expert. One threat that every insurance company faces is the threat of catastrophic (“cat”) weather events. While there is a 95% chance of an El Nino storm this year, we feel HCI is adequately covered by its reinsurance towers. However, if cat losses exceed $1.42B, it could send HCI’s combined ratio above 100%. This remains a risk regardless of the insurance company, but we believe that HCI is prepared due to strict underwriting standards and conservative loss and loss adjustment reserves. Lastly are the litigation reforms. Florida has passed many changes since 2019 to reduce insurance fraud, and while it has appeared to reduce fraud in more rural regions of Florida, the true test will be populus cities such as Miami, where insurance fraud is far more prevalent. If fraud remains at its current level, HCI’s loss ratio will be higher than we have forecasted through 2025. In our downside scenario, the projected stock price is $21.57, reflecting a 60% decrease from yesterday's closing price. This decline could materialize in the event of a storm that exceeds a 1-in-318-year occurrence or due to adverse loss development.

**Exhibit 1: Financial Forecasts**



**Exhibit 2: How We Differ from Consensus**



Exhibit 3: Key Financial Data, Valuation and Relative Performance

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# Appendix

## Valuation Rationale and Assumptions

Historically, HCI trades at a lower P/E than the broader market. This is not uncommon for insurance companies as the current industry P/E multiple is around 12.0x compared to the S&P multiple of 17.9x. HCI appears to split this difference. Utilizing the G10, we see that HCI’s NTM P/E is a 22% discount to the broader market. This gives us a P/E multiple of 14.0x. To give us a better idea of what HCI will trade at when it posts consistent loss ratio reductions, we looked at historical P/E ratios. We took quarterly P/E’s dating back to 2016. These ranged from 9.14x on the low end and 25.0x on the high end. The average gave us 15.5x which is the P/E we utilized for our base case.

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| **FY’25 EPS** | **P/E Multiple** | **Price Target** |
| **$4.43** | **15.5x** | **$68.62** |

HCI's price-to-book ratio is higher than the average in the property casualty insurance sector. Even among Florida-based carriers, HCI's price-to-book stands at almost twice the market average. While this premium might concern value investors, we believe it's justified given the significant growth opportunities HCI has in the challenging Florida homeowner’s insurance market. To value HCI fairly, we examined its quarterly price-to-book ratios since 2016. These values ranged from a low of 2.1x to a high of 3.0x. The average gave us 2.5x which is the P/B we utilized for our base case. During this time, HCI consistently reported profits and provided a strong return on equity. We anticipate this trend to continue in the near future, justifying HCI's higher price-to-book ratio.

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| **FY’25 BVPS** | **P/B Multiple** | **Price Target** |
| **$25.91** | **2.5x** | **$64.78** |





## Scenario Rational and Assumptions

**Base Rationale:** Policy in force growth of 15% and 5%, arriving at 269,000 policies in force by FY’25. Premium growth per policy of 15% and then decreasing by 4% for a gross premium per policy of $4,000. We kept reinsurance ceded at 36% after our conversation with an expert in the reinsurance space. These assumptions have our net premiums earned growing at 32% in FY’24 and 1% in FY’25. These assumptions are driven by the scenario where HCI partially completes its policy takeout goal of 75,000 additional policies; considering churn of ~11% derived from our proprietary survey, we arrive at 256,000 policies in force. On the expense side, we forecast a pre-litigation loss ratio of 61%; however, if the litigation changes prove to be moderately effective, it will result in a 5% reduction in fraud. We applied a 0.95x “litigation effectiveness” discount to this loss ratio, wiping out 5% of loss expenses that would otherwise be used on fraud cases. Holding all other expenses constant in line with historical averages, we get combined rations of 97% for FY’24 and 96% for FY’25.

Our $68.62 base case price target was derived by applying a 15.5x P/E multiple to our above-consensus FY’25 EPS estimate of $4.43.

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| **FY’25 Policies in Force** | **Total Net Premium Growth** | **FY’25 Combined Ratio** |
| **269,000** | **33%** | **96.5%** |

**Upside Rationale:** Policy in force growth of 15% and 7%, arriving at 275,000 policies in force by FY’25. Premium growth per policy of 15% and decreasing 2%, keeping gross premiums per policy above $4,000. The upside has no effect on reinsurance costs, keeping reinsurance ceded at 36% across the board. These assumptions have our net premiums earned growing at 32% in FY’24 and 5% in FY’25. These assumptions are driven by the scenario where HCI successfully completes its policy takeout goal of 75,000 additional policies, accounting for organic growth due to market consolidation and churn derived from our proprietary survey; we arrive at 275,000 policies over the course of two years. On the expense side, we forecast a pre-litigation loss ratio of 63%. However, in this scenario, the litigation changes prove to be highly effective. We applied a 0.90x “litigation effectiveness” multiple to this loss ratio, wiping out 10% of loss expenses that would otherwise be used on fraud cases. Holding all other expenses constant in line with historical averages, we arrive at a loss ratio of 93.7% for FY’24 and FY’25.

Our $100.61 upside scenario price target was derived by applying a 16.0x P/E multiple to our above-consensus FY’25 EPS estimate of $6.28.

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| **FY’25 Policies in Force** | **Total Net Premium Growth** | **FY’25 Loss Ratio** |
| **275,000** | **37%** | **93.7%** |

**Downside Rationale:** Policy in force growth of 5% both years, arriving at 245,000 policies in force by FY’25. Premium growth per policy of 4.8% for both years. The downside has no effect on reinsurance costs, keeping reinsurance ceded at 36% across the board. These assumptions have our net premiums earned growing at 10% in FY’24 and 10% in FY’25. These assumptions are driven by the scenario where HCI is slow to complete its policy takeout goal of 75,000 additional policies; accounting for churn, we arrive at 245,000 policies. On the expense side, we forecast a pre-litigation loss ratio of 64%. However, in this scenario, litigation proves to be marginally effective. We applied a 0.99x “litigation effectiveness” multiple to this loss ratio, resulting in a 1% reduction in loss expenses that would otherwise be used on fraud cases. Holding all other expenses constant in line with historical averages, we get loss ratios of 100% for FY’24 and FY’25. One thing to consider when looking at the downside: this scenario accounts for HCI falling short of its targets on policy growth, premium growth, and lowering loss ratio while remaining profitable. There still exists the “downside scenario” of a multiple cat year that wipes out HCI’s loss reserves. Due to the fact that weather is unforecastable two years out, we kept our assumptions in line with the underperformance of the base case scenario, not a catastrophic weather event.

Our $23.53 downside scenario price target was derived by applying a 12.5x P/E multiple to our below-consensus FY’25 EPS estimate of $1.89.

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| **FY’25 Policies in Force** | **Total Net Premium Growth** | **FY’25 Loss Ratio** |
| **245,000** | **20%** | **100%** |

## Proprietary Research to Support Investment Thesis

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