S&P Global
Market Intelligence

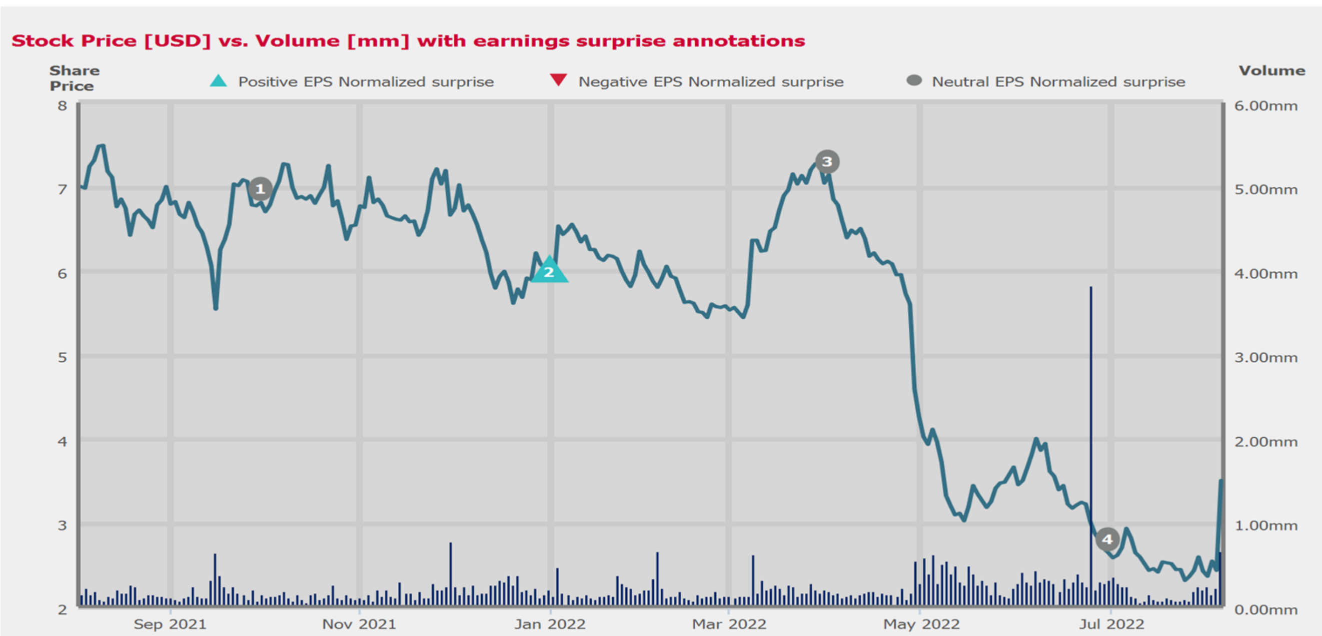
Heritage Insurance Holdings, Inc. NYSE:HRTG
FQ2 2022 Earnings Call Transcripts

Friday, August 05, 2022 1:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.12)	0.11	NM	(0.12)	(1.12)	NA
Revenue (mm)	158.99	163.77	3.01	165.60	645.61	NA

Currency: USD
Consensus as of Aug-05-2022 4:57 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2021	(0.27)	(0.59)	NM
FQ4 2021	0.16	0.41	156.25 %
FQ1 2022	0.22	(1.15)	NM
FQ2 2022	(0.12)	0.11	NM

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Call Participants

EXECUTIVES

Ernesto Jose Garateix
CEO & Director

Kirk Howard Lusk
Chief Financial Officer

ANALYSTS

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Marla Susan Backer
Sidoti & Company, LLC

Paul Newsome
Piper Sandler & Co., Research Division

Presentation

Operator

Good morning, and welcome to the Heritage Insurance Holdings Second Quarter 2022 Earnings Conference Call. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Kirk Lusk. Please go ahead.

Kirk Howard Lusk
Chief Financial Officer

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.

Ernesto Jose Garateix
CEO & Director

Thank you, Kirk, and thank you all for joining the call today. To start, I would like to express my appreciation for our team at Heritage and for their hard work and dedication to the company. The commitment of our employees, policyholders and value partners continues to drive growth across our 16-state footprint. We especially appreciate the solid relationships we have built with our reinsurance partners.

During the call today, I will provide a brief overview of our second quarter 2022 performance. Kirk will then provide an update on our key financial performance metrics, and then we'll open up the call for Q&A.

First of all, I'd like to highlight the positive underwriting income for the quarter. Despite the many challenges we face in our markets, our rate, underwriting and exposure management initiatives are having the desired impact on our results. Our net combined ratio of 99.4% attest to the positive impact our strategic initiatives, which resulted in underwriting income for the quarter.

Overall, I'm very pleased with our second quarter results. Excluding the impact of a goodwill write-down, second quarter net income was $2.9 million or $0.11 per diluted share, up from a net loss of $4 million in the prior year quarter. This improvement was primarily driven by higher net earned premium, which outpaced the increase in losses.

Net current accident year weather losses increased to $38.1 million, up 7.34% from the prior year quarter. However, our net loss ratio of 64.1% was down nearly 5 points from the prior year amount.

The rate and form changes strategically implemented throughout the book of business over the last 1.5 years, along with our geographic diversification, intentional exposure management and selective underwriting for new and renewal business has begun to positively impact our portfolio. These initiatives resulted in improved average premium per policy by 11.5% from the second quarter of 2021.

Our continued selective underwriting efforts to date were on display this quarter as we experienced a nearly 6-point reduction in our combined ratio. Rate increases continued to meaningfully benefit written premiums throughout the book of business. We remain committed to proactively and appropriately raising rates to offset higher loss costs and taking underwriting actions to continue to improve our profitability.

During the second quarter, we completed our catastrophe reinsurance program, integrating traditional reinsurance and insurance-linked securities without the use of parametric covers. The success of our program and level of maturity made the new Florida RAP program unnecessary to complete the risk transfer. Our program includes deployment of Citrus Re, which brings additional collateralized reinsurance through capital markets.

Lastly, we did suspend offering new personal residential policies in the more highly populated counties in Florida during the quarter. Efforts to increasingly diversify business outside Florida remain successful as we experienced an 18.9% reduction in policies in force and a 14.9% reduction of total insured value for the state of Florida.

We also continued to evaluate the impacts of legislation on the homeowners insurance marketplace. The litigious practices in Florida are not only causing companies to go out of business, be downgraded, reduce their writings in the state but also are driving up cost to every single property insurance buyer in the state of Florida. We appreciate the action taken by the Florida legislature and are cautiously optimistic that actions we'll take have a positive impact on our results and challenging claim environment but also believe that more needs to be done.

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

Kirk Howard Lusk
Chief Financial Officer

Thank you, Ernie. Good morning. As Ernie stated, we are pleased with the underwriting results of the second quarter. Our focus on rate adequacy, underwriting and profitability in all our geographies has started to gain momentum and resulted in an adjusted net income, a non-GAAP measure of $2.9 million or $0.11 per diluted share when excluding the impact of the goodwill write-down.

Despite the underwriting gain in the quarter, management determined that it was appropriate to write down the remaining goodwill at this time. The determination primarily reflects the decline in economic conditions, which impacted the current stock price and the volatility of the property insurance market caused by the impact of inflation, higher reinsurance costs and litigated claims in some of our markets. At this point, the company does not have any goodwill remaining on the balance sheet. There was no write-off of intangibles.

Driven by the noncash goodwill write-down of $92 million or $90.8 million after tax, the net loss for the quarter was $87.9 million or $3.32 per diluted share. In-force premiums grew by 3% from Q1 this year to just over $1.2 billion, while policies in force decreased by 1.6% from Q1. The in-force premiums are at the highest level with average personal lines property policy premiums for the first time is just under $2,000.

Year-over-year premium in force was up 3.4%, while policies in force were down by 7.3%. The decrease in policies was most pronounced in Florida where our personal lines policy in force was down nearly 19% year-over-year. We are committed to the Florida market, but recognize the challenges with conducting business in Florida.

Abusive litigated claims practices are a primary concern, and we have taken underwriting actions aimed at reducing the adverse impact of these market challenges. We anticipate rate increases in all our geographies will continue to align with lost costs. Our strategy to remain focused on rate adequacy, underwriting and profitability in all geographies has been successful and will continue to drive moderate reductions in policy count, which will mostly be offset by rising rates in all states.

Total revenue for the quarter was up 9% from the prior year quarter, reflecting an increase in premiums earned, investment income, fewer realized losses and slightly lower other income from policy fees due to lower policies in force.

The second quarter weather losses were $38.1 million compared to the prior year weather losses of $35.5 million. The weather losses this quarter impacted the net loss ratio by 24.1 points and is very consistent with last year's impact of weather losses of 24.2 points on the loss ratio.

Development was negligible with $610,000 of favorable development in 2021 and about $82,000 of unfavorable development this quarter. Our net combined ratio for the second quarter of 2022 decreased 5.8 points to 99.4% from 105.2% in the second quarter of 2021. The decrease reflects a 4.7 point improvement in the loss ratio, predominantly driven by our underwriting and rate actions and a 1.1 point improvement from expenses.

The ceded premium ratio was 46.6% in the second quarter, down 2.1 points from the second quarter of 2021 of 48.7%. The decrease primarily stems from the growth of gross premiums earned outpacing ceded premium growth and a severe convective storm reinstatement premium in the second quarter of 2021.

Shareholders' equity decreased to $180.5 million or $6.80 per share for the second quarter of 2022, driven mostly by the write-down of goodwill and unrealized losses on our fixed income investment portfolio, which is driven by higher interest rate environment. With over $200 million in cash and cash equivalents, we don't anticipate the need to sell these investments in advance of maturity, given a duration of 3.6 years. Adding back the unrealized losses, the adjusted book value per share is $8.35 per share.

We operate by design in some very challenging markets and are focused on generating an underwriting profit and remain unfettered in that pursuit. We have derisked in some areas and have expanded in others. We have shut down production in some locations and expanded in others. We are disappointed with the current stock price. And while a good write-down was necessary, we believe that the only way to regain the value of the company is to consistently generate a profit and to achieve our target return on equity over an extended time frame.

The entire management team and the Board of Directors are committed to achieving that objective and will take the actions necessary to create value for shareholders. 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.

Question and Answer

Operator

[Operator Instructions] And our first question will come from Mark Hughes of Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Did you all disclose kind of your typical rate hike in Florida and then in other markets? And would be curious to get that versus how you see loss cost trends now.

Kirk Howard Lusk
Chief Financial Officer

Yes. The rate increases in the Florida market has been in the mid-teens. Outside of that, it varies from the low single digits to double digits. In a few states, it is higher than that, and actually exceeding the teens in some locations where we just had the ability to get more rate.

On top of that, we do have an inflation guard factor, which is 10% in the Southeast in Hawaii and 7.5% in the Northeast. So combining those 2 rate increases are across the board definitely in the mid-teens to higher.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Right. So the inflation curve would be on top of the mid-teens in Florida? Or is that inclusive?

Kirk Howard Lusk
Chief Financial Officer

That -- yes, it would be on top.

Ernesto Jose Garateix
CEO & Director

Yes.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. So premium increases would be 20% plus presumably in Florida?

Kirk Howard Lusk
Chief Financial Officer

Yes.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

With the inflation guard of...

Ernesto Jose Garateix
CEO & Director

Yes, that's correct.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then how do you see loss cost trends at this point? What's the rate of increase there?

Kirk Howard Lusk

Chief Financial Officer

Yes. Loss costs, we have been seeing those. To get that type of stuff, I mean, we look at it at a 3-, 5- and 10-year time frame and it's been right around 11%, 12%.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

How about lately? I guess it seems like some of the material prices have been coming down. So maybe it's too volatile at this point, but just curious to get your sense of how it's running as we sit here today.

Kirk Howard Lusk
Chief Financial Officer

Yes, it is down. I mean it's clicked down a point or 2 over the last couple of quarters. So it is trending favorably, but it still is right around that 11% range.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Then what is the total statutory capital and maybe both at -- in Florida and then in the Northeast at Narragansett?

Kirk Howard Lusk
Chief Financial Officer

Yes, the statutory capital on that. And then also, one other question that always comes up is what is our nonregulated cash that is about $30 million. The stat equity across the group, Heritage has about 106, Zephyr 78, NBIC 92, total 275.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then what kind of position are you in to the extent that you -- there's a large storm in Florida. It's a full retention hit. You've got $40 million on $106 million in the stat capital. What's the -- what happens then?

Kirk Howard Lusk
Chief Financial Officer

Well, that is backstopped also by Osprey, which is our captive. So the hit to the insurance company isn't near that extreme. It's actually in the low numbers, it's like $5 million, $10 million as opposed to the $40 million, which would be absorbed by Osprey, and Osprey is already fully collateralized for that.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. So in the event of the storm, not a capital situation, you...

Kirk Howard Lusk
Chief Financial Officer

Correct.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Okay. And then depending on the size of the storm, I guess, your judgment of -- with the contracting subsidiary, you've got the opportunity to make up for those losses.

Kirk Howard Lusk
Chief Financial Officer

Yes. Right.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

The total ceded premium or ceded premium ratio when we think about the full Q3, Q4, what kind of numbers are we looking at?

Kirk Howard Lusk
Chief Financial Officer

Despite the increase in reinsurance this year, which has very -- been very substantial. When we look at the increase in the premiums and the rates we're getting that type of stuff, it actually is going to be relatively flat from the first half of the year. I mean third quarter will be -- third quarter is going to be slightly elevated but then fourth quarter will be down. So for the second half of the year, it will be very comparable to the first half.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Kind of 47-ish?

Kirk Howard Lusk
Chief Financial Officer

Yes.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Ceded premium to gross premiums earned? Okay. And you said the holdco capital was $30 million.

Kirk Howard Lusk
Chief Financial Officer

Correct.

Operator

The next question comes from Paul Newsome of Piper Sandler.

Paul Newsome
Piper Sandler & Co., Research Division

Nice to see an underwriting profit. That's just fantastic. The -- I kind of have actually some follow-up questions. On the stat capital, what are your RBC ratios looking like of late?

Kirk Howard Lusk
Chief Financial Officer

You would be looking at probably the Heritage company in excess of 300 -- I'm sorry, probably in excess of 320. Zephyr would be in excess of 400 and NBIC would be in excess of 370.

Paul Newsome
Piper Sandler & Co., Research Division

So well in excess of what -- [indiscernible] cares about.

Ernesto Jose Garateix
CEO & Director

Correct. Correct.

Paul Newsome
Piper Sandler & Co., Research Division

And then on the goodwill write-down, was there a specific trigger for the second quarter versus, say, the first quarter? A lot of the things you talked about, like the declining economy and the low share price have been true for a while. And I was wondering if there was a specific trigger, whether it be reinsurance or something else that caused the write-down other than say like an annual end of [indiscernible].

Kirk Howard Lusk
Chief Financial Officer

Right. No, it was actually a combination of things. And one of the things I would comment on, though, first of all, is that it was not due to the performance of the underlying assets. The underlying assets are performing well. And it really comes down to the stock price. There's 2 parts of the analysis. One is your discounted cash flow. The other part is what is your stock price multiply times a control premium that gives you an idea of what it is and then you take the difference between that and goodwill. And so it's really -- the main driver as far as the math is concerned is the stock price.

The drivers are the combination of those items over a period of time. So when we look at the first quarter, some of those were trending that way. As far as drops in stock price, poor economic performance overall, dislocation in the property market in some of the markets we operate in. And I think that it's in looking at all those factors. And so therefore, being consistent for a couple of quarters, that's why we evaluated on an interim basis as opposed to typically on 10 1.

Operator

[Operator Instructions] And the next question comes from Marla Backer of Sidoti.

Marla Susan Backer
Sidoti & Company, LLC

Can you talk a little bit about what kind of -- what your expectations might be for potential regulatory changes in the Florida market? I mean, given that this is a topic that's been under discussion for quite some time.

Ernesto Jose Garateix
CEO & Director

So yes. So first, I'll say that the reform and the changes that we did get out of special session, we're very grateful and appreciative of. But as we stated, we do believe there's more that needs to be done. And we think that what came out of special session is more discussions around what those specifics are.

So we are actively working and providing feedback, but I don't think there's anything just quite yet. But I think the overall goal is to limit the litigious nature of what we have here in the state of Florida. So I do think that momentum will continue going forward into the next session.

Marla Susan Backer
Sidoti & Company, LLC

Okay. And given where you are right now in the process of derisking and improving profitability, do you feel that at this point, you're getting close to looking for new market to -- in which to do business potentially in order to grow your book of business?

Ernesto Jose Garateix
CEO & Director

So I think we're always looking at some new markets, and we do the due diligence around that. So we'll continue with the current objectives that we have, which is limiting what we have in Florida, but we're always constantly looking at those other markets and seeing where there's opportunities as they arise.

Operator

The next question is a follow-up from Mark Hughes of Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Just curious, when you think about the losses in the quarter, your weather losses as you laid them out were still pretty high, but the underlying losses, it looks like improved pretty meaningfully. Is that entirely kind of the rate underwriting actions? Was there some other aspects of the weather that maybe it was just a little more favorable this quarter? I'm just kind of curious whether this is just -- and again, I had the numbers in front of me, and it looks like there's still a lot of weather losses. But I'm just sort of curious whether there's any other dynamic that one might attribute the improvement to other than what you've laid out in your [trends].

Kirk Howard Lusk
Chief Financial Officer

Yes. And when you look at the weather losses from a ratio standpoint, last year, second quarter weather losses made up 24.2 points of the loss ratio. This year, 24.1. So even though you could say, hey, the losses are elevated, they're very consistent from a ratio standpoint year-over-year.

Ernesto Jose Garateix
CEO & Director

And Mark, what I will say is we've mentioned several times the underwriting initiatives that we've taken on. Given the market conditions, we have been more selective on the policies and better quality of risk that we're taking. I think you're seeing that come through.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. And then your posture in Florida at this point, you're obviously getting nice rate increases. You've been working to reduce your total insured value. Would you anticipate though that, that stabilizes and maybe you get some growth in Florida? Or what's the posture now? Still trimming in Florida and just [indiscernible] that with rate increase?

Ernesto Jose Garateix
CEO & Director

Yes. At this point, we're very confident about the initiatives we're continuing to take. Should the market conditions change and there is an opportunity for growth in the state of Florida, we will consider that. But at this point in time, we're very pleased with the initiatives we're taking. And we'll keep down that same path at this time.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Yes. Any way to characterize the -- if we look at the loss ratio in Florida versus outside of Florida, are they comparable, different, a lot different?

Kirk Howard Lusk
Chief Financial Officer

Yes. No, they have been higher. And I think because of the lot of the rate and the underwriting actions, that type of stuff, it is starting to turn. But it will take a little while before it gets more consistent. And of course, the litigious environment in Florida does elevate that substantially.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Ernie Garateix for any closing remarks.

Ernesto Jose Garateix
CEO & Director

We'd like to thank everyone for joining the call today, and wish everyone a great weekend.

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