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Heritage Insurance Holdings, Inc. NYSE:HRTG

Earnings Call

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Call Participants

EXECUTIVES

Ernesto Jose Garateix
CEO & Director

Kirk Howard Lusk
Chief Financial Officer

ANALYSTS

Jon Paul Newsome
*Piper Sandler & Co., Research
Division*

Maxwell Fritscher
*Truist Securities, Inc., Research
Division*

Presentation

Operator

Good morning, everyone, and welcome to the Heritage Insurance Holdings Second Quarter 2023 Earnings Conference Call. [Operator Instructions] Please also note today's event is being recorded. And at this time, I'd like to turn the floor over to Kirk Lusk, Chief Financial Officer for the company. Please go ahead, sir.

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 reconciliation 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 us today. I will provide some highlights of our second quarter performance, discuss our progress in achieving key objectives and offer insights into our strategic initiatives. Following my remarks, Kirk will provide details on key financial performance metrics, after which we will open the call for Q&A. I am pleased to report another consecutive quarter of solid financial results, with net income for the second quarter of \$7.8 million. The improvement from last year reflects the progress we are making with our strategic profitability initiatives as well as the benefit of favorable weather this quarter. As I described last quarter, our strategic profitability initiatives include rate adequacy, selective underwriting, capital allocation, providing the appropriate coverage for the market and a balanced and diversified portfolio.

We believe that the combination of these initiatives will enable Heritage to achieve consistent long-term quarterly earnings and shareholder value. Our continued rating actions throughout our book resulted in achieving our highest in-force premium, while decreasing policy count by 11.1% as compared to the second quarter of last year. We are also maintaining our underwriting discipline, including tightening underwriting criteria within regulatory guidelines and restricting new business for policies written in over concentrated markets or products. We are allocating capital to products and geographies that maximize long-term returns.

During the quarter, we selectively grew our Florida commercial residential in-force premium by 75.5% over the prior year quarter, while total insured value, or TIV, for that product increased 35.3% and policies in-force increased by only 12.7%. We intentionally reduced the policy count for our Florida personal lines product by 15.8% from Q2 2022 and 3.9% from the first quarter of 2023. Reducing Florida personal line exposure remains a key focus, and we will continue until the positive impact of recent legislation to reduce abusive claim practices is realized. Our disciplined underwriting approach and focus on rate adequacy resulted in a policy count reduction of 8.7% in other states, while generating a 4.2% increase in premiums in-force.

Efforts to maintain a balanced and diversified portfolio continued with no state representing more than 26.2% of the company's TIV, despite the substantial increase in commercial business. The top four states within our portfolio grew TIV by an average of 2.6%, while the smallest five states grew by 27.3%. As a result of the diversification efforts, the top five personal line states represented 71.6% of all TIV in the second quarter of 2023 compared to 72.5% of all TIV at second quarter 2022. We will continue to seek profitable opportunities while maintaining a balanced portfolio. We are pleased to have completed and fully placed our 2023 catastrophe excess of loss reinsurance program.

We appreciate our reinsurance partners continued support and the recognition of our efforts to provide the appropriate coverage for the market. We expected rates to increase from last year and have taken and will continue to take underwriting actions within statutory guidelines to ensure long-term profitability in the markets we serve. Our catastrophe reinsurance program this year includes coverage by the RAP program, created by the Florida legislature last year, which will provide reinsurance below the FHCF layer at no cost to the company. This year's catastrophe reinsurance program and costs will also include the remaining limit of \$100 million from catastrophe bonds issued in 2022 by Citrus Re, which provides multiyear reinsurance protection as well as a \$235 million of multiyear fully collateralized catastrophe bonds issued by Citrus Re earlier this year.

We look forward to seeing favorable impacts of the new legislation aimed at curtailing litigated claims and other abuses in the Florida property market. We are closely observing post-litigation claim activity and will take new trends into consideration in our strategic plan going forward. As we wait for favorable impacts of the legislation to work through the book of business, we selectively grew our commercial residential business. Continued efforts to ship Florida personal lines business away from Florida have left to a 15.4% reduction in Florida personal lines policy count as compared to the second quarter of last year. To improve systems and process efficiencies, we are investing in a systems transformation, which includes billing, policy and claims modules.

The claims component has been implemented, and the billing and policy system components is expected to be rolled out in early 2024. We anticipate the new system will improve process efficiencies as well as enhanced data collection and analytics with a focus on scalability and speed to market. In addition, the new system is better geared for customer self-service and to improve the policyholder experience. Our second quarter results underscore the effectiveness of our targeted strategies. We anticipate the rate increases and underwriting changes made in 2022 and planned for 2023 will continue to have a favorable impact on our financial position throughout the year. We are focused on achieving consistent long-term quarterly earnings and a sustainable shareholder value.

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, everyone. As Ernie mentioned, Heritage had its third consecutive positive quarter with \$7.8 million of net income or \$0.30 per diluted share for the second quarter of 2023. This result reflects an improvement from the net loss of \$87.9 million or a loss of \$3.32 per diluted share in the second quarter of 2022. The improved financial results can primarily be attributed to higher net premiums earned and investment income, partially offset by higher operating expenses. The net loss in the prior year quarter was due to \$90.8 million net of tax or \$3.43 per diluted share noncash goodwill impairment charge.

The net income for the quarter resulted in an annualized ROE of 19.7%. On a year-to-date basis, the net income for the company is \$21.8 million which returns an annualized ROE of 29.9%. Premiums in-force exceeded \$1.3 billion this quarter, representing a 10.5% increase from the second quarter of 2022, while policy count was down 11.1%. The increase in premium was driven by rate increases across the portfolio as well as selective growth in the company's commercial residential business and the use of inflation guard. These actions resulted in the average premium per policy increasing 24.3% from the second quarter of 2022 and 6.8% from the first quarter of 2023. In the second quarter of 2023, our gross premiums written increased 8.6% to \$396.6 million, up from \$365.3 million in the same period of 2022.

Gross premiums earned increased to \$330 million in the second quarter of 2023, an increase of 11.4% compared to \$296.2 million in the second quarter of 2022. Similar to the in-force premiums, the growth in earned premiums can be attributed to our strategic efforts to selectively expand our commercial residential business, higher average premium per policy throughout the book and the use of inflation guard, all of which more than offset a reduction in premium from exposure management. Total revenues for the second quarter of 2023 reached \$185.3 million, a 13.2% increase compared to \$163.8 million in the second quarter of 2022.

In addition to higher net earned premiums, the growth reflects an increase in net investment income which rose from \$2.2 million in Q2 of 2022 to \$6.6 million in 2Q of 2023. The current yield curve has led us to invest proceeds from fixed income maturities and incoming premiums into short-term treasury bills and money market funds, resulting in higher levels of liquidity and higher returns. Our total cash plus invested assets ended the quarter at \$955.4 million. Losses and loss adjustment expense for the quarter were \$106.6 million, up from \$101.5 million in the second quarter of 2022, driven mostly by higher attritional loss. Net current accident year weather losses of \$33.8 million were down from \$38.1 million in the prior year quarter.

There were no catastrophe losses in the quarter compared to weather losses of \$32.1 million in the prior year quarter and \$33.8 million of other weather losses in the current quarter, up from \$6 million in the prior year quarter. The net loss and LAE ratios ended the second quarter of 2023, 60.3%, a 3.8 point improvement from the prior year quarter of 64.1%. The net loss ratio also benefited from favorable loss development of \$2.7 million, compared to unfavorable development in the second quarter of 2022 of \$81,000. For the quarter, the net combined ratio was 95.1%, an improvement of 4.3 points from 99.4% in the second quarter of 2022. This reflects the lower net loss ratio just mentioned and a 0.5 point improvement in the expense ratio which decreased to 34.8%.

We continue to make substantial progress in our margins and expect that progress to continue. The corporate effective tax rate was 43% for the second quarter of 2023, compared to a negative effective tax rate of 0.6% in the prior year quarter. This was driven by the impact of permanent differences in relation to pretax income or loss each quarter. The effective tax rate in the second quarter of 2023 was impacted by a valuation allowance of \$2.5 million related to a tax election made by Osprey Re, our captive reinsurer domiciled in Bermuda. The effective tax rate in the second quarter of 2022 was impacted by mostly the nondeductible goodwill impairment charge described earlier.

Book value per share rose to \$6.27 as of June 30, 2023, which is up 22.2% from the fourth quarter of 2022. This increase from the fourth quarter of 2022 was driven by the net income generated in the first and second quarters of 2023 as well as the benefit of lower unrealized losses on our fixed income securities portfolio. Heritage's fixed income portfolio credit rating is A+ with a duration of 2.6 years as of June 30, 2023. With over \$247 million in cash and cash equivalents, we don't anticipate the need to sell fixed income securities in advance of maturity. The amount of cash held outside our investment portfolio and money market funds is now generally earning a return north of 5%.

The Board of Directors will continue to assess our dividend distribution and stock repurchase strategies on a quarterly basis to ensure alignment with the company's financial performance and market conditions. As such, the Board of Directors has decided to continue its temporary suspension of the quarterly dividend to shareholders. No shares of common stock were repurchased during the quarter. Our second quarter and first half of 2023 results highlight management's continued focus on our strategic profitability initiatives. We operate in a constantly evolving business landscape and seek to capitalize on growth opportunities, effectively manage risk exposures and maintain cost discipline to continue to improve financial results. We remain committed to delivering long-term value to our shareholders and maintaining sustainable growth and profitability in the future. We will continue to look for opportunities to [write] business and to make investments and other decisions that improve the profitability of the company and drive shareholder value. Thank you, and we will now open the line for questions.

Question and Answer

Operator

[Operator Instructions] And our first question today comes from Maxwell Fritscher from Truist Securities.

Maxwell Fritscher

Truist Securities, Inc., Research Division

I'm calling in today for Mark Hughes. I was wondering if you all will be participating in the Citizens Takeout process.

Ernesto Jose Garateix

CEO & Director

So we are exploring the Citizens Takeout process, but we're doing that in conjunction with other opportunities that we have in front of us. And as long as they align with our strategic profitability initiatives, it will be something we'll consider in the future.

Maxwell Fritscher

Truist Securities, Inc., Research Division

Okay. And for the regulatory reform in Florida, have you seen any impact of that flowing through the P&L? I know it's still early.

Ernesto Jose Garateix

CEO & Director

Sure. And it is. It is early. We are seeing some optimistic signs and metrics that are coming in. But since it's still early, we are kind of optimistic that, that will continue and then kind of see the long-term effects of that in the P&L.

Maxwell Fritscher

Truist Securities, Inc., Research Division

And then finally, how has the trajectory in lawsuits been this quarter?

Ernesto Jose Garateix

CEO & Director

So the trajectory has been on the decline on that piece of it. But again, it's still a little bit early. We are seeing some decline in the number of lawsuits that we're getting on -- from a total perspective on that, but we are kind of really focusing on making sure it's a long-term trend.

Operator

And our next question comes from Paul Newsome from Piper Sandler.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Congratulations on the quarter. I wanted to ask about any impact of increased costs from the reinsurance. I assume it's costed more this quarter, but then the RAP probably helped that. What's the net of all of that?

Kirk Howard Lusk

Chief Financial Officer

Yes, the costs did go up. And again, it did impact the quarter a little bit. However, because it incepted in June, it only impacted one month for the entire quarter. So going forward, it will impact it far more. I think

you can expect our probably ceded ratio will probably go up a couple of points from kind of where it is right now.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Great. The transformation system that your -- system transformation you mentioned, is that going to have a measurable impact on the expense ratio?

Kirk Howard Lusk

Chief Financial Officer

Yes, I think it should have favorability on the efficiency of the overall operations than speed. One of the biggest things also is the ability to put in rates and get those in as opposed to relying upon an outside programming department to basically do that, it's a bit more table driven. So therefore, we'll also be able to expedite some efficiencies as far as getting things into the system, which, again, leads to some economic benefit.

Jon Paul Newsome

Piper Sandler & Co., Research Division

That's good. But no initial costs as you're investing in the system that's on that basis?

Kirk Howard Lusk

Chief Financial Officer

Yes, it's capitalized, and there won't be any initial -- expense savings would probably over a period of time.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Great. And then sort of thinking about the dividend as mentioned. Are there any targets from a financial perspective in capital levels or debt that are maybe tied to your thinking about when the dividend might resume? Are you looking to put debt at a certain level? Or are we seeing ratios at a certain level before you recommend resumption in the dividend?

Kirk Howard Lusk

Chief Financial Officer

Yes. I think the Board is evaluating a number of different factors and looking at that. They're looking at the future opportunities, how to deploy capital in the future, is it better to return that capital now or keep it internally for those future opportunities? So it's a myriad of items that they're looking at as far as determining when and if there will be a dividend.

Jon Paul Newsome

Piper Sandler & Co., Research Division

But any thoughts, I guess, related to that on capital levels and where you want to be prospectively?

Kirk Howard Lusk

Chief Financial Officer

Not specific on the capital. I mean it is one of the factors that they look at, but it's not the sole one. And they don't have a target. It's also more or less based upon, hey, what is the best use of the capital going forward for the growth and the opportunities that the company is looking at?

Operator

And ladies and gentlemen, with that, we'll be concluding today's question-and-answer session. I'd like to turn the floor back over to Ernie Garateix for closing remarks.

Ernesto Jose Garateix

CEO & Director

We'd like to thank everybody for joining the call today, and hope everyone has a great day.

Operator

And with that, ladies and gentlemen, we'll conclude today's conference call and presentation. We do thank you for joining. You may now disconnect your lines.

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