S&P Capital IQ

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Heritage Insurance Holdings, Inc. NYSE:HRTG

FQ4 2016 Earnings Call Transcripts

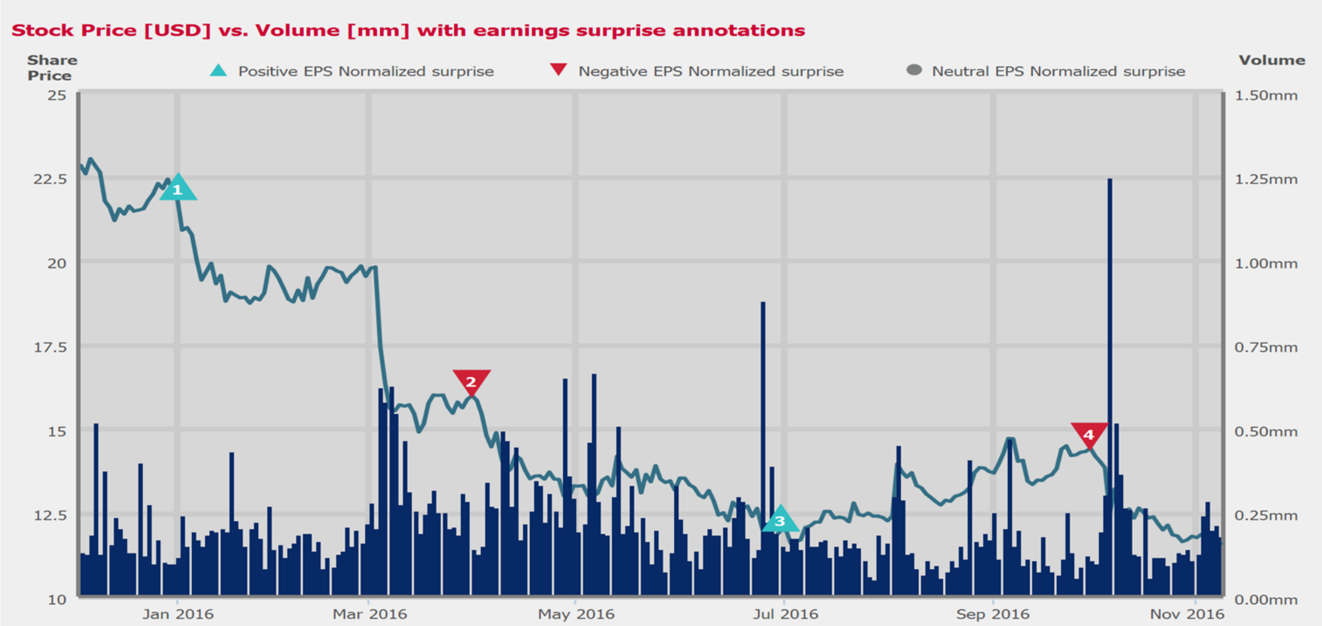
Thursday, March 16, 2017 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ4 2016-			-FQ1 2017-	-FY 2016-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	(0.22)	(0.09)	NM	0.42	1.06	1.14
Revenue (mm)	104.93	102.81	▼(2.02 %)	105.09	440.20	438.96

Currency: USD

Consensus as of Mar-16-2017 5:25 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2015	0.65	0.66	▲1 1.54 %
FQ1 2016	0.45	0.24	▼2 (46.67 %)
FQ2 2016	0.55	0.62	▲3 12.73 %
FQ3 2016	0.38	0.37	▼4 (2.63 %)

Call Participants

EXECUTIVES

Bruce Lucas
Chairman of the Board & CEO

Melanie Skijus

Steven Martindale
Chief Financial Officer

ANALYSTS

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Presentation

Operator

Good morning, and welcome to Heritage Insurance Holdings' Fourth Quarter and Full Year 2016 Financial Results Conference Call. My name is Andrew, and I will be the operator today. [Operator Instructions] Please note this event is being recorded. [Operator Instructions]

I would now like to turn the conference over to Melanie Skijus. Please go ahead.

Melanie Skijus

Good morning. The fourth quarter earnings release can be found on the Investors section of heritagepci.com. The earnings call will be archived and available for replay. Today's call may contain forward-looking statements. These statements, which we undertake no obligation to update, represent our current judgment and are subject to risks, assumptions and uncertainties. For a description of 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 and other filings made with the SEC.

With us on the call today are Bruce Lucas, Chairman and CEO; and Steve Martindale, Chief Financial Officer. Also on the call is Steve Rohde, Financial Consultant to the company.

I'll now turn the call over to Bruce.

Bruce Lucas
Chairman of the Board & CEO

Thank you, Melanie. I would like to welcome all of you to our fourth quarter and full year 2016 earnings call. Before we begin with a discussion of the quarterly results, I'd like to thank all of our employees for their dedication and contribution to our company. The fourth quarter was particularly active. During the fourth quarter, we completed a capital raise of $73 million in net proceeds in a senior secured note offering. The proceeds from the note offering put us in a financial position to take advantage of the consolidation trend in Florida and to continue our strategic growth initiatives outside of Florida. I'm very pleased with the growth we have seen in the Carolinas, and we have just begun to write new business in Georgia. Our footprint continues to expand and we intend to seek out M&A and strategic partnerships to further our growth initiatives.

We also experienced our second hurricane, Hurricane Matthew. Matthew presented an opportunity to test our vertically-integrated claims model on a large scale. To our knowledge, we were the first Florida carrier to issue a binding suspension at a time when Matthew was south of Haiti. We immediately mobilized catastrophe adjusters and implemented our cat plan well in advance of the storm's approach toward Florida. Our execution was tremendous and highly successful. We had over 100 construction and mitigation personnel in the field responding to claims in real time. During the first few days of the storm, we tarped hundreds of roofs, removed fallen tree limbs and mitigated water damage. It was common for us to respond within hours of reported claims. Our model is truly unique and provides us with opportunities to address claims quickly, avoid costly assignment of benefits and deliver results to our customers and bottom line. Out of approximately 2,700 claims, Heritage was able to provide mitigation and construction services to over 25% of our reported claims. This statistic is particularly relevant given that approximately 37% of our claims were closed without payment because the damage was not significant. We have had relatively few assignment of benefits in connection with Matthew, and have closed over 92% of all reported claims. Our unique claims model helped us to better manage this event and our Matthew losses were reserved at $18.6 million.

Despite our unique response to Matthew, 2016 was a challenging year in the Florida market. We experienced record tornado claims in the first quarter and 2 hurricanes in the second half of the year, all of which significantly impacted our financials. We also greatly increased our loss reserves throughout the year in response to the claims environment in Florida, which further impacted our financials but serves to ensure our long-term financial viability. Our industry continues to experience assignment of benefit fraud, particularly from the Tri-County area, which pressured earnings. Importantly, the percentage of AOB claims at Heritage has remained essentially flat over the past 4 years. We believe that unique trend is tied directly to the way that we handle claims to our quick response and vertically-integrated claims model. That said, AOB severity increased during 2016 in the industry as a whole, as a result of more aggressive tactics by attorneys and their clients. In response to this activity, we stopped writing personal lines policies in the Tri-County about 1 year ago, and do not plan to reenter the Tri-County personal lines market until we are approved for appropriate policy options at acceptable rates. As our personal lines business in Tri-County slowly shrinks and as our rate increases work their way through our book of business, we expect to see an improvement in our loss ratio over time.

In 2014, we were the first Florida personal lines carrier in the current market to aggressively pursue a large commercial residential portfolio, which has provided a hedge to our AOB exposure in the Tri-County. As our total insured value in the Tri-County is reduced from our reduction in personal lines, our commercial residential portfolio will have more opportunity to grow without overly stressing our probable maximum loss for reinsurance. We believe our decision in 2014 to combine personal and commercial lines in anticipation of our current market today has been prescient and extremely successful. Our deep commercial residential team was developed internally from the ground-up with virtually few costs, and provides a unique hedge for Heritage. Since we launched this unique blended portfolio, several Florida companies have tried to replicate our ground-up business model. We believe our comparative success is a testament to the strength of our commercial division and its ability to execute. Despite record tornadoes, AOB abuses and 2 hurricanes, we produced $33.9 million in net income and posted a 9.5% return on average equity in 2016. We were able to produce these results while significantly adding to loss reserves and without compromising reinsurance coverage.

We are in the middle of placing our reinsurance tower for the 2017 treaty year. Due to current negotiations, we are not going to provide pricing guidance to the market until our program is closed. We recently closed our 5th ILS bond issuance. Just like our claims model and diverse lines of business, we believe our reinsurance program is unique compared to the rest of the Florida market. We have over $860 million in multiyear reinsurance, which provides us with more pricing certainty and a hedge against post-hurricane price increases. Our latest bond was arguably our most successful. It was over 100% oversubscribed at 50 basis points lower than the initial bond range. We expect our pricing differential to the traditional markets to generate substantial savings. The bond has several unique features that were innovated and tailored specifically to Heritage's needs. We are extremely grateful to the ILS community, their support of our program and the relationships that we have formed over the past several years.

Moving on to the fourth quarter and full year results. Some highlights include a 26% increase in policy count in the fourth quarter of 2016, as compared with the fourth quarter of 2015. Gross premiums written and gross premiums earned increased 7% and 22%, respectively in 2016 as compared to 2015. Net loss for the fourth quarter of 2016 was $2.9 million. Net income for the full year of 2016 was $33.9 million. Return on average equity was 9.5% for the year, $358 million in stockholder's equity as of December 31, 2016. Our book value improved year-over-year to $12.41 a share as of December 31, 2016. We repurchased 334,664 shares for a total of $5 million in the fourth quarter of 2016. And for the full year, we repurchased 1,759,330 shares for a total of $25.6 million. We had $73 million in net proceeds that were raised from a private placement of senior notes, which will be used for M&A and strategic investments. Heritage has addressed and closed roughly 2,500 claims out of over 2,700 claims related to Hurricane Matthew, and roughly 500 claims out of 530 claims filed related to Hurricane Hermine. Our Board of Directors once again approved a dividend in the fourth quarter of $0.06 a share and all of our HO3 policies are now approved for a 9.9% overall rate increase. We believe that the current Florida market is producing a finite set of companies poised for success and numerous other companies that will experience significant headwinds. We are stronger company today and enter 2017 with a solid capital position. We are looking for opportunities to expand our footprint and further diversify risk. Underwriting discipline will continue to drive profitable new business and our focus is on bottom line results. The opportunities in front of us in 2017 are encouraging, as we will look to increase returns for shareholders.

I will now turn the call over to Steve to provide more detail on our financials.

Steven Martindale

Chief Financial Officer

Thank you, Bruce. Good morning. Gross premiums written for the quarter were $154.9 million, down 8% from a year ago. Assumed premiums written were minus $200,000 compared to $32 million assumed in the fourth quarter of 2015. Approximately 11% of gross premiums were written outside of Florida for the quarter with 9% coming from Hawaii and 2% coming from North Carolina and South Carolina. Voluntary business written in Hawaii, Florida and the Carolinas helped to offset the absence of policies assumed from Citizens. Our total policy count at December 31, 2016, was approximately 323,300. Our personal residential policy count was approximately 319,700 and our commercial residential policy count was 3,600. Personal lines policy counts by state were 238,200 in Florida, 73,400 in Hawaii, and 8,100 in the Carolinas. All commercial residential policies were written in Florida.

Gross premiums earned for the quarter were $160.2 million compared to $143.4 million a year ago largely due to the acquisition of Zephyr. Our ceded premium ratio as measured against gross premiums earned was 40.8% for the fourth quarter of 2016 compared to 32% for the fourth quarter of 2015. This increase was primarily due to growth in the fourth quarter of 2015 from Citizens' takeout activity, that did not reoccur in the fourth quarter of 2016. A modest decline in the gross earned premium in the fourth quarter of 2016 compared to the third quarter of 2016, combined with a true-up in the non-catastrophe reinsurance programs, caused the ceded premium ratio to be about 2 points higher in the fourth quarter of 2016 than previous guidance given. We expect our ceded premium ratio for the first 5 months of 2017 to return to approximately 39%. Our loss ratio as measured against gross premiums earned was 43.3% for the fourth quarter of 2016 compared to 27.2% for the fourth quarter of 2015. Claims associated with Hurricane Matthew accounted for approximately $19 million or 11.9 points of the difference. Excluding Hurricane Matthew, our loss ratio for the quarter of 31.3% was within our guidance of 29% to 32%, which we provided during our first quarter earnings call.

Moving into 2017, we anticipate our gross loss ratio excluding hurricanes will trend downward from approximately 33% in the first quarter of 2017 to approximately 27% in the fourth quarter. Our projected loss ratio is lower for the fourth quarter of 2017, as we expect fewer non-hurricane weather claims compared to the first quarter of 2017 and we expect our loss ratio to improve, as our rate and underwriting actions earn through the book.

During the quarter, we increased our IBNR loss reserves by $9.2 million to $83.6 million. IBNR reserves for hurricanes accounted for approximately $3.7 million of the increase and $5.7 million of the total IBNR reserves. IBNR represented approximately 60% of our total loss reserves at December 31, 2016, and the change in IBNR reserves accounted for 5.7 points of the loss ratio for the quarter compared to 4.4 points for the fourth quarter of 2015. The change in IBNR for hurricanes accounted for 2.3 points of the loss ratio for the fourth quarter of 2016. Approximately $1.1 million of the increase in IBNR for the quarter was related to prior year claims. Our expense ratio as a percentage of gross premiums earned was 23.2% for the fourth quarter of 2016 compared to 20.3% for the fourth quarter of 2015. We provided guidance on our second quarter earnings call, that an expense ratio ranging from 23.5% to 24% was reasonable without the benefit of assumed earned premiums from Citizens. The impact of the growth from Citizens takeouts in 2015 improved the expense ratio in the fourth quarter of 2015 by 2.9 points, while there was minimal benefit in the fourth quarter of 2016 from takeout activity in 2016. Amortization of intangible assets of $2.4 million associated with the purchase of Zephyr also accounted for approximately 1.5 points of the expense ratio in the fourth quarter of 2016. Including interest expense from our December debt issuance and amortization of intangible assets, we expect our expense ratio to be approximately 27% in the first quarter of 2017 and 26% thereafter. Our combined ratio on a gross basis was 107.3% for the fourth quarter of 2016 compared to 79.5% for the fourth quarter of 2015. Excluding the impact of hurricane Matthew and the reinsurance true-up, the combined ratio would have been approximately 93.6%. Excluding the benefit of Citizens takeouts and a better estimation of the impact of AOB and litigated claims, the fourth quarter of 2015 combined ratio would have been approximately 92.4%. Over the next 4 quarters, we expect our combined ratio without hurricanes to trend downward from approximately 99% in the first quarter of 2017 to approximately 89% in the fourth quarter. We recorded a net loss of $2.9 million for the fourth quarter of 2016 compared to net income of $20.2 million for the fourth quarter of 2015. Hurricane Matthew reduced net income for the quarter by approximately $11.5 million. Net income for the full year of 2016 was approximately $33.9 million compared to $92.5 million

for 2015. On the balance sheet side, stockholders equity was $358 million compared to $357 million at December 31, 2015. Common stock repurchases totaling $25.6 million and dividends declared on common stock totaling approximately $7 million offset most of the net income recorded for the year. Statutory surplus in our insurance company subsidiaries at December 31, 2016, totaled approximately $276 million. Our invested assets at December 31, were at $603 million. Approximately $571 million was invested in bonds with an average credit quality of AA in a duration of approximately 3.2 years. Our cash position was approximately $106 million and our total assets stood at over $1 billion. Our financial results for the year of 2016 were positive despite experiencing severe weather in the first quarter, a hurricane in the third quarter, and a second much stronger hurricane in the fourth quarter.
With that, Bruce and I are now available to take your questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

I had a question on some of the guidance. I think -- so you said, the ceded premium ratio should be about 39% to 40%. So what -- why in 1Q is that, I guess, ticking up from -- so if you adjust 4Q for the true-up, it goes down to just under 39%. So it looks like it's going up a little bit, just curious what's driving that?

Steven Martindale
Chief Financial Officer

It's generally, earned premium is going to trend down slightly first quarter, also with the -- the commercial book has grown. And so the non-reinsurance -- I'm sorry, the non-catastrophe reinsurance is about 1 point now ongoing.

Bruce Lucas
Chairman of the Board & CEO

So we have a pretty aggressive per risk in facultative reinsurance program on the commercial lines, and that limits our overall loss to $1 million per risk. And as that portfolio has grown and developed, obviously, there are some additional expenses in connection with that. And we made the -- we made a bold decision 1 year ago to shut down Tri-County personal lines production. We knew that, that would have a slight downward trend factor as we reduced exposures in the Tri-County due to the current claims environment and that results in a little bit less earned premium for the quarter. And thus, the reinsurance ratio slightly increases.

Steven Martindale
Chief Financial Officer

One other thing is we have an equipment breakdown, that is no risk on a company, that our commercial folks have just been selling more of. So that number goes on to the gross earned, and then also on to the ceded earned, and that's just becoming a larger piece. It was kind of a rounding error before, now it's contributing to that.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Was this equipment breakdown piece, can you -- sorry, can you repeat that?

Steven Martindale
Chief Financial Officer

It's part of -- it's included in that 1%, so that has grown too as the commercial book, as we've sold more of that.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And then just going to the loss ratio guidance. And I think there you said to expect about 33% for the first quarter. Excluding cats and favorable or end of adverse development, it looks like fourth quarter was 30.4%. So is the uptick from 30.4% to 33%, is that from weather in the first quarter? Or is there something else that's impacting that?

Bruce Lucas
Chairman of the Board & CEO

I really don't think it's primarily weather-driven, I think that we are trying to get our reserves booked a little faster, paid a little faster. That's been a conscious effort, so we've seen a little bit of an acceleration there. We had a few claims that were handled by an outside adjusting firm that we took over. And so we've kind of accelerated the track on those, we just moved a little quicker. And generally speaking, it's that time of year where the bad guys in the industry that are perpetrating with the assignment of benefit fraud, they get really concerned about the legislature actually taking some action and doing something. And so they get more and more aggressive, as this time of year happened last year as well. And so that adds to the severity a little bit.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So -- and so basically that's 33%. So what was the trajectory, 33% 1Q, and then the expectation for 4Q is 29%?

Steven Martindale
Chief Financial Officer

Yes.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And so just to make sure I understand. The uptick from 4Q to 1Q is basically just more aggressive AOB or...

Steven Martindale
Chief Financial Officer

Yes. There is a little more weather first quarter compared to fourth quarter, but it's not unusual like we had 1 year ago. So some of that elevated ratio compared to fourth quarter would be weather, but not a lot. Bruce is absolutely correct that the bad guys kind of take a break off in December. They take a holiday and then they come back with gang -- like gang busters in January and February and March. But the 33% will trend down to 27%. And so it would be probably a little higher second quarter and then, I would say maybe 31% kind of 30%-ish third quarter and then 27% fourth quarter.

Bruce Lucas
Chairman of the Board & CEO

Yes. And a lot of that is, if you think about what we're doing here, we're making a strategic decision. We have not received the help, regulatorily speaking, to crush this assignment of benefit fraud. It is the largest homeowners fraud ever to take place in the state of Florida. The legislature is not going to do much of anything about it. I can virtually guarantee that. Whatever they pass will be a watered-down version of what is needed. So we're kind of looking into the future and saying we have to price for that risk. We have to price for that uncertainty. We shut down a lot of production down there. Going back 1 year, essentially we've written no new business in the Tri-County in essentially in the past 12 months. So as you put rate through the system and you have fewer Tri-County policies, you get fewer AOB claims, you get lower severities, you get less frequency, and it has a meaningful impact on the loss ratio going forward. Essentially, what I'm trying to say is that, you could actually shrink some of your production results, and actually, make more money with a slightly smaller book of business. And also the correlation to that on the cat side, although I'm not going to give 2017 cat pricing guidance at this time, I can tell you that there will be some very meaningful reinsurance savings in the second half of the year without a question, because of these actions.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And just I guess on the -- in terms of the rate that you were mentioning, I think you said, in the release 9.9% overall average rate increase for HO3. So is that -- the 9.9%, is that both across Florida, Citizens and Florida voluntary?

Bruce Lucas
Chairman of the Board & CEO

Correct.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And I know the Florida Citizens piece of it went into effect December 15, if I'm not mistaken. What about the voluntary piece?

Bruce Lucas
Chairman of the Board & CEO

We are -- for new business, that will probably go with an effective date in mid-May and for renewals June 1.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay.

Bruce Lucas
Chairman of the Board & CEO

And the rate increases just like on the Citizens pieces are heavily weighted toward Tri-County.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And so basically, in terms of the rest of your books, so that's the Florida Citizens, Florida voluntary. What is the ratings situation look like for commercial Zephyr and North Carolina, South Carolina?

Bruce Lucas
Chairman of the Board & CEO

We expect Zephyr to be slightly down, in terms of overall rate in connection with what appeared to be some reinsurance savings. North Carolina, it depends on the territory, some places need a decrease, some need an increase. South Carolina, the book just isn't very big. And then we have other -- the commercial program in Florida. We really rate it on a per policy basis, so it isn't a per se rate increase or decrease that takes place there. I can tell you that we have targeted combined ratios and we watch the TIV aggregation for reinsurance. And we price each risk at the front end of production to meet a targeted CR and that premium, kind of, it is what it is. It could be lower, it could be higher.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And were there any buybacks in 1Q '17 year-to-date?

Bruce Lucas
Chairman of the Board & CEO

No, it's a blackout period.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Blackout period? Okay.

Bruce Lucas
Chairman of the Board & CEO

But obviously, the blackout comes off here in a couple of days.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And are your buybacks being done via a plan or just manually?

Bruce Lucas
Chairman of the Board & CEO

We do all of our buybacks through Citigroup. We do have some targeted metrics around the share repurchase, the price, the volume et cetera. We do not have like a 10b plan that's out there. We trade based on what we think are attractive metrics. And when book value multiples are lower, we get definitely much more aggressive than we are if book value multiples are high.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

All right. And then just a couple of quick more on -- in terms of the top line, I know Tri-County is shrinking. Ex-Tri-County though, how is the retention, including midterm cancellations of just year-over-year?

Bruce Lucas
Chairman of the Board & CEO

I would say, we're running right on our historical track rate of around 80%, including midterm cancels. So we really haven't seen the retention numbers move at all in the last say, 4 or 5 years.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And Steve, I think you said that there weren't any meaningful cats 1Q year-to-date or what was that [indiscernible]?

Bruce Lucas
Chairman of the Board & CEO

Right. That's correct.

Steven Martindale
Chief Financial Officer

Yes, we've had some tornadoes early in the year. And so weather has been -- its been more active than Q4, but not nearly as active as 1 year ago.

Bruce Lucas
Chairman of the Board & CEO

1 year ago, yes.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

All right. Is there like a rough dollar amount for weather so far?

Steven Martindale
Chief Financial Officer

Yes. It's minor. It's not a huge issue. It's in the hundreds of thousands.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

All right. And it's included within that 33%, I assume, right?

Steven Martindale

Chief Financial Officer

That's correct.

Operator

The next question comes from Mark Hughes of SunTrust.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

The combined ratio that you had guided to in the fourth quarter, I got the 99% in Q1. What did you expect that to be in Q4?

Steven Martindale
Chief Financial Officer

89%.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

The expense ratio, the 27% -- or no I'm sorry that would be 27% expense ratio, that seems elevated. Did I hear that correctly? And why the tick up there?

Steven Martindale
Chief Financial Officer

We got about 2.9% or points impact from the amortization of intangible assets associated with the Zephyr acquisition, that's 1.5 points. That will go down to 0.3 points in the second quarter. And then the other piece is the interest expense from the debt we raised and that's 1.4 points.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Right. And so the -- are you counting the interest expense in that -- the expense ratio?

Steven Martindale
Chief Financial Officer

Yes. We need to add it up into the combined ratio. So -- but I'm giving you those, so if you don't want to count it, that's great.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

And then the amortization, what was the amortization previously, just so I'm -- because you did amortize -- amortizing Zephyr correctly?

Bruce Lucas
Chairman of the Board & CEO

It would have been -- oh, okay, yes. I got you.

Steven Martindale
Chief Financial Officer

Yes. The Zephyr deal, we needed to finish the purchase accounting on that within 1 year of closing the transaction. So we actually got that together a quarter early. And so yes -- so we -- well, yes, we've got Balboa [ph] of -- we had about $7 million is what we amortized, including Balboa [ph] and then the other pieces that have a longer amortization period. So that's going to drop down to about 0.3. So it was a little lower probably second and third quarter but then as we finalized, we had kind of a just a bigger intangible asset bucket.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Right. So there is a kind of a step-up in amortization, is 1 factor and then the interest expense, we can treat however you want.

Steven Martindale
Chief Financial Officer

So there will be less goodwill and a little more intangible assets, but you get kind of through the first year and that then it get levels off to pretty manageable.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Right. When combining all that stuff together it would be 27% and then it dropped off, okay. The tax rate for the year, what should we think about?

Steven Martindale
Chief Financial Officer

Yes. The tax rate was 40% and 1.4% of that was some permanent differences, just some items that we weren't allowed to expense from a book basis and then from a tax basis, we are not allowed to. And really those aren't too different from 1 year ago. It's just we're comparing it to a much lower before tax income. So just the dollar amounts are very similar, but we're comparing against a lower base compared to 1 year ago.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

So on a go-forward basis, you will use 39%?

Steven Martindale
Chief Financial Officer

Yes. 39%, 40%-ish, it kind of depends -- some of it, it depends on our book value.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Okay. On the other revenue -- other revenue was -- continues to grow nicely. Is that -- should we sort of assume that continues to progress from here? Or should that flatten out, with this quarter particularly calm?

Steven Martindale
Chief Financial Officer

That other revenues, yes, yes, it's pretty flat going forward.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

Okay. And then the -- how do you feel like you're -- I guess, you're saying your retention hasn't really changed in the book and you had a couple of months of the 9.9%, at least within the Citizens book. Do you think it will impact your ability to grow voluntarily once we get the 9.9% in May?

Bruce Lucas
Chairman of the Board & CEO

Not really, because the 9.9%, I mean, it is massively weighted to the Tri-County where we don't want to grow. We are writing all of our policies right now, 100% of them outside of the Tri-County, every policy. And the rate increases there really didn't change that much, although it's 99%, overall. Because Tri-

County is the -- are the 3 counties where we have really high rate indication needs because of the fraud that's been perpetrated down there. So we're growing outside of the Tri-County and those rates really aren't moving too much, in some cases they go down. So I think we're in pretty good shape there.

Steven Martindale
Chief Financial Officer

And year-over-year, we've grown from almost 23,000 new business, is what we wrote for voluntary in 2015 and then almost 27,000 in 2016. So we expect to continue to grow there.

Bruce Lucas
Chairman of the Board & CEO

And that's without any Tri-County production, right, are very little. So it goes to show you how fast we're growing outside of the Tri-County and diversifying the policy count. Right now, when I look at our personal lines TIV, Tri-County is only about 17% or 18%. So we're really diversifying the risk factors here. We think that's the prudent move long-term. And you're going to start to see it in the loss ratios, and in my opinion the profitability going forward.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

As to the acquisition -- policy acquisition costs this quarter, I guess, on an absolute basis were relatively stable sequentially. That's a kind of 13%, 14% range. Is that the normal do you think? I think, historically, it would have been, I guess, influenced by the Citizens takeouts. But it seemed like a little better than [ph] 12%?

Steven Martindale
Chief Financial Officer

Yes. Probably 14% would be better, yes, without Citizens takeouts, getting -- acquiring policies with no acquisition costs, going forward that's going to stay up -- that's a little higher.

Operator

The next question comes from John Barnidge of Sandler O'Neill.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

About Zephyr, do you see that as a platform for growth in the state of the Hawaii?

Bruce Lucas
Chairman of the Board & CEO

You can grow it, if you really want to drop the premiums. We're not really interested in dropping the premiums too much out there. We have a very, very sound and strict underwriting discipline at the company. We look at -- take Florida by analogy, over the last several years, everybody in the states have been dropping their rate left and right and giving away coverage. We didn't do that. We were smart enough to see that the future claims environment would include higher severity. So we took our rate up and we didn't give away coverage. Zephyr is the same thing, I mean, it can get a little soft out here with E&S. We could chase rate down and grow top line to the detriment of bottom line. So although, there'll be some minor rate reductions there and they kind of lock step in correlation with the reinsurance cost, we're not really interested in growing that top line to sacrifice bottom line results. We're a bottom line focused company. We've never been focused on growth, growth, growth and then you end up -- you will lose money for the year or you'll make almost nothing for the year. That doesn't sound too appealing to us. So we're going to be strict in our underwriting discipline. We have an extremely high retention rate there, about 95%. Agents know and trust us in that state more than anybody else. We've got a great management team. And we know that if we're a few points higher than the market, I really don't think it's a bad thing to do, but that means that you're not going to have game buster growth out there.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Okay. I think I heard it correctly. Did you say that you think there'll be significant reinsurance savings in the second half of the year due to your actions you're taking in the Tri-County area?

Bruce Lucas
Chairman of the Board & CEO

Yes.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Okay. As far as the vertical integration and how it performed in the storms in the second half of the year, did you just use any outside contractors?

Bruce Lucas
Chairman of the Board & CEO

We absolutely did. And we bring in outside contractors, particularly to help us with tree removal and roof tarping as 2 great examples. We knew that fallen trees would be a big issue. So we had already lined up relationships with companies that have the necessary equipment to do tree removal. And we stockpile roof tarps here year around, and if you need more bodies to throw those roof tarps on, you're going to do that. And then, we had a little bit of outside resources lined up to help us out with water mitigation because we wanted to be able to respond to a huge influx of claims within a very short time period. But they did it at our rates. And so that's the key, it didn't cost us anything more. So I would say, if you look at the claims that we did, I mean, I think on the repair side, I think BRC got like 95% of them. We really over executed on this cat. It was -- it produced meaningful savings for the company and proved that our vertically integrated claims model, not only is it unique, but it works. And that should help translate into better risk profile heritage for reinsurance and reinsurers are absolutely taking note of what we're doing.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

The 9.9% rate increase in HO3, how does that compare to last year?

Bruce Lucas
Chairman of the Board & CEO

Yes. I think last year, if you look at the voluntary side, that was probably low to mid-single digits. So it's a little higher.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

The $1.1 million in prior year claims, what was that in the third and second quarter?

Steven Martindale
Chief Financial Officer

So the second and third quarter, was -- we had about 15 first quarter, 1 here. We had about 18.8 total. So...

Bruce Lucas
Chairman of the Board & CEO

It's negligible.

Steven Martindale
Chief Financial Officer

Yes, it's that negligible difference.

Bruce Lucas
Chairman of the Board & CEO

Call it $1 million-a-quarter-ish.

Steven Martindale
Chief Financial Officer

Yes, most of the development, obviously, we caught first quarter.

Bruce Lucas
Chairman of the Board & CEO

Yes. And that's the thing. We were the first Florida public company to come out in 1Q and say, time to add to prior year reserves, because of what we're seeing in claim severity and aggressive tactics. Since then, we really haven't had to add much. If you compare it to what a lot of other guys are doing, they're still playing catch up. I think we've got a pretty good handle on it here at Heritage. So we were first in front of the curve and we're seeing the benefits today.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

And then, Allstate is in the headlines for seemingly making a move into Florida property. Can you talk about this?

Bruce Lucas
Chairman of the Board & CEO

Yes. And so we've been in discussions with Allstate for quite some time about joining the Ivantage network. That is absolutely true. They are not only reducing the number of carriers that they have, I think, Cypress is a good example of that here in Florida. But Castle Key is absolutely growing in Florida. They're going to be more aggressive in Florida. We're not an Ivantage carrier. So it doesn't really impact us at all, but I can tell you that I've confirmed this at an extremely high level over at Allstate, that they are definitely going to be growing in Florida and cutting back on the Ivantage production.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

I think last quarter, North Carolina represented 50% of new premiums. Is that still the case or has it even grown -- let's focus maybe on expansion states, ex-Florida, what percent of new premiums is that?

Bruce Lucas
Chairman of the Board & CEO

We would have to do a quick calculation here. Let me pull up that report.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

In the meantime, I've got another question.

Bruce Lucas
Chairman of the Board & CEO

Yes, let's go ahead.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

All right. M&A landscape, where do you think your focus is going to be on geography -- geographically? I mean, there have been headlines about Demotech down, possibly downgrading the smaller capitalized insurers. Do you see like M&A focus in Florida take advantage of the landscape after the storm? Or do you see it more outside Florida?

Bruce Lucas
Chairman of the Board & CEO

I see it more outside Florida and I will tell you why. There is -- I'm not going to name names of these companies that Demotech deciding to, but there is probably about 10 of them that you've got to look at a lot of these guys and I'm just not so sure that they're going to make it. There is a 5 or 6 that jump out immediately. There is nothing that I have seen that's happened in the last 1 month or 2 months that has changed the solvency of these guys, it's pretty minor. It is extremely difficult to outrun a terrible book of business and terrible management. And that's what I see. I see companies that came in, they tried to be like us. The problem is they did everything differently than we did. We took our policies first. We saw the opportunity before anyone else did and we stopped taking it when we didn't like the underwriting bucket. We took our rates up, we're not virtual, and we didn't overweight in the Tri-County. And these guys did everything exactly the opposite. And so I look at those books of business and quite honestly, I have 0 interest in them. I don't think they're good books. I don't think you make money on them. I think they're headed back to Citizens at the end of the day. And then where there is some real statutory reform on this abuse that's taking place in the Tri-County, there is going to be a huge goldmine opportunity at Citizens again but I believe that's years into the future. So our focus right now is diversifying the footprint away from Florida, similar to what you've seen with our ex-Florida growth and our acquisition of Zephyr.

Operator

And we have a follow-up from Arash Soleimani of KBW.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

In terms of the 33% 1Q '17 loss ratio, does that include any prior year development or is it just the pure accident year number?

Steven Martindale
Chief Financial Officer

We won't know about prior development until we complete our reserve study after the end of the quarter. So we're not planning for development. We wanted to capture that at year-end.

Bruce Lucas
Chairman of the Board & CEO

Yes. We really have not been seeing prior year development in the last several quarters, right? And so we're bucking the trend in Florida. We're adequately reserving in management's best estimate. We -- I can tell you that claim counts are going down, lawsuits are going down. These are all very positive things and ex-hurricane, of course, these are all positive things in terms of the forward trend on our loss ratios.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Right. Okay. And the other question I had, I know you're shrinking in Tri-County. So is the goal to, on the personal line side, to exit Tri-County completely? Or is the goal to say, okay, we still have a core book in Tri-County that is profitable that we want to keep? I'm just trying to see, again, is it a complete exit you're looking to do in Tri-County or just to wiggle it down to a core business?

Bruce Lucas
Chairman of the Board & CEO

No, we're not looking to do a complete exit in Tri-County. I think you can solve a lot of Tri-County issues if you put enough rate on it. There isn't a problem in this world that you can't solve without rate. And so our rate increases are meaningful. And our position in Tri-County is that, we need to have higher rate to justify the risk profile. You shouldn't go into Tri-County and make a few points of profit, that's absurd with the risk factors that are taking place there. The margin has got to be bigger because the risk factors are bigger. And all I see from Tri-County right now is more and more aggressive tactics, bigger and bigger claims coming in. That is a market that you do not grow into. That is a market that you take underwriting action and rate action and that's what we're doing. That's prudent for the company in the long-haul. But we'll still have a core book of business. We credit score our book and we're putting a lot of rate on it and those 2 things are going to help us a lot. We also have a pretty large HO3 portfolio in -- that we have call it, 35% to 40% of our houses, that are plus 40 years old. Those policies are automatically capped at $10,000 in water damage. That is going to significantly help the loss ratio and the underwriting profile in the Tri-County.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And you seem -- all right, go ahead.

Steven Martindale
Chief Financial Officer

The loss ratio of Tri-County is at around 43% and the goal is to get that down around 35% for the personal lines.

Bruce Lucas
Chairman of the Board & CEO

I believe, we're making money down there, it's just, I think that we should be making more because of the risk factors. I don't know what the acceleration of the fraud is going to be, given that the legislature is not going to do anything about it.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And you see more pessimistic, I guess, about the legislature than maybe you have in the past. Is there...

Bruce Lucas
Chairman of the Board & CEO

Yes.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

I guess any reason for that or...

Bruce Lucas
Chairman of the Board & CEO

Well, I think if you look at some of the elections that took place and there are a lot of, let's just say, trial bar friendly people in very prominent positions on the committees. In order to get a bill through, you've got to have ex number of stops in the house and the Senate in order to get approval. Those stops are all committee stops. And the committees don't seem to be real friendly to AOB reform. So kind of is what it is. And that's just where we are. I'm just being realistic about it. Unfortunately, I think there a lot of people in the current legislature, are making money off of this or their cronies are making money off of this scam. And they are more than happy to punish homeowners in their own precincts for years to come, as long as they're getting rich on it and that's just reality. So I don't think there's anyone in the state that really knows what they're talking about that would disagree with that statement. So I'm not banking on reform. I'm not counting on reform. We are taking action on our own to take care of our policyholders and our organization.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

I guess, how many -- so you mentioned, you have the 9.9% increase overall and that's much higher in Tri-County. So it sounds like pretty much everyone is doing a double-digit increase in Tri-County. So I guess, my question for you is, how many rounds of, I guess, double-digit increases do you think it takes until they're kind of forced to do something?

Bruce Lucas
Chairman of the Board & CEO

Yes, that's a good question. I don't know that it's necessarily a reflection of rounds of double-digit increases, as it’s a reflection of Citizens policy count swelling back up again with essentially a Tri-County book of business. They are getting hammered at Citizens right now. The tactics being employed there are just disgusting. And they are being preyed upon. There is no other way to look at it. Severities are outrageous, frequency is like jaw dropping, twice industry average, lawsuits, twice industry average. And what's going to happen is, is the current trend is going to continue. It's going to whittle down the surplus there. That weakens their financial solvency, it weakens their ability to buy reinsurance. They're going to have a cat at some point, it's a matter of when that is. And it will be a state of emergency for Florida, because it will become a non-fundable liability, if it goes on long enough. Then you'll get reform. I don't necessarily know that it's just a reflection of passing rate through to the customers. Heck, if that were the case, we'd have reform already because everyone is passing rate through them.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

Right. And just to touch back on the expense ratio. That 27% that you mentioned, did you say by the end of the year that goes down?

Steven Martindale
Chief Financial Officer

Yes, it drops to 26% because 1.2 points of the intangible -- the amortization of the intangible assets goes away after the first quarter. So if its 27%-ish, you drop the 1.2 off of it and is 26%-ish.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

And that amortization, is that just reflected in G&A?

Steven Martindale
Chief Financial Officer

Where are we running there? We're running that through PAC.

Arash Soleimani
Keefe, Bruyette, & Woods, Inc., Research Division

PAC, okay. And then just touching back on the 33%, again. So if I go back to the first quarter of 2016 and I back out development and cats, there's like a -- it's about a 28% loss ratio. So I just wanted to -- with the 33% -- I know you said, the bad guys are taking a break in December, coming back kind of in full force. But what I guess -- so I'm just trying to figure out like, why is it going up by 500 basis points, ex cat and ex development?

Steven Martindale
Chief Financial Officer

Right. It's -- and it's -- we talked earlier about kind of mini cats, which we -- when I talked about weather, we're talking about all loss causes of weather and we average about $10 million per accident quarter. And so we only have -- and so fourth quarter, the last couple of years has been $5 million or $6 million. So you go back to your average weather in January and you would be at $10 million, and 1 year ago, that was about $16 million for all. So we expect more weather just in January -- I'm sorry, in the first quarter than we do in fourth quarter. Fourth quarter is a depressed weather quarter ex hurricanes.

Bruce Lucas
Chairman of the Board & CEO

Yes. And I think -- on top of that, I think when you see an increase in loss ratio across the Florida industry, and it's not us, it's everybody, it's -- in my opinion, it's not an increase in frequency, in fact our claims are going down. It's increase in severity, and a lot of that delta you can attribute that to the fraud and especially out of the Tri-County area.

Operator

The last question today...

Steven Martindale
Chief Financial Officer

We do have an answer from a previous question. The question was, how much of the new business from -- did North Carolina and South Carolina contribute on the voluntary side? It is 29% of policies and 25% of the premium.

Operator

And the last question will come from Mark Hughes of SunTrust.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

And I think you've probably addressed this, but when you look at the AOB issue, I know you're reducing your exposure. But do you think the -- in the market as far as an issue, has it leveled off? Has it flattened out or is it still getting worse do you think?

Bruce Lucas
Chairman of the Board & CEO

I think we're doing better to be honest with you. There are some pockets of high AOB abuse outside of the Tri-County, most notably Western Hillsborough in the town and country corridor. We shut that down a long time ago. And so that has helped. But overall, I mean if you look at how our percentage of AOB claims has developed overtime, I actually think we ticked down last year as a percentage versus 2015, is the way we handle claims. So our AOB percentages are getting smaller, it's just that the ones that you're generating out of Tri-County, which is the vast majority of them, they are just more and more aggressive. And when they get that way and file lawsuits, your severities go up. I can tell you though, like fourth quarter lawsuits dropped for us. It was lower than third quarter. So we're trending in the right path. It takes a little bit of time to kind of turn the trajectory, but I do think that we've peaked on it and we are going to be heading down. And a slightly smaller book down there will not only save the reinsurance cost, because the reinsurers are starting to surcharge Florida companies based on their Tri-County exposure because they're concerned about the same issue post cat. So we'll save money there. And we'll save money just on the AOB loss ratio. As the rate goes through, we have fewer policies, fewer claims, all of that will be -- have a meaningful impact on the loss ratio. So I'm actually pretty positive about our future trajectory. I'm not bullish about legislative reform but in terms of the actions that we're doing here, we took bold steps over 1 year ago ahead of the rest of the market to combat this. I see people now starting to shut down in the Tri-County very recently. We were 1 year ahead of that curve. And so we're going to be 1 year ahead of all of those companies in terms of our performance, once the book starts to turn back.

Mark Douglas Hughes
SunTrust Robinson Humphrey, Inc., Research Division

All right. How would you -- if you take a step back and look at the industry as a whole, how do you think the trend has been on AOB?

Bruce Lucas
Chairman of the Board & CEO

I think they're absolutely going higher. I have spoken to, I won't name names, but a lot of CEOs, and I have spoken to a lot of reinsurers who kind of delve into these issues and everybody is shocked that our percentage of AOB actually trended down a little bit last year. And that, over the last call it, since inception of the company until now, is essentially flat for us. That's not a normal trend in this market.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Bruce Lucas, Chairman and CEO for any closing remarks.

Bruce Lucas
Chairman of the Board & CEO

I would like to thank everyone for participating in our fourth quarter and year-end 2016 conference call.

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