S&P Capital IQ

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Heritage Insurance Holdings, Inc. NYSE:HRTG

FQ2 2014 Earnings Call Transcripts

Tuesday, August 05, 2014 2:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2014-			-FQ3 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.32	0.39	▲21.88	0.16	1.34	2.57
Revenue (mm)	46.05	46.54	▲1.06	46.16	190.68	315.42

Currency: USD
Consensus as of Aug-05-2014 6:25 AM GMT

Call Participants

EXECUTIVES

Bruce Lucas
Chairman of the Board & CEO

Stephen L. Rohde
Advisory

ANALYSTS

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

Matthew John Carletti
JMP Securities LLC, Research Division

Presentation

Operator

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

Statements in this conference call that are not historical facts are forward-looking statements without limiting the generality of the foregoing words such as anticipate, believe, budget, contemplate, continue, could, envision, estimate, expect, guidance, indicate, intend, may, might, plan, possibly, potential, predict, probably, pro forma, project, seek, should, target or will, or the negative thereof, or other variations thereon, and similar words or phrases or comparable terminology are intended to identify forward-looking statements.

The matters discussed on this call that are forward-looking statements are based on current management expectations involving risks and uncertainties that may result in these expectations not being realized. Actual events, outcomes and results may differ materially from what is expressed or forecasted in forward-looking statements made on this call due to numerous risks and uncertainties, including, but not limited to the risks and uncertainties described in this conference call or press release issued today or other filings made by the company with the SEC from time to time. Forward-looking statements made during this presentation speak only as of the date on which they are made. And Heritage Insurance Holdings specifically disclaims any obligation to update or revise any forward-looking statements to reflect new information, future events or circumstances or otherwise.

Now at this time, I would like to turn the conference over to Bruce Lucas, Chairman and CEO of Heritage Insurance Holdings. Please go ahead.

Bruce Lucas
Chairman of the Board & CEO

Thank you, Drew, and good morning to everyone joining us for the call. This is Bruce Lucas, Chairman and CEO of Heritage Insurance; and with me is Steve Rohde, our CFO. I would like to welcome all of you to our first earnings call.

Before we begin the discussion of our quarter, I would like to take a minute to thank all of our employees. Our accomplishments to-date are a reflection of our exceptional employees and their commitment to our company.

We had a successful and exciting second quarter, our first as a public company. From a financial perspective, we had an excellent quarter. Our reinsurance costs are lower; our gross written premium increased significantly; attritional loss ratios remained stable; and we generated an attractive return on equity for our shareholders.

In addition to our strong financial results, we also accomplished a number of things during the quarter which align with our strategic vision for the company and position us for continued success in the quarters and years to come.

First, we completed the acquisition of approximately 33,000 policies, roughly $59 million in in-force premium from Sunshine State Insurance Company. The acquisition of these policies creates a better spread of risk throughout Florida and lowers our PML-to-premium ratio by 8.5%. Furthermore, our in-force premium post-transaction increased by 26%. However, our probable maximum loss only increased 11%. These favorable metrics are just one indication of the synergies created by the transaction.

Second, we launched our commercial residential program and have built the deepest department in Florida, which currently has 7 professionals. We have 3.6 million of in-force premium in this line and are well positioned for strong growth in this line of business as the team slowly ramps up and we gain scale.

Third, we increased our voluntary agent network by over 10% and formed valuable relationships with some of the largest agencies in Florida. The addition of these 150 new agencies are in areas where we want to grow our production, and our support from the agent community has been exceptional.

Lastly, we capitalized on favorable reinsurance market conditions in a number of ways which we believe places us in a leadership position amongst our peers. We led the Florida private insurance market by placing $200 million of multiyear catastrophe bonds, Citrus Re 1 and Citrus Re 2, on very favorable terms.

Our decision to pursue a large multiyear insurance-linked security transaction was unique in the Florida market and yielded considerable savings to the company. We also placed a substantial portion of our lower layers of reinsurance on a multiyear basis and locked in favorable reinsurance terms at market lows. Our reinsurance initiatives provide a stable pricing platform at which will help to produce more stable and predictable underwriting results while reducing reinsurance volatility in future years. It goes without saying that all these accomplishments took place during the quarter in which Heritage completed its initial public offering, which to me, shows the strength of our team and makes the results all the more impressive. We have exciting plans for the future of the company, and we look forward to updating our investors as they unfold.

Now for the financial results, I will turn the call over to Steve Rohde, our Chief Financial Officer. Steve?

Stephen L. Rohde
Advisory

Thank you, Bruce, and good morning. First, I'd like to give you a few financial highlights from the second quarter. Our gross written premiums were $99.3 million. Net income was $9.6 million. Our combined ratio as measured against gross earned premium was 79.9%. And we increased stockholders' equity by $111.5 million largely from net proceeds received from the IPO, the concurrent private placement and the warrant exercise. In June, we completed the acquisition of approximately 33,000 policies from Sunshine State Insurance Company following SSIC's receivership. This acquisition resulted in an increase in our gross written premiums of $29.3 million during the quarter, representing the unearned premiums on the policies acquired at the time of the acquisition. While we recorded $29.3 million as written premium, the policies assumed from SSIC represent approximately $59 million of annual premium. With the SSIC policy acquisition, our policy count reached 171,000 policies at June 30, an increase of approximately 22% over March 31, and 92% over June 30, 2013.

Our total in-force premium at June 30 was $317 million, an increase of 80% over the prior year. As of June 30, approximately 69% of our policies are from Citizen takeouts, 19% from SSIC and 12% from voluntary business. Policy count of our voluntary business produced by our network of agents increased 27.5% over the previous quarter.

As Bruce mentioned, our reinsurance costs are lower following the placement of our reinsurance program on June 1 in part due to the issuance of $200 million of CAT bonds through Citrus Re in addition to favorable terms received in the marketplace. The cost savings accruing from this year's program are not yet fully apparent in our second quarter financial statements, but the benefit we're seeing in future quarters. Our ceded premium ratio, as measured against gross earned premiums, was actually higher in the second quarter than the first quarter or the prior year.

During the fourth quarter of 2013 following the hurricane season, and the first quarter of 2014, the company increased its policy in-force significantly by participating in 5 Citizens' depopulations causing our policy count to grow from 85,000 policies at September 30, 2013, to 140,000 policies at March 31, 2014. This resulted in gross premiums earned increasing substantially without a corresponding increase in ceded earned premiums until June with the placement of the new reinsurance program. This explains the increase in our ceded premium ratio, though we could expect to see a similar pattern emerge over the course of the next 4 quarters.

For comparative purposes, our reinsurance costs this year are approximately 31% of in-force premium at June 30. Last year, our reinsurance costs were approximately 43% of in-force premium with substantially the same coverage when viewed on a probable maximum loss basis. Some of the improvement in the ceded premium ratio is due to rate increases on Citizens renewal policies, but most of the improvement is from favorable reinsurance terms and the issuance of the CAT bonds, an important and excellent result for us, which will continue to benefit our results in the coming quarters.

As an overview of the reinsurance program we placed in June, we have $990 million of first event protection and $1.2 billion of total event coverage. We retained only the first $15 million of pretax losses from the first event, $6 million from the second event and $2 million per event after that.

Osprey Re, our captive, has an additional $45 million retention at the top of our program, where the probability of attachment is very low. Our loss experience continues to be positive and well within our expectations. Our loss ratio as measured against gross earned premiums was 30% for the quarter and 31.9% year-to-date. Our loss ratio on a reported basis was 24% for the quarter and 25% year-to-date with IBNR increases making up about 6 points of the loss ratio for the quarter and 7 points year-to-date. In total, our unpaid loss in LAE reserves at June 30, 2014, were $34.5 million, which included $19.9 million of IBNR or 58% of the total loss in LAE reserves. Our expense ratio as a percentage of gross earned premiums was approximately 19% for the quarter and year-to-date as well, reflecting the economies of scale we have achieved in such a sort time. The $10 million acquisition payment for the SSIC policies was capitalized in June and is being amortized in relation to earning out of the unearned premium that we acquired and will be reflected on our expense ratios in the next 2 quarters.

With the synergies, we will receive -- with our reinsurance placement due to the geographic spread of risk, the expected loss experience from this book and the increased economies of scale we will receive from an expense standpoint, we feel very good about the transaction. Our combined ratio as a percentage of gross earned premiums was 79.9% for the quarter and 81.6% for the year-to-date, results that we were very pleased with, especially considering each component of our combined ratio; reinsurance, losses and expenses were each in line or better than our expectations.

On the balance sheet side, we netted about $101 million from the IPO, concurrent private placement at warrant exercise. $55 million was placed in our insurance subsidiary as paid-in-surplus to support the growth we expect from our entry into the commercial residential line of business. We put $45 million into our captive for some top-end cover in our program when the probability of attachment was very low as a way to reduce our overall reinsurance cost. After the hurricane season, these funds can be pulled out of Osprey and used for other corporate purposes.

Our invested assets at June 30 were $157 million with approximately $130 million invested in bonds with an average credit quality of A and a duration of approximately 4.1 years. Our cash position was $182 million at June 30, higher than usual due to the IPO proceeds. Our portfolio managers are currently investing the excess cash. Overall, our assets were $525 million at June 30, and our stockholders' equity was $222 million.

And with that, I'll turn it back to Bruce.

Bruce Lucas
Chairman of the Board & CEO
Thank you, Steve. We had an excellent quarter. And now, I will open the call for any analyst questions.

Question and Answer

Operator

[Operator Instructions] The first question comes from John Barnidge of Sandler O'Neill.

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

A peer of yours recently announced a joint venture backed by a reinsurer looking to penetrate the voluntary homeowners market in Florida. How do you anticipate this impacting the competitive environment for you? And could you also touch on the competitive environment in general during the second quarter? And I have one other question once we're finished with that.

Bruce Lucas
Chairman of the Board & CEO

Sure, John. This is Bruce. Welcome to the call. With regard to Federated and the Monarch transaction, to be quite honest with you, we haven't seen the details there. We don't know what their underwriting focus is going to be. I would just simply add that to the extent they go through the application process, get an approved carrier, you're probably talking 6-plus months easy just to get that process finished. Then once they get in place, they got to get their systems up and running. So really that's probably a 2015 issue. That's just my guess. But the addition of 1 extra carrier and the premiums that they look to add, I don't think is really going to have an overall major impact on the market. With your Part B question, which is the overall competitive market, I mean, listen, every insurance market is competitive. We are seeing, right now, that things appear to be pretty stable. I know that we've seen lower reinsurance costs. Some carriers are taking lower premiums as a result; some are not. We haven't seen any empirical evidence to suggest that the market is any way eroding from our rate standpoint. Other than that, I'll go ahead and take any follow-on questions that you may have.

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

Sure. Just one last one, and I'll requeue. Is there a level of gross premiums written or net premiums earned that once you reach kind of like a threshold that you'll see your fixed expense ratio fall?

Stephen L. Rohde
Advisory

This is Steve Rohde. Yes, I believe we are close to our place of economies of scale. And so I can -- I see continuing improvements -- modest improvement in our combined -- our expense ratio, which then translates to a combined ratio. But I believe -- I feel pretty good about where we are right now with our expenses in relation to our premium, which is basic 20% expense ratio, which we feel very good about.

Bruce Lucas
Chairman of the Board & CEO

And you have to -- and John, this is Bruce. You have to also take into consideration that with an increase in policy count, you have to have the staffing on hand that can handle claims, customer service, underwriting, water mitigation issues. We feel like it's pretty scalable. You're going to get some synergies as you continue to grow top line. But I agree with Steve; there was probably going to be some improvement there, but I wouldn't look for it to be anything more than, say, a modest improvement going forward.

Operator

Okay. The next question comes from Matt Carletti of JMP Securities.

Matthew John Carletti

JMP Securities LLC, Research Division

My first question relates to the kind of the various growth avenues you have going forward. I thought the split that Steve gave was helpful in terms of Citizens, SSIC and voluntary business. And I guess, my question is as you look out 1 year, 2 years, 3 years, how do you see that changing, the Citizens versus, say, not just SSIC but maybe other M&A opportunities versus personal residential and then commercial residential? What do you see as your best growth avenues as we look forward 1 year or 2?

Bruce Lucas
Chairman of the Board & CEO

Well, it's really a combination of all of the above. And certainly, there are a lot of policies still at Citizens. And when you listen to Citizens' chief actuary, they talk about rate adequacy in place on about 600,000-or-so policies there. So certainly, that is an avenue of future growth for us. We're going to continue to look at those transactions as they unfold, and we intend to participate in Citizens' depopulations going forward. I would also say though that the voluntary production has been a focus of our company since day 1. We actually wrote voluntary before we ever did takeouts. And we are continuing to add very key agent relationships there. Just in the past quarter, we added an additional 150 new agencies into the fold for voluntary business; very high-quality agents, who have been very supportive of us, particularly in light of the Sunshine State acquisition. So we are looking to continue to ramp up on the voluntary production side. With respect to commercial lines, commercial residential is a big push of the company. And as you know, Matt, we went and hired some very experienced professionals who are highly regarded in the state to run that program. We have now built the department out to 7 people, and we have a new policy processing system that's coming online in the fourth quarter to help with that and to help scale. We are looking to significantly grow that line of business. We think there's a big opportunity out there in commercial residential if you have the right agent relationships and enough capital to back the line, which we do.

Matthew John Carletti
JMP Securities LLC, Research Division

Great. And then just one quick other one, just more focus on M&A. I know Sunshine State was a bit of a special situation that worked out great for you guys. Longer term, absent, say, a storm that puts a lot of stress on some of the weaker players, do you see good opportunities for other M&A? Or do you think it'll be more event driven that we need some weather to put some stress on some peers?

Bruce Lucas
Chairman of the Board & CEO

Well I, in my opinion, I think that in Florida, I don't think a strategic acquisition would make much sense for us given that you just don't see the same synergies. We are evaluating some M&A opportunities right now that are outside of Florida. And I think that is where our focus will remain in terms of M&A activity. So you look at the synergies that you get by leaving the state in terms of a potential acquisition. And obviously, reinsurance costs will have the greatest impact of going down, which would increase profitability from an acquisition. I think that's where our focus is going to remain. We're not going to rule it out, but we're also not going to do a transaction unless it really makes sense for the company.

Matthew John Carletti
JMP Securities LLC, Research Division

Great. And it would be safe to assume that outside Florida focus would be somewhat similar states, let's call it, coastal environments where wind and other things play a factor?

Bruce Lucas
Chairman of the Board & CEO

Yes, that's correct.

Operator

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