S&P Global
Market Intelligence

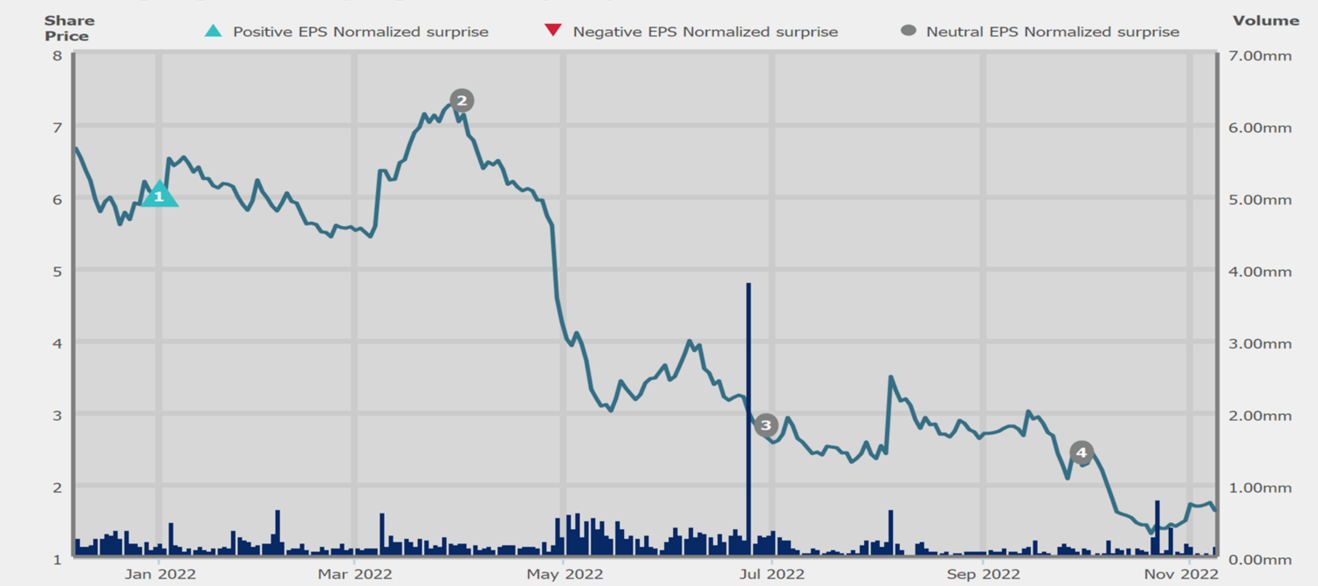
Heritage Insurance Holdings, Inc. NYSE:HRTG
FQ3 2022 Earnings Call Transcripts

Wednesday, November 9, 2022 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(1.06)	(1.83)	NM	0.14	(1.96)	NA
Revenue (mm)	162.61	165.49	1.77	172.61	650.68	NA

Currency: USD
Consensus as of Nov-08-2022 10:12 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	0.16	0.41	156.25 %
FQ1 2022	0.22	(1.15)	NM
FQ2 2022	(0.12)	0.11	NM
FQ3 2022	(1.06)	(1.83)	NM

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Call Participants

EXECUTIVES

Ernesto Jose Garateix
CEO & Director

Kirk Howard Lusk
Chief Financial Officer

ANALYSTS

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Paul Newsome
Piper Sandler & Co., Research Division

Presentation

Operator

Good day, and welcome to the Heritage Third Quarter 2022 Earnings Call. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I'd now like to turn the conference over to Ernie Garateix, Chief Executive Officer. Please go ahead.

Kirk Howard Lusk
Chief Financial Officer

Good morning, and thank you for joining us today. We invite you to visit the Investors section of our website, investors.heritagepci.com where the earnings release and our earnings call will be archived. These materials are available for replay or review at your convenience.

Today's call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based upon management's current expectations and subject to uncertainty and changes in circumstances. In our earnings press release and our SEC filings, we detail material risks that may cause our future results to differ from our expectations.

Our statements are as of today, and we have no obligation to update any forward-looking statements we may make.

For a description of the forward-looking statements and the risks that could cause our results to differ materially from those described in the forward-looking statements, please refer to our annual report on Form 10-K, earnings release and other SEC filings.

Our comments today will also include non-GAAP financial measures. The 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 for joining our call today. We'll discuss our third quarter 2020 results during this call. I will provide overview of our strategic initiatives. Kirk will provide an update on key financial performance metrics. And then we will open the call for Q&A.

Our thoughts continue to be with all those impacted by Hurricane Ian, which made landfall in Florida on September 28. We remain committed to assisting our policyholders, and I'm proud of the hundreds of employees we've mobilized and deployed to respond to this event. Our customers have been loyal to us based on the promise to deliver a service in their time of need. We are committed to fulfilling that commitment by providing timely payments of valid and covered claims.

Our experienced claims team has deep catastrophe handling experience, which includes distinguishing causes of loss from wind versus flood. We continue to execute strategic initiatives that will enable Heritage to achieve consistent, long-term quarterly earnings and drive shareholder value.

Our initiatives, which are described in our earnings release, include rate adequacy and selective underwriting, product selection and capital allocation and diversification of our portfolio of policies throughout 16 states.

Getting appropriate rates for our coverage offer is paramount. We continue to take rate in all our markets to keep up with the cost of reinsurance, higher frequency of weather events and higher repair and replacement costs driven by inflation of products and services. These higher rates are the primary driver of our 13.6% increase in the average premium per policy throughout the book, and we expect this trend to continue.

We continue to derisk and diversify our policy mix outside of Florida. These efforts have led to the growth of premiums in force in all states outside of Florida. In addition, total insured values outside of Florida represents approximately 75% of our portfolio, up from 71% at this time last year.

Our underwriting continues to be more selective, and we continuously evaluate coverage changes so our product serves our markets, but also produces margin. A considerable market disruption has caused us to tighten our underwriting criteria while also restricting new business in our over concentrated markets. Even with the tightening of our criteria and limiting new business, our premiums in force are at a historic high of $1.24 billion at the end of the quarter. We seek to align our capital with our products and geographies that maximize long-term returns. Correspondingly, we will exit products in states that we don't believe can generate long-term returns or have limited upside potential.

I am pleased with our progress in this area. However, we continue to evaluate our portfolio and expect to make more changes going forward as we focus on both short- and long-term returns. Reinsurance capacity and pricing is a factor in how we allocate capital by product and state. The cost of reinsurance is expected to increase, and capacity constraints are on the horizon. We appreciate our reinsurance trading partners with whom we have developed a long-term consistent relationship.

Given the expected pricing and capacity for catastrophe reinsurance going forward, we will continue to evaluate and adjust our portfolio to manage exposure concentration. This includes the amount of new business we expect to write and the amount of existing business we may renew while maintaining compliance with individual state regulations.

Product selection is also key to our long-term success. As we reduce business in products or geographies that don't provide sufficient margin, we are entering markets we believe offer opportunity for our company and our customers. For example, we entered the California and Florida markets on an excess and surplus lines basis, which allows us to be nimble and responsive to pricing and product offerings. We continue to analyze and evaluate the challenging markets in which we operate, and we'll look to expand our excess and surplus line capabilities in other states and markets.

Despite the negative impact Hurricane Ian had on our third quarter 2022 results, we are pleased with the progress we continue to make towards sustainable profitability. Rate increases continued to meaningfully benefit written premiums throughout the book of business, and we remain committed to proactively and appropriately raising rates to offset higher cost for reinsurance as well as higher loss costs. We are taking underwriting actions to improve profitability.

This concludes my remarks. Let me now turn things over to Kirk Lusk 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. The third quarter net loss totaled $48.2 million or $1.83 per diluted share compared to a net loss of $16.4 million or $0.59 per diluted share in the prior year quarter. This loss was primarily attributable to a $40 million net retained loss for Hurricane Ian that previously was announced on October 13, and without which, our net loss and LAE for the quarter would have declined by $14.8 million or 10.6% from the prior year quarter. The company has received close to 14,000 claims associated with Hurricane Ian, and we project ultimate gross losses, including loss adjustment expense, of $655 million. At this level, we expected ultimate loss from Hurricane Ian will remain well within the second layer of our cat excel tower.

The third quarter was also impacted by a $10.7 million tax valuation allowance related to Osprey Re and its Internal Revenue Code Select Section 953(d) election for which we are able to recover the valuation allowance as Osprey generates future net income. As Ernie mentioned, in-force premiums are at their highest level at $1.24 billion, up 5.8% while policies in-force are down 6.9% and CIB is up 2.1%. The increase in premiums and decrease in policy count reflects the amount of rate earning through the portfolio and tightening underwriting. In-force premiums in all states other than Florida grew by 14.4%.

Policies in-force decreased by 18.8% for Florida admitted personal lines policies. While personal lines Florida in-force premium was down 7.8%, we grew our commercial lines premium by 18.2% over the prior year period. The increase in our commercial portfolio while decreasing our personal portfolio in Florida results from our effort to shift capital to those lines of business and geographies that generate sufficient returns and away from lines that do not.

Total revenue for the quarter declined 1% from the prior year quarter, reflecting an increase in ceded premium of 12.4% exceeding the increase in gross earned premiums of 4.2%.

The ceded premium ratio ended the quarter at 48.1%, up 3.3 points from 44.8% in the prior year quarters. The increase primarily stems from higher cost of our 2022 to 2023 catastrophe excess of loss program. The increase in this program was driven by higher rate online as well as higher total insured value.

In addition, other income is down due to a reduction in policy fees associated with fewer policies in-force, which is partially offset by an increase in investment income with higher interest rates.

The net current accident year weather losses of $63.8 million ended the quarter up 24.2% from $51.4 million in the prior year quarter. As mentioned, current accident catastrophe weather losses included $40 million of net current accident quarter catastrophe losses attributable to Hurricane Ian, up 150.5% from $16.0 million in the prior year quarter and $23.8 million of other weather losses, down 32.8% from $35.4 million in the prior year quarter. Attritional losses were also up slightly in the quarter, most notably in the Northeast.

Expenses are up due to acquisition costs related to the increase in gross written premium with a net expense ratio driven higher by the reduction in net earned premium.

The net combined ratio for the quarter was 133.3%, up 20.8 points from 12 in the prior year quarter, driven by higher net loss ratio and net expense ratio just mentioned.

Our focus on profitability will continue to drive reductions in policy count along with rate increases anticipated to align with inflation reinsurance and loss costs.

Abusive litigated claims practices inflation continued to be our primary concern for first lines business in Florida, and we have taken underwriting actions aimed at reducing the adverse impact of market challenges and inflation. We are also restricting underwriting to address the surging policies that certain markets are becoming more dislocated. We're also including inflation guard on all states.

Our book value per share is $4.54, but when adding back the unrealized losses in the investment portfolio, the adjusted book value is $6.65. With over $297 million in cash and cash equivalents, we don't anticipate a need to sell any of these investments in advance of maturity with the abundant cash held outside our investment portfolio.

Our duration is short at 3.4 years and the average credit rating on our invested fixed asset income portfolio is A+. As such, we expect the unrealized losses to decline as investments mature.

We operate by designing some very challenging markets and are focused on generating an underwriting profit and remain unfettered in that pursuit. We will continue to analyze and evaluate our portfolio to optimize returns and reduce volatility. We are dissatisfied with our stock price and do not believe it reflects the true value of the company. We firmly believe that each of our current operating companies are worth more than the total market capitalization of the company.

Management and the Board are committed to providing shareholder value and will take the steps necessary to drive that value. We remain focused on sustainable profitability and long-term shareholder returns. As I stated before, we will consider all options to realize the value of our entities and will also take the actions necessary to improve margins.
That concludes our prepared remarks. Operator, we are ready to begin the question-and-answer portion of the call.

Question and Answer

Operator

[Operator Instructions] The first question comes from Mark Hughes from Truist.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Kirk, how did you say -- how much cash is in the holding company?

Kirk Howard Lusk
Chief Financial Officer

$30 million.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then what is the surplus within the insurance operations?

Kirk Howard Lusk
Chief Financial Officer

Yes. The total surplus is -- between all entities is $261 million.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

Then how do you look at the capital adequacy in terms of the underwriting leverage, $261 million. How much more business could you put on? Or is the idea here -- from here that you taper? I guess you've continued to grow premiums and you're growing commercial in Florida. How do you view that capital adequacy?

Kirk Howard Lusk
Chief Financial Officer

Yes. I think when we look forward, I mean, our count, we anticipate that is going to continue to decrease. And we are taking substantial rates on top of our inflation guard factors. And that really is what's driving our premium increase.

When we look at going forward, we actually think that our kit count is going to continue to decrease. And I think our exposures are probably going to be leveling off a little bit.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then for reinsurance, refresh me on how much multiyear reinsurance you have in place, how much of your power will you have to buy this year or next year?

Kirk Howard Lusk
Chief Financial Officer

Yes. We do have a cat bond for the Northeast tower, and that would be the extent of our multiyear.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

So most of your spend will be the market in...

Kirk Howard Lusk
Chief Financial Officer

Yes. Correct.

Mark Douglas Hughes
Truist Securities, Inc., Research Division

And then anything -- any expectations for the Florida legislative session? Any particular fixes or strategies under discussion as far as you're aware?

Ernesto Jose Garateix
CEO & Director

So we have been discussing with legislators the one-way feed statute and doing something on the cat bond and they're all considering all those items, but those items are being discussed now and being strategized for a special session at this point.

Kirk Howard Lusk
Chief Financial Officer

Yes. One other comment I'd just make on going back to the reinsurance piece is we did defer on the RAP program last year. So that is available for us this year, which would assist below the FHCF.

Ernesto Jose Garateix
CEO & Director

And keep in mind, the FHCF accounts for almost 50% of the reinsurance program.

Operator

[Operator Instructions] Our next question comes from Paul Newsome from Piper Sandler.

Paul Newsome
Piper Sandler & Co., Research Division

Did you talk at all about -- you're saying with the RBC ratios were in the subs or I missed that. I apologize if I did.

Kirk Howard Lusk
Chief Financial Officer

Yes. At year-end, RBCs for HPCIC was just a little over $310. Zephyr was in the $440 range and NBIC was in the $420 range.

Paul Newsome
Piper Sandler & Co., Research Division

And that's as of last year's year-end.

Kirk Howard Lusk
Chief Financial Officer

That's as of year-end. I mean it is calculated kind of on an annualized basis based upon a 12-month rolling basis. So that's why we look at where it was versus the surplus.

Paul Newsome
Piper Sandler & Co., Research Division

Right. So presumably, those numbers will be different in the fourth quarter given the losses.

Kirk Howard Lusk
Chief Financial Officer

Yes. Given the losses, we anticipate -- I mean, Zephyr is still going to be well above $400. NBIC, I mean, and Heritage, we are looking to provide them with some additional capital or expense forgiveness in the fourth quarter. So that is already planned and in our expectations.

Paul Newsome
Piper Sandler & Co., Research Division

Could you talk about what would happen if Hurricane Nicole ends up being a significant event from the insurance perspective? Is it very much the same as what happened with Ian? Or does it have other changes?

Kirk Howard Lusk
Chief Financial Officer

Yes. I think from a retention standpoint, our attention -- match retention on a second event would be $32 million. Anything over $20 million, we basically have to cover that's $0.40 on the dollar. So even at $30 million would be $26 million, $40 million would be $32 million. And that would be the extent of our retention, so depending upon the severity of that particular storm.

Paul Newsome
Piper Sandler & Co., Research Division

Great. Can you talk all about the difference in profitability between Florida and non-Florida. How much of the difference in the profit?

Kirk Howard Lusk
Chief Financial Officer

Yes, yes. We think about -- we look at ourselves as a single segment from a reporting standpoint. So therefore, kind of look at it in totality.

I would tell you that our objective is to become rate adequate across the footprint, and that is in every state, every jurisdiction and every product. And so that's when you tense amount of rate we've been taking, both in the Northeast and the Southeast and also a little bit in Hawaii. That is reflective of that goal to basically focus on rate adequacy.

Paul Newsome
Piper Sandler & Co., Research Division

Any thoughts, I'll have this be my last question, about what level you're currently getting in terms of rate perspectively versus what you think the current inflation is on the business? Seems like there hasn't been a lot of makeup in the difference. Inflation has been remarkably higher and these price increases last couple of years. So where are you in view in terms of what you think the underlying claims inflation is versus just...

Kirk Howard Lusk
Chief Financial Officer

Yes. When we look at the underlying claims inflation, we think it is running a little over 10%, maybe even over a little 11%. That is baked into our pricing. And then we also have inflation going on top of that.

When you look at when we start taking rate and then the compounding of that is that the initial catching up, I think, with inflation was a little -- was slow, but we're starting to pick up ground. And when we look at the amount of rate earning through the portfolio year-over-year it increased in '22 from '21. And then going into '23, it actually is increasing substantially more that it did over the last several years. So it's really -- a lot of that rate we've been taking is starting to take effect into '23 and actually into '24.

Operator

[Operator Instructions] There are no more questions in the queue. This ends the question-and-answer session. I would like to turn the conference back over to Ernie Garateix for any closing remarks.

Ernesto Jose Garateix
CEO & Director

We thank everybody for joining the call today. And I hope everyone has a great day.

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