S&P Capital IQ

CONTENTS

Heritage Insurance Holdings, Inc. NYSE:HRTG

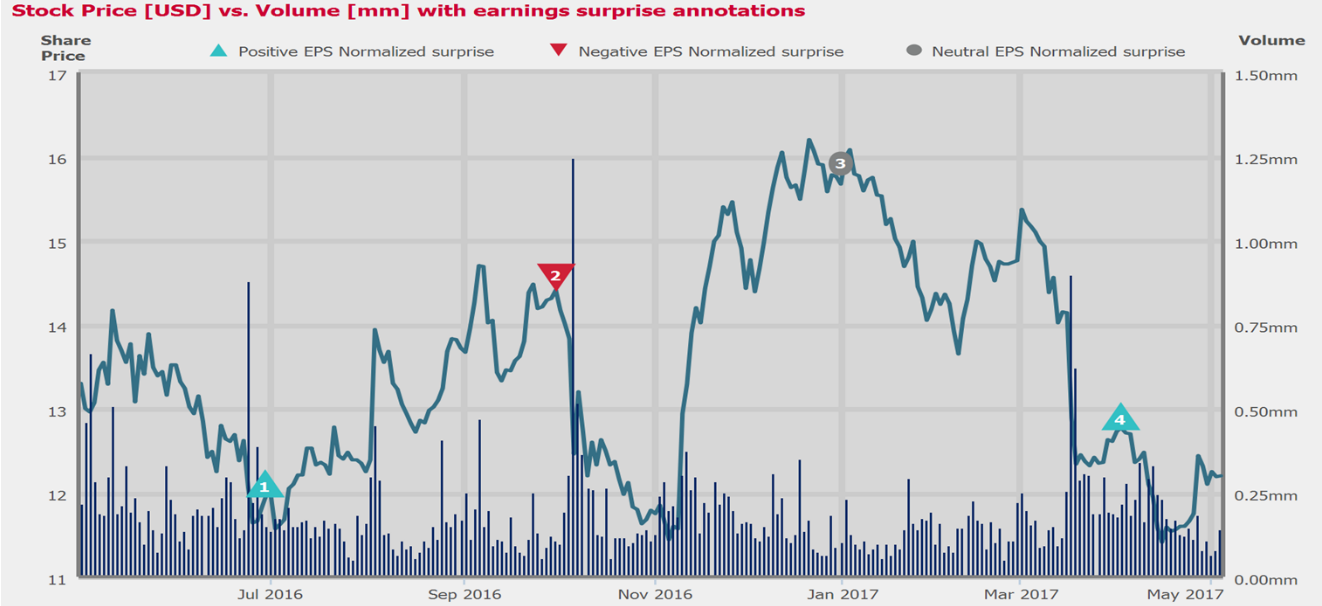
FQ2 2017 Earnings Call Transcripts

Wednesday, August 09, 2017 12:30 PM GMT

S&P Capital IQ Estimates

	-FQ2 2017-			-FQ3 2017-	-FY 2017-	-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.21	0.23	▲9.52	0.36	1.12	1.76
Revenue (mm)	100.17	96.94	▼(3.22 %)	99.79	398.00	414.65

Currency: USD
Consensus as of Jul-20-2017 5:18 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2016	0.55	0.62	▲12.73 %
FQ3 2016	0.38	0.37	▼(2.63 %)
FQ4 2016	(0.22)	(0.09)	NM
FQ1 2017	0.18	0.21	▲16.67 %

Call Participants

EXECUTIVES

Bruce Lucas
Chairman of the Board & CEO

Joseph R. Peiso
Vice President of Compliance

Stephen L. Rohde
Advisory

Steven Martindale
CFO & Secretary

ANALYSTS

Anthony To
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 the Heritage Insurance Holdings Second Quarter 2017 Financial Results Conference Call. My name is Keith, I will be the operator today. [Operator Instructions] Please note, this event is being recorded.

I'll now turn the conference over to Joe Peiso.

Joseph R. Peiso
Vice President of Compliance

Good morning. The second quarter's earnings release can be found in the Investor 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 will 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 will now turn the call over to Bruce.

Bruce Lucas
Chairman of the Board & CEO

Thank you, Joe. I would like to welcome all of you to our second quarter 2017 earnings call.

Before we begin the call, I'd like to thank all of our employees for their dedication to our company. I will first address the second quarter and then discuss our pending acquisition of Narragansett Bay Insurance. The second quarter continued to reflect significant improvements in several key metrics. For example, claims and loss ratios continued to trend favorably and our year-over-year non-catastrophe loss ratio improved 1.4 points during the second quarter.

The Tri-County continues to lead Florida in assignment of benefits or AOB and other abusive claims practices. However, we have implemented underwriting initiatives in the past year that we believe are yielding positive results. We completed our 2017 and 2018 reinsurance treaty, which resulted in more favorable terms and conditions as well as a reduction of approximately $20 million in premium compared to the 2016, 2017 treaty. In addition, voluntary policies written in the second quarter, set another new record for the company as we continue to grow new business in Florida, and production in the Carolinas and Georgia increases. The company continued its multi-state expansion and wrote its first new business policy in Alabama. Notable highlights for the second quarter are as follows: non-catastrophe loss ratio improved 1.4 points to 28.4% in the second quarter of 2017 compared to the second quarter of 2016; net income of $6.6 million for the quarter; book value increased by 2% to $12.97, when compared to June 30, 2016; shareholders' equity was $365.3 million at June 30, 2017; capital returned to stockholders to a dividend of $0.06 of share coupled with a stock repurchase of 322,811 shares for a total of $4.1 million during the second quarter; new business production increased 48% compared to the second quarter of 2016, which sets another new record for the company. The company continued its multi-state expansion and wrote its first new business policy in Alabama.

As I've discussed before, we continue to look for ways to strategically expand our geographic footprint. To that end, I am excited to announce that Heritage has signed a definitive agreement to purchase Narragansett Bay Insurance or NBIC, subject to customary closing conditions and regulatory approval. NBIC is a seasoned company with a strong track record and a talented management team. NBIC has over $300 million of personal lines gross written premium in New York, New Jersey, Connecticut, Rhode Island and Massachusetts, as of June 30, 2017. And is the market leader for coastal insurance in the

Northeast. We believe the NBIC acquisition will be a transformational event for the company, with far-reaching impacts on the company. And will produce a significant accretion to earnings with little to no dilution to shareholders.

The pending transaction has several key features: we expect the combined entity will increase our gross written premium by 50% to more than $900 million annually. Heritage will immediately become a superregional carrier. We expect that combined organization would generate approximately 55% of revenue from Florida and 45% of revenue from other states. The consolidated organization will be the most diversified of the Florida superregional carriers. And the spread of risk throughout the Southeast, Northeast, and Hawaii, results in significant catastrophe and income hedges, that are truly unique among our peers. Upon closing, we expect our Tri-County personal lines policies will represent only 7% of all TIV. We believe our superior diversification will further differentiate the company and we also believe this is an excellent hedge against AOB volatility and will give us another strategic advantage over our peers. We anticipate NBIC's upside potential to be significant. As following the closing of the acquisition, we will have new products, partnerships and bundle products that we expect to further enhance our growth and earnings potential. We also believe the transaction will ultimately result in significant reinsurance and expense synergies with a run rate of approximately $25 million a year. We expect it will take us at least 2 years to fully achieve this run rate due to multiyear reinsurance contracts at NBIC. Nevertheless, we expect the savings in year one to be substantial. Also following the acquisition, we expect 2018 net income on a consolidated basis to increase by approximately 50% to over $70 million. These estimates take into consideration all debt service related to the transaction. We anticipate the transaction will be financed with a combination of cash on hand, debt which may include a convertible bond and approximately $40 million in Heritage common stock. If the company does finance the acquisition, in part, with a convertible bond, it will include an appropriate repurchase of our common stock to minimize the impact of the convertible bond on our share price and to negate a large portion of the dilution caused by issuing $40 million of Heritage equity to the sellers.

Finally, I'm extremely proud of the vision and execution by our management team since our inception. What we have accomplished in only 5 years, took our main competitors approximately 20 years to try to replicate. The NBIC transaction is strategically important for a variety of reasons already mentioned. But it is also worth noting that allowing NBIC to be acquired by one of our peers would have put Heritage at a significant disadvantage. When we shifted 2 strategic M&A in 2014, we identified 2 strategic acquisitions that we believe would take decades to replicate. These acquisitions were Zephyr and NBIC. We believe there were no other attractive acquisitions outside of Florida that would create a diversification and synergies of these 2 organizations. We acquired Zephyr in 2015, but have been interested in NBIC since 2014. While we believe Zephyr has been a home run for the company, we expect NBIC to be a grand slam. We expect the anticipated upside potential and diversification benefits to completely change the dynamics of our company and will establish Heritage as the most diversified and hedged coastal insurer in the United States. We look forward to working with NBIC's exceptional management team, employees and agents for many years to come.

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

Steven Martindale
CFO & Secretary

Thank you, Bruce. Good morning. Gross premiums written for the quarter were $159.3 million compared to $177.3 million a year ago. Approximately 13% of gross premiums were written outside of Florida, with 9% coming from Hawaii and 4% from the Carolinas and Georgia. For the quarter, we wrote approximately 23% of our new business premiums in the Carolinas and Georgia and approximately 2% in Hawaii. Our total in force policy count at June 30, 2017 was approximately 316,400. Our personal lines policy count was approximately 311,300 and our commercial residential count was 3,433. Personal lines policy counts by state were approximately 226,000 in Florida; 72,300 in Hawaii; and 13,000 in the Carolinas and Georgia. All commercial residential policies were written in Florida.

Gross premiums earned for the second quarter were $152.4 million compared to $163.6 million a year ago. The change is due primarily to actions we've taken to manage catastrophe and attritional risk exposure, which included writing no personal lines business in the Tri-County area and assuming no policies from Citizens in more than a year. Our ceded premium ratio as measured against gross premiums earned was 40.6% for the second quarter of 2017 compared to 33.5% for the second quarter of 2016. The ceded premium ratio for the second quarter of 2016 was 3.3 percentage points lower due to the benefits of assuming policies from Citizens during the fourth quarter of 2015 and the first quarter of 2016. The second quarter of 2017 ceded premium ratio was approximately 2 percentage points higher due to the decline in our gross premiums earned noted previously. In addition, reinstatement premiums associated with our per risk reinsurance program added 0.6 points to the second quarter 2017 ratio. On June 1, we renewed our catastrophe reinsurance program. This year's program provides for up to $2.62 billion of multi-event protection, $1.75 billion of first event protection in Florida, and $731 million first event coverage in Hawaii. In addition, we reduced first event retention to $20 million this year from $40 million a year ago, to reduce potential volatility in our earnings and to provide enhanced protection to our balance sheet. The estimated cost of the 2017 catastrophe reinsurance program was $223 million, the savings of approximately $20 million compared to the cost of the 2016 program. The savings were a result of proactive catastrophe risk exposure management over the past 12 months, coupled with improved pricing. The cost of the reinsurance is amortized over the 12 months beginning June 1. In addition, the estimated cost of per risk and facultative reinsurance coverage is $7 million.

Our loss ratio as measured against gross premiums earned was 30.2% for the second quarter of 2017 compared to 29.8% for the second quarter of 2016. Development on 2016 hurricane claims accounted for approximately 1.8 points of the second quarter 2017 loss ratio.

Our operating expenses as a percentage of gross premiums earned were 24.8% for the second quarter of 2017 compared to 22.4% for the second quarter of 2016. We recorded no benefit to the expense ratio in the second quarter of 2017 related to the assumption of policies from Citizens, where there are no acquisition expenses associated with the premium compared to a 1.9% benefit to the expense ratio a year ago.

Our combined ratio as a percentage of gross premiums earned was 95.3% for the second quarter of 2017 compared to 85.7% for the second quarter of 2016. The increase was primarily due to the previously noted changes in the ceded premium and operating expense ratios.

Net income for the second quarter of 2017 was $6.6 million compared to $18.4 million for the second quarter of 2016. In addition to the previously noted reduction in gross premiums earned and changes in our ceded premium and loss expense ratios, interest and amortization of issuance costs totaling $2.2 million associated with our senior notes issued in December of 2016 accounted for the change in net income for the quarter compared to a year ago.

On the balance sheet side, stockholders' equity stood at $365.2 million at June 30, 2017, compared to $358 million at December 31, 2016. We repurchased shares of common stock totaling $4.1 million during the quarter and declared dividends of $1.8 million. Invested assets stood at $601 million at June 30, of which $569 million was invested in fixed maturity securities with an average credit quality of AA and an average duration of 3.5 years. Our cash position was $134.2 million. Approximately $110 million of cash and short-term bonds were held by our nonregulated entities. Our total assets stood at $1.1 billion at June 30.
With that, Bruce and I are available to take your questions.

Question and Answer

Operator

[Operator Instructions] And the first question comes from John Barnidge with Sandler O'Neill.

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

Congrats on the transaction. That $70 million number you stated for net income for 2018, was that after tax?

Bruce Lucas
Chairman of the Board & CEO

Yes.

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

Okay. And should we assume that buybacks are going to be suspended for the foreseeable future?

Bruce Lucas
Chairman of the Board & CEO

No.

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

Unless to offset dilution or no?

Bruce Lucas
Chairman of the Board & CEO

No. I would not make that assumption. I mean, part of what we're going to do John, is more than likely issue a convertible bond offering. If that is the route that we take, there will be a substantial buyback in connection with the bond, which will counteract any short interest from edge funds and it will also retire stock to negate dilution caused by financing a small portion of the transaction through equity.

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

Okay. And then part of the transaction is stock related, have you locked in right now how many shares you will be issuing or not yet?

Bruce Lucas
Chairman of the Board & CEO

Not yet. We are pursuant to the purchase agreement, we used the average of the 5 trading days prior to the closing date. So whatever that price is, it is. We did not want to lock in the stock -- the share count now because we believe that we are massively undervalued outside of Narragansettt Bay acquisition, but with the Narragansettt Bay acquisition we feel like the equity price will perform extremely well, and so we thought it would be better to lock in share price toward the end of the transaction rather than the front to minimize dilution.

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

How much equity the Narragansett Bay has as of Q2 '17 because at least what I could find on SNL implied as of 1Q was roughly $95 million?

Bruce Lucas
Chairman of the Board & CEO

Yes. So if you remember our purchase price is based on the targeted book value of Narragansett Bay at year-end. And so at year-end, the GAAP book value is estimated to be approximately $118 million. On a multiple basis, it's about 2.1x year-end book value and on an earnings basis, we're buying the company for about 3.5x gross earnings and then roughly 6x net earnings.

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

Okay. And then my last question and I'll re-queue. At least according to SNL, Narragansett Bay had a 9% expense ratio in FY '16, is that correct? And possibly more importantly, should we expect the expense ratio decline on a consolidated basis in 2018 for Heritage?

Stephen L. Rohde
Advisory

John, this is Steve Rohde. Narragansett uses a lot of quota share reinsurance so their expense ratio is understated if you look at like on a gross basis. The expense ratio on a gross to gross earned premium is about -- almost 25%, 24.8% in that range. I think we look at Narragansett because of the use of their quota share is that on a gross basis, their combined ratio right now is running about 88%, 89% range. And then, we expect the synergies to have about an 8 point impact on that so bringing their run rate combined ratio down into the low 80s, 81%, 82%.

Operator

And our next question comes from Soleimani Arash with KBW.

Anthony To
Keefe, Bruyette, & Woods, Inc., Research Division

This is Anthony in for Arash. So I guess you were talking about multiple of 2.1 and that seems a bit still modest premium to the current environment and what they are paying for. Can you talk a little bit about that context?

Bruce Lucas
Chairman of the Board & CEO

Yes. So, I think, first and foremost, you cannot look at an acquisition just based on a multiple of book value. I think that this entire sector and in the way we look at acquisitions is a little bit outdated, antiquated, I'd say. You cannot look at it on that basis. You have to look at it on the return on your investment. So for example, Narragansett Bay, we are paying 2.1x expected year-end book value. We paid 1.7x book value for Zephyr that has been an absolute home run for the company, another recent acquisition was UPC of American Coastal, roughly 1.7x book value. We look at this and say okay, it's not that far outside of the range on a book value basis, but when you look at it on a return basis, and what your upside potential is, this is a great buy for us. We're essentially buying the company for its 3.5x forward gross earnings. And net of income tax only 6x earnings. The synergies are off the chart on this transaction. We are literally expecting to increase EPS by 50% year-over-year, and increase top line 50% year-over-year with little to no dilution to our common stock shareholders. We believe that Narragansett Bay has a lot of opportunity to expand its product offerings, increase the top line and the more expansion that we have from Narragansett Bay, the more synergies we're going to generate on the transaction, which means more upside for the company. This is a strategically important company. As I mentioned in my prerecorded statements, when we looked at M&A in 2014, we really thought that there were only 2 insurers outside of Florida that had any real merit to them that are really hard to replicate and have big upside potential. Those 2 are Zephyr and Narragansett Bay. It's been a company that we've been at various points of time talking to over the past 3 years about acquiring them because we saw the upside potential. So we're pretty excited about it, and we think that we bought this company at a very good price.

Anthony To
Keefe, Bruyette, & Woods, Inc., Research Division

Great. That's really helpful. Just a follow-up on that. How much of the purchase price reflects goodwill?

Bruce Lucas
Chairman of the Board & CEO

Goodwill was roughly $130 million-ish.

Stephen L. Rohde
Advisory

Which includes the intangible assets so some will be -- if we do a purchase accounting some will be recorded as intangible assets, some will be recorded as goodwill. But overall excluding any reclassification of deferred acquisition costs, which does also gets rolled into intangible assets, it'll be about $130 million of call it regular goodwill.

Anthony To
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And then I guess, lastly, it looks like NBIC's net income and combined ratio has been improving a lot. But the improvement seems to be quite unusual in 2016. What's the actual run rate amount for this?

Stephen L. Rohde
Advisory

Well. I think if you look at the $327 million of expected written premium -- gross written premium for 2017 and they've been growing -- expect to grow in 6% to 7% range going forward. And as mentioned earlier, I think their kind of gross combined ratio gives gross earned premium the combined ratio is running around 88% right now, but with synergies that would equate to about 80%, 81% gross combined ratio. And we expect that to continue to go forward.

Anthony To
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And then lastly, can you talk about the thought process behind the convertible bond, the repurchases, and the debt issuance? Why not just use debt to -- why not just use all debt to finance the transaction rather than just going through all that trouble? Is it market conditions or is there something more than that?

Bruce Lucas
Chairman of the Board & CEO

Well. I guess I'm not really sure I understand the trouble of issuing only $40 million in equity. We wanted the sellers to have some skin in the game. And that's important for me. And so, on an acquisition of this size, we wanted them to have a common alignment with our Heritage common stock shareholders. So the issuing $40 million really made a lot of sense to us given that the probability of doing a convertible bond with a big share buyback will result in negligible dilution to shareholders and there is a chance that even that could be 0. I like the prospect of increasing top line and net operating income 50% year-over-year, without diluting our shareholders. So debt on this transaction certainly makes a lot of sense. I can tell you that the markets have been pretty receptive to what we're doing here. So I think this is a good way to go in terms of the mix of cash and stock, given minimum shareholder dilution and extremely high accretion to EPS and top line earnings.

Operator

And next question comes from Mark Hughes with SunTrust.

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

I might have missed this earlier. Of the -- with the synergies at 80% to 81%, how much of that is reinsurance? Is there any expense synergy you think you'll get?

Bruce Lucas
Chairman of the Board & CEO

Yes. We -- there are expense synergies and obviously, reinsurance synergies. We're more comfortable just saying in total between all synergies we're expecting about $25 million, without giving the breakdown. But that's a ballpark number of what we're expecting on a run rate basis.

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

And then you'd suggested they have been growing -- or the expectation is to grow 6% to 7% going forward, is that what they've been growing historically? And that you'd mentioned kind of opportunities for product expansion, geographic expansion, can you talk a little bit more about that?

Bruce Lucas
Chairman of the Board & CEO

Yes. So in 2014, the written premiums were $240 million, in 2015 it was $278 million, last year it was $307 million, and we are well above that number now in terms of for 2017. So $327 million is where we think we're going to be at by or they will be at by the end of this year. And that number continues to ramp higher as we move forward. One of the issues that you run into with any reinsurer is aggregation of risk. And as you continue to aggregate policies on top of one another, it could really send your reinsurance costs exponentially higher. So we believe that having a combined reinsurance program similar to what we do now with Zephyr and the Carolinas for example, will help to diversify the spread of that risk, which means you can actually grow the top line in Narragansett Bay, a lot more in the future without getting the same punitive reinsurance prices. So we do believe that that's a big factor, and we also believe there are a lot of products and bundled opportunities that we're going to roll out once we close on this acquisition that will meaningfully impact the top and bottom line.

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

And then, in your core Florida business, did you mention any other impact in the quarter?

Steven Martindale
CFO & Secretary

We did not have any -- this is Steve Martindale. We did not have any weather -- non-hurricane weather impact. We did have a little bit of development on Matthew.

Bruce Lucas
Chairman of the Board & CEO

Very small.

Steven Martindale
CFO & Secretary

Yes. Maybe $1 million or so.

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

And then you might have touched on this, I apologize, but where Narragansett has seen success, what's driven that, is that another dislocated cat market kind of similar to Florida, or what's the kind of fundamental reason why they've been, -- they've prospered as much as ?

Bruce Lucas
Chairman of the Board & CEO

Well. They are a coastal insurer like Heritage. And so their play is predominantly coastal exposures. That's where a lot of the bigger companies, the Allstates of the world et cetera don't really play that much. So there is a huge opportunity, Eastern seaboard, coastal exposure, all the way through the golf coast of United States. I mean, that's kind of the -- that's the sweet spot for companies like, Heritage and other Florida insurers and Narragansett Bay. The company has really built a solid reputation in terms of their underwriting. Their targeted growth has been exceptional, they been able to execute on their business plan year in year out, they've got great relationships with agents, GEICO is a big producer for them. They've really built a first-class organization. They inspect every property that they underwrite inside and out. That's a pretty rare thing to see in this business. So we know it's a extremely high quality book of business. Basically they've really built an exceptional management team with a great business plan, and it's translated into pretty impressive growth over the past 4 or 5 years. And they've really become a very profitable insurer and we think it's going to be a great diversification hedge upon our existing portfolio.

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

Are you able to say how much is GEICO and are there any other meaningful relationships like that, that are -- producers help them get policyholders?

Bruce Lucas
Chairman of the Board & CEO

Yes. I would rather not give out market share data like that, just because we view that as proprietary. But it is pretty meaningful in terms of the GEICO relationship and we see some pretty good upside potential there as well.

Operator

And the next question is a follow-up from John Barnidge with Sandler O'Neill.

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

You are obviously buying scale in New England. What are your thoughts on bringing the vertical integration of claims management that you have in Florida area as well?

Bruce Lucas
Chairman of the Board & CEO

Yes. That's a really good question because that has saved us tens of millions since our inception. We believe in that model, and I can tell you that Narragansett Bay and some their areas, they do have preferred vendor networks and pricing. And they are -- in those instances where they're used, they are saving money versus not using their network. So with the concentration that we see in New England, we believe that we can start to roll out a similar repair program and increase the bottom line and increase customer satisfaction with a claim experience.

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

You guys in Florida has acquired kind of like a contractor, would you think there'll be some interest in doing something similar in New England as well?

Bruce Lucas
Chairman of the Board & CEO

Possibly. I think, it's difficult to find the right contractor. You need to find a company that has scale and has quality people, and they have to know the insurance industry. Those are 3 very hard things to find. We've been lucky with our acquisitions so far and that they've ticked all the right boxes and have been highly accretive to us. But it is something that we will look at in the Northeast as well.

John Bakewell Barnidge

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

And then, on that -- sorry go back to that $70 million after tax number, that was 50% growth on an absolute basis as well as EPS, is that correct?

Bruce Lucas
Chairman of the Board & CEO

That's right. We're projecting next year well over $900 million in gross written premium and we are projecting over $70 million of net operating income.

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

So then would that imply $45 million for net income for this year?

Bruce Lucas
Chairman of the Board & CEO

I don't think we're giving that level of guidance right now.

Stephen L. Rohde
Advisory

As compared to 2018.

Bruce Lucas
Chairman of the Board & CEO

Yes. We're looking at 2018 earnings as the increase, 50% of 2018 earnings.

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

Okay. And then, you said, total insured value from the AOB Miami Tri-County will be 7% going forward. What was it as of the most recently completed quarter?

Bruce Lucas
Chairman of the Board & CEO

It would have been somewhere around mid-teens.

Operator
And as there are no more questions. This concludes question-and-answer session as well as the call. Thank you so much for attending today's presentation. You may now disconnect.