S&P Global
Market Intelligence

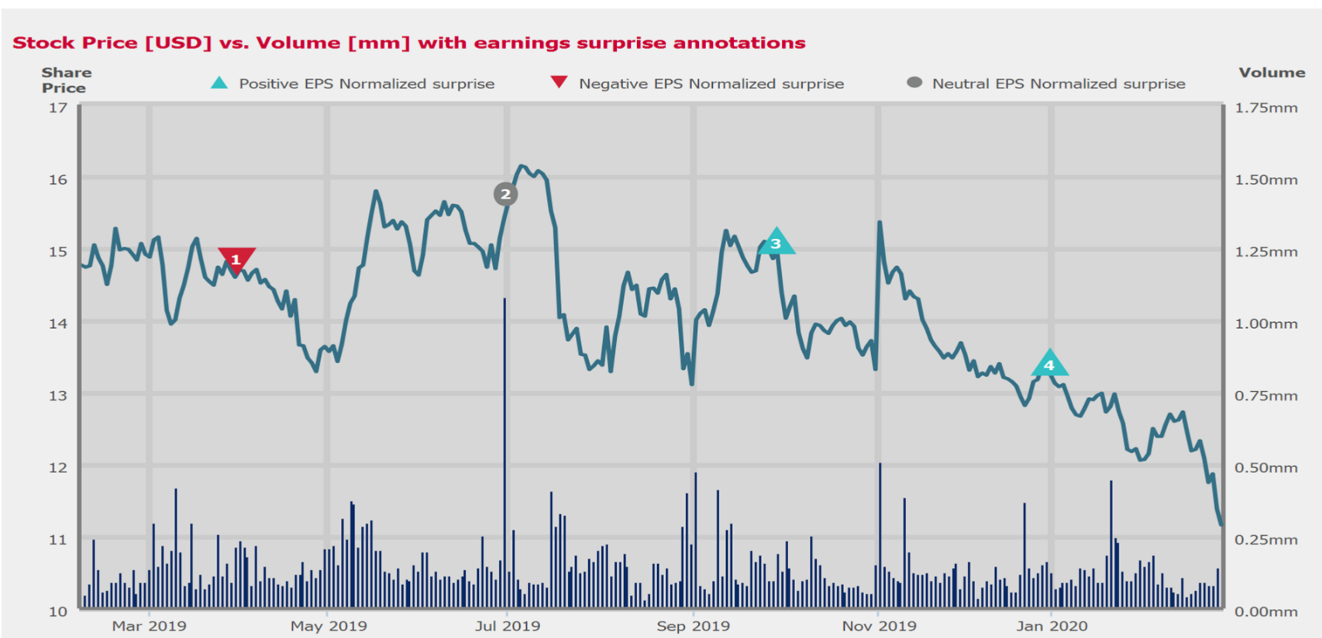
Heritage Insurance Holdings, Inc.
NYSE:HRTG
FQ4 2019 Earnings Call Transcripts

Friday, February 28, 2020 1:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2019-			-FQ1 2020-	-FY 2019-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.37	0.42	▲13.51	0.36	0.86	0.88
Revenue (mm)	130.19	138.50	▲6.38	130.39	499.86	511.30

Currency: USD
Consensus as of Feb-28-2020 12:25 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2019	0.31	0.21	▼1 (32.26 %)
FQ2 2019	0.00	0.00	2 0.00 %
FQ3 2019	0.14	0.28	▲3 100.00 %
FQ4 2019	0.37	0.42	▲4 13.51 %

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Call Participants

EXECUTIVES

Arash Soleimani
Executive Vice President

Bruce Thomas Lucas
Chairman & CEO

Kirk Howard Lusk
Chief Financial Officer

ANALYSTS

Jon Paul Newsome
Piper Sandler & Co., Research Division

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

Matthew John Carletti
JMP Securities LLC, Research Division

Presentation

Arash Soleimani
Executive Vice President

Good morning and thanks 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 on management's current expectations and are subject to uncertainty and changes in circumstances.

In our earnings press release and in 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 risks that could cause the 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.

With us on the call today are Bruce Lucas, our Chairman and Chief Executive Officer; and Kirk Lusk, our Chief Financial Officer.

I will now turn the call over to Bruce.

Bruce Thomas Lucas
Chairman & CEO

Thank you, Arash. I would like to welcome all of you to our fourth quarter 2019 earnings call. Before we begin the call, I'd like to thank all of our employees for their dedication to our company.

The fourth quarter was another very strong quarter on all fronts, including solid organic growth and underwriting margins and another consecutive quarter of favorable prior year reserve development. Gross premiums written grew 6.2% year-over-year to $235.4 million, including 9.4% growth outside of Florida, an acceleration from 7.9% in the third quarter of 2019.

I believe organic growth will continue to be strong for the foreseeable future as we benefit from our independent agency relationships, our auto carrier partnerships and a favorable rate environment. Our higher growth rate outside Florida reflects our continued shift to more stable and diversified markets.

Heritage is a super-regional insurer that is headquartered in Florida, but that does not mean we are a Florida carrier or heavily concentrated in Florida. It is easy to paint all Florida-based carriers with a broad brush, but we look nothing like Florida companies that are extremely concentrated in Florida and Florida's Tri-County. At year-end 2019, approximately 30% of our consolidated TIV is in Florida, with only 6.4% consolidated TIV in the border of Tri-County region, and I'm unaware of any peer carrier that has this advantage.

I received a number of inquiries about macro conditions in the Florida market and where we sit against this backdrop. First, the primary market is -- in Florida is hardening at the fastest pace I've ever seen. Over the years, I have watched countless competitors suppress pricing to grow market share, and many of these same companies have been understating loss reserves to support the growth. That certainly makes them look good in the short term, but it is not a viable long-term business plan.

Growing top line at inadequate rates only compound solvency issues, rate need and adverse reserve development. There are numerous companies that have only recently begun to address these issues by closing territories, not renewing agents and policies, taking very large rate increases, in some cases, large enough to require public rate hearings and booking very large adverse reserve development charges. I believe these trends will continue in 2020 as numerous companies continue to struggle with the compounded problem of fast growth and inadequate pricing and reserves.

Recently, it isn't unusual to see Florida carriers see great increases between 20% and 40% and post large adverse development charges. And stark contrast to this trend, Heritage was a first mover and began to address these foreseeable issues as early as 2016. Since the first quarter of 2016, we have consistently taken meaningful rate increases in Florida, particularly in the Tri-County while virtually shutting off new business in troubled regions in the state.

Since the first quarter of 2016, we dropped $23 billion in Tri-County TIV, massively reduced our Florida concentrations and substantially increased our loss reserves. In very simple terms, we saw the trends early and took bold action to mitigate their impact, whereas most of our peers were struggling to manage these issues, which are far more pronounced today.

Unlike some of our peers, many of our key metrics have been improving as a result of the prudent steps we've taken, and we believe that today, we have a better spread of risk, a stronger balance sheet, more adequate reserves and more conservative financial leverage. Top line growth has returned and is accelerating while our premium mix continues to shift outside of Florida.

Favorable non-adverse reserve development is becoming the norm for Heritage. While it is impossible to always have favorable development, we have managed an impressive 6 consecutive quarters of favorable reserve development. And we have done that while substantially increasing our non-cat reserves since 2016.

Claim trends continued to improve and the percentage of litigated non-hurricane claims stemming from the Tri-County region in Florida declined by 830 basis points year-over-year. I am unaware of any Florida-based carrier that can make these statements. They existed. They would disclose it to their shareholders.

While we still have work to do, core metrics related to growth, underwriting quality, reserve development, diversification and national partnerships look very favorable at this time. And although there's a lot of noise in the Florida market, I want our investors to know that I believe our proactive response over the past 4 years has addressed most of these issues and the results are apparent in our earnings numbers.

I'm sure I will get questions related to reinsurance renewals at June 1. While I won't comment on specifics at this time, I will state that so far, the process had been very orderly and not contentious. We have built significant reinsurance relationships from the outset of our company. We have approximately 60 trading partners on our catastrophe program alone, and many of our largest trading relationships span well beyond our excess of loss program.

Reinsurers respect the results we have delivered versus our Florida-only peer set. We have reduced our Tri-County forward exposures by $23 billion. Since the first quarter of 2016, we have achieved diversification through intelligent organic growth outside of Florida and through strategic acquisitions and now have less than 30% of our TIV in Florida.

We are a U.S. super-regional insurer now with nearly 500 employees, including sizable legal and claims groups and not just a Florida specialist or takeout insurer. We have a strong capital position with $449 million of GAAP equity. Again, reinsurers respect these core differences, and we believe that reinsurers will differentiate diversified insurers such as us and the Florida insurers that have failed to diversify.

To the extent that our rates are higher this year, we will file for a limited reinsurance rate increase that will likely begin in September. This will significantly mitigate potential reinsurance rate increases, albeit with a slight lag.

Moving on to the financials. In light of a very strong fourth quarter, our book value increased to $15.66. This represents an 8.5% growth rate relative to year-end 2018. Despite some severe weather losses this year, our book value per share has increased significantly. Our operating results have been very strong, and we intend to continue our share repurchase program.

In the fourth quarter, we repurchased $4.3 million of common stock at a 12.5% discount to fourth quarter 2019 book value per share, and we intend to continue retiring shares as long as we are trading below what we believe to be fair value.

I will now turn the call over to Kirk to provide more details on our financials.

Kirk Howard Lusk
Chief Financial Officer

Thank you, Bruce. Good morning. Net income for the quarter was $12.8 million or $0.44 per diluted share and was up from $3.9 million or $0.15 per diluted share reported during the fourth quarter of 2018. As Bruce mentioned, we have had strong organic growth in the fourth quarter of 2019. And for the full year of 2019, gross written premiums increased by $14.6 million or 1.6% year-over-year. The growth includes 8.1% growth outside Florida partially offset by 3.9% decrease in Florida from planned derisking in the second and third quarters.

We indicated during the third quarter call that we expect the amount of derisking to diminish in future quarters. This can be seen by the growth in all states experienced during the fourth quarter and with $13.7 million of our full year growth of $14.6 million being achieved in the fourth quarter. We continue to prudently evaluate our exposures in all geographies and take the necessary pricing and underwriting actions to ensure long-term rate adequacy and strong underwriting margins.

We continue to get rate increases in excess of expected claims trend. The ceded premium ratio was down from the fourth quarter of 2018 by 5.3 points and down 2.5 points from the third quarter of 2019. The decrease reflects reinsurance synergies and the elimination of the gross quota share of our Northeast business, which was partially offset by the purchase of more cat XOL to replace gross quota share. 2019 Q4 net earned premiums were up 2.7% from the fourth quarter of 2018, reflecting the changes just mentioned.

Losses and LAE were up $7.1 million or 3% from the prior year quarter. The net loss ratio was 51% for the fourth quarter of 2019 compared to 50.3% for the fourth quarter of 2018. The increase relates to lower income from vertically integrated operations and higher current accident year non-weather losses partially offset by lower weather losses. Since we did our in-depth reserve review in mid-2018, we continue to show favorable prior year reserve development, which reflects our prudent reserving process. For the full year of 2019, favorable prior year development was $3.7 million.

The net expense ratio was 38.3% for the fourth quarter of 2019 compared to 36.1% for the fourth quarter of 2018. The variance is driven by an increase in licenses and fees coupled with the timing of variable compensation accruals. The net combined ratio for the fourth quarter of 2019 was 89.3%, which is up from 86.4% in the prior year period. The increase reflects the items just noted.

Interest expense was down $2.6 million and other nonoperating losses are down by $11 million, both reflecting the refinancing, which was completed in the fourth quarter of 2018. Shareholders' equity increased from year-end 2018 by $23.5 million to $448.8 million at December 31, 2019. Book value per share increased by 8.5% year-over-year. In addition, for 2019, the company paid $7.1 million to shareholders in dividends and also repurchased over 1.1 million shares of stock at an average cost of $14.26, which is 8.9% below the December 31, 2019, book value per share.

Of the $50 million of stock buybacks authorized by the Board of Directors in August of 2018, over $33 million remains available. As of December 31, the company has over $34 million of cash in nonregulated companies and also $40 million available under its revolver.

We are pleased with the results of the fourth quarter and even more pleased with how the company is positioned for 2020. We are positioned for our solid organic growth, rates are continuing to favorably impact the P&L and our reserve position is strong.

Bruce and I are now available to take your questions.

Operator

Before we begin the question-and-answer session, I'd like to turn the conference back over to Bruce Lucas for closing comments.

Bruce Thomas Lucas
Chairman & CEO

Thank you. Before we move to Q&A, I'd like to comment on recent market activity. Over the past week, global markets have experienced significant declines based on coronavirus fears. Whether the fear is SARS, coronavirus or other catalysts, panic tends to wash over markets on a macro level and everything moves lower. This has certainly been the case for Heritage and other stocks in our sector. Once the panic subsides, and it always does, investor focus returns to fundamentals.

One excellent reason to own our stock in the long-term is that our fundamentals are not impacted by events like coronavirus. We are not in the travel and hospitality sectors or other sectors that feel an impact from these types of events. We are a homeowners insurance company. And if you own a home, you're going to buy homeowners insurance regardless of macro events like coronavirus.

I'm confident that when the fear trade subsides, our fundamentals will be given fair value by investors. In the interim, we intend to use this opportunity to repurchase our shares at these levels because it will generate an outsized return for our shareholders.
Kirk and I are now available to take analyst questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Matt Carletti of JMP.

Matthew John Carletti
JMP Securities LLC, Research Division

Bruce, I was hoping you could update us a little bit just on -- you have, I think, the 3 partnerships, Liberty Mutual Safeco, National General and GEICO. Just kind of where each of those stand and how are they progressing?

Bruce Thomas Lucas
Chairman & CEO

Yes, that's a great question, and I do get that question a lot from various shareholders and analysts. And what I can tell you is I can't comment on specifics per my agreement with all 3 of those partners. So I can't get into production levels or states where we're partnering in. I can tell you that these relationships are material. They are a large driver of our growth, especially ex Florida. We do value these relationships. We work hard to earn them. And other than that, I really can't comment on specifics.

Matthew John Carletti
JMP Securities LLC, Research Division

Okay. One other question for you just broadly on capital. Can you just talk a little bit about -- you're returning to growth, so maybe what sort of growth you think it could support on your current capital base? Then alongside that, to the extent there's excess capital, you have been buying back stock. But how would you think about M&A in this environment? Whether that be kind of whole companies or if books become available or otherwise?

Bruce Thomas Lucas
Chairman & CEO

Yes, our capital position -- another great question. Our capital position is pretty strong. We've got the lowest underwriting leverage of any of the so-called Florida peer companies. We're about -- on a net ceded basis, we're about 1x GAAP to equity, which is by far the lowest.

So we've got a lot of room in the capital stack for growth. We do not think that we need any capital for the foreseeable future to sustain that growth. And our target internally is to reach upper single digits, low double digits growth at this point in time. The sales numbers are just massively accelerating. We saw that trend in the third quarter. It went up 300% or so fourth quarter. It's up again in the first quarter. We like where we stand in terms of the growth, and we know that we have enough capital to sustain that growth.

With respect to M&A, which was the second part of your question, I never say never. I mean we've definitely led the Florida market in terms of our M&A activity, and we've done several of them, Zephyr, Narragansett Bay, Sawgrass, Sunshine State and others. I can say this. With respect to Florida, we're going to be very conservative. We've worked incredibly hard over the last 4 years to change the mix of our portfolio to be more diversified and less dependent on the volatility in the Tri-County region and Florida market in total.

That doesn't mean that we have no room for growth in Florida. In fact, we are anticipating growth in Florida in 2020. It's just that it needs to be the right type of growth. And I've seen several opportunities recently, companies that are looking to sell or divest their portfolios. I can tell you, we haven't seen one acquisition prospect in the Florida market that looked appealing to us.

So we'll keep our powder dry. We'll be opportunistic if the right transaction comes our way. Until then, we're going to keep going with the organic growth because it's accelerating and it's far cheaper versus an acquisition.

Matthew John Carletti
JMP Securities LLC, Research Division

All right. Appreciate the answers and best of luck in 2020.

Bruce Thomas Lucas
Chairman & CEO

Thank you, Matt.

Operator

Our next question comes from Mark Hughes of SunTrust.

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

When we think about the loss ratio in 2020, could you give us some sense of, one, what do you feel like a good underlying loss ratio is? Obviously, it's going to be dependent on weather, et cetera. But kind of where should this business be operating? And then, how is that influenced by the Florida -- outside of Florida mix? Is the loss ratio appreciably different one or the other?

Kirk Howard Lusk
Chief Financial Officer

Okay. Yes. I mean as far as like the overall loss ratio, I think, in the low 50s is kind of where we look at where we want to operate. When you look at 2019, even though there really wasn't a lot of hurricane activity, the other weather activity we had on the full year basis was much more severe than we'd experienced in the last several years.

We have an estimate of what we think, call it, the non-hurricane cat should be in any given year. And 2019 definitely exceeded all those expectations. So it actually even kind of made up for the difference of not having a cat this year. So really, when we look at it going forward, I think that's probably where we should be taking it.

Bruce Thomas Lucas
Chairman & CEO

And I'll comment, too. Ex Florida loss ratios tend to run higher, and that's because reinsurance costs are lower. And so I've had questions in the past with people saying, "Oh, your loss ratio or gross reserves are up." Yes. Well, of course, they are. Our book is expanding outside of Florida and the loss ratios there tend to be higher because the cap costs are so much lower.

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

Understood. How about -- I think you talked about the percentage of litigated non-hurricane claims in Tri-County is down. How about -- when you look at your litigated claims count overall, what do you see there?

Bruce Thomas Lucas
Chairman & CEO

It's also down. You just get less litigation frequency when you move away from the Tri-County. So where you tend to see it is just throughout the state of Florida, and then ex Florida, you just don't see it. It's the exception to have a lawsuit outside of Florida. Usually, those get resolved pretty easily. It doesn't mean we don't have a handful of them, we do. But nothing that even remotely approaches the stratosphere of numbers you see in Florida, which is why we like the continued diversification trend to our 15 other states of operation.

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

And then your latest thought on AOB reform, how meaningful that is, as you sit here today?

Bruce Thomas Lucas
Chairman & CEO

Yes, we've actually seen a big reduction. We're down over 70% year-over-year on AOBs. That is pretty material. Some of that, I'm sure, is driven from the fact that we've had an increase in non-Florida business and a reduction in a lot of areas within Florida, particularly in the Tri-County where you see a lot of these AOBs. But even assuming those factors into the equation, we have seen a very, very large reduction in AOBs coming in the front door. That is really, really good for us and the rest of the market.

The main reason for that, Mark, is when you have a direct lawsuit with an insured on a loss, it's one lawsuit. When you have an AOB, usually, there's 4, 5, 6, sometimes 10 AOBs on one particular claim, and so you end up with 4, 5, 6, 10 lawsuits. And so having a big reduction in AOBs on the front end means that you're going to have a big reduction in the litigation expenses and litigation activity on the tail end.

Operator

[Operator Instructions] And our next question will come from Paul Newsome of Piper Sandler.

Jon Paul Newsome
Piper Sandler & Co., Research Division

Could you touch a little bit upon what you think of claims inflation on an underlying basis is outside of Florida? Obviously, you see lots of concern in the market in general about things like social inflation and other impacts that seem to be hitting everyone.

Bruce Thomas Lucas
Chairman & CEO

Yes, that's a really interesting question. We don't really see it. I mean, it's there. We -- there is insurance fraud everywhere. You can't escape it. But we do not see it hitting our numbers in a big enough way where we can actually quantify it. It tends to be a one-off issue, whereas in Florida, it's just more commonplace to have AOBs and claim inflations and you get the so-called storm chasers that go and knock on your door and give you a free roof. And that's a big scam hitting Central Florida right now, by the way. We don't really see it. By comparison, it pales to the extent that it's so small, we really can't even quantify it. But I'd say within Florida, it's probably responsible for tens and tens of millions of dollars of losses on an annual basis.

Jon Paul Newsome
Piper Sandler & Co., Research Division

And then maybe probably more of a review. But could you walk us through how we should think about the impacts of rate coming through with the possible offset of reinsurance costs? I would assume, and please correct me if I'm wrong, you've got a fair amount of rate coming through as we speak right now that would affect, I guess, second quarter? And then maybe there's a change because of reinsurance and then there's an offset.

How does that -- I sort of envision sort of a sign wave here in terms of impact. But is that the right way to think about it? Or how should we think about it as -- from an income statement perspective as opposed to actual rate taking at the moment?

Bruce Thomas Lucas
Chairman & CEO

Right. Yes, you are correct in that. We do have some pretty decent-sized rate increases coming through the system. Over the years, and you could go back, I don't care what year it is, we have always tried to grab double-digit rate. Especially, starting kind of 2015 to '16, when we saw the problems the market is choking on today, we saw them then, and we've been taking 14-plus percent rate increases virtually every single year across the line, and we've been hitting Tri-County for the last 3 years with 25% rate increases across the Board.

And so we do have a lot of rate coming through. That means our rate need is now lower than what it has been in the past as the rate has flowed through the book and the portfolio has shifted. That brings us into what happens with reinsurance pricing.

Now we don't know where pricing is going to end up. It was not some doomsday event for us. Last year, we actually saved $10 million last year over the prior year and bought a bigger tower. Not saying it's going to happen this year, but it is a hard market out there, but our diversification is a big factor for us in hedging against those rate increases.

And to the extent we get it, the process works as follows. We lock in our pricing. We then file for a limited reinsurance rate filing. By statute in Florida, the regulators have 45 days to get that rate approved and then it's about 45 days thereafter. We're charging the higher rate to our customers on a per-policy basis.

So the lag roughly is about 3 months before you start recouping those additional dollars. But the other rate increases that we have in the system are still playing their way through. And so that helps to blunt the impact during that 3-month gap.

Operator

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

Bruce Thomas Lucas
Chairman & CEO

I want to thank everyone for joining our fourth quarter 2019 earnings call.

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