


Heritage Insurance Holdings, Inc. NYSE:HRTG

FQ3 2020 Earnings Call Transcripts

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S&P Global Market Intelligence Estimates

	-FQ3 2020-			-FQ4 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(0.62)	(0.76)	NM	0.33	(0.01)	NA
Revenue (mm)	138.10	165.12	 19.57	146.56	580.40	NA

Currency: USD

Consensus as of Nov-03-2020 7:06 PM GMT

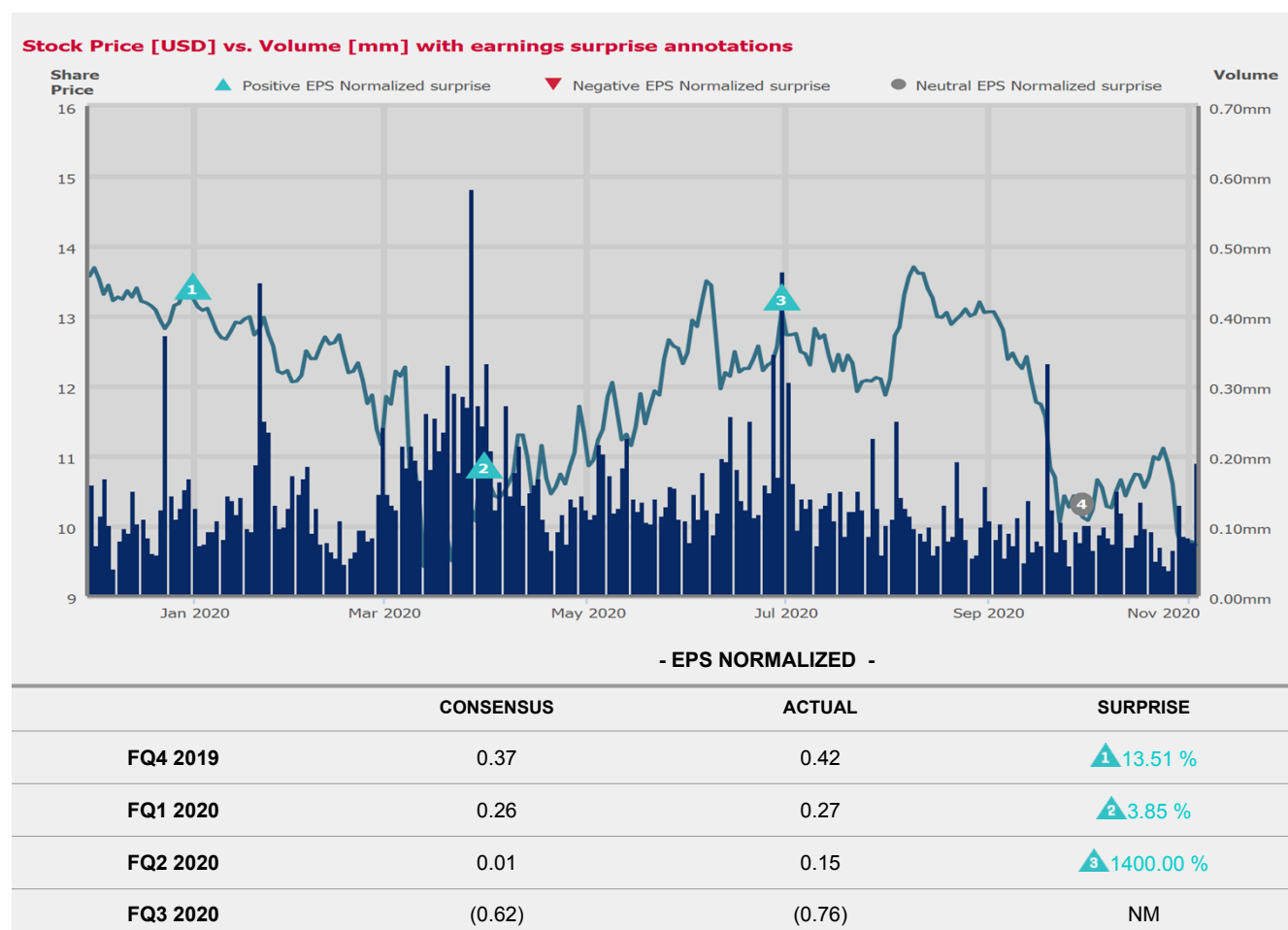


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Call Participants

EXECUTIVES

Arash Soleimani
Executive Vice President

Bruce Thomas Lucas
Consultant

Kirk Howard Lusk
Chief Financial Officer

ANALYSTS

Jon Paul Newsome
Piper Sandler & Co., Research Division

Marla Susan Backer
Sidoti & Company, LLC

William Harry Broomall
Dowling & Partners Securities, LLC

Presentation

Operator

Good morning, and welcome to the Heritage Insurance Holdings Third Quarter 2020 Financial Results Conference Call. My name is Cole, and I will be the operator for today. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Arash Soleimani, Executive Vice President at Heritage. Please go ahead.

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 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.

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

Consultant

Thank you, Arash. I would like to welcome all of you to our third quarter 2020 earnings call. Before we begin the call, I'd like to thank all our employees for their dedication to our company.

The third quarter was challenging only because we experienced record catastrophe losses related to Hurricane Isaias and Sally in addition to elevated non-cat weather losses. Despite elevated weather losses, the core fundamentals of the company continued to improve year-over-year and quarter-over-quarter.

Over the past year, I've commented that new business has and will continue to accelerate as we launch new states, new partnerships and develop additional revenue channels in our existing states. This trend has been remarkably strong and has continued in the third quarter as new business sales set a fifth consecutive quarterly record and gross premiums written increased 17% year-over-year.

During the quarter, we launched operations in Delaware and anticipate launching Maryland in the fourth quarter, which will add additional revenue growth in 2021. I've been very focused on growing our national partnerships, which I believe sets us apart from our peers and will continue to add to our record growth. There are several more partnerships and expansions of existing partnerships that I believe will be announced in the near future. This is truly an exciting time for the company, and I don't see any material impediments to our growth for the foreseeable future.

Equally important is that our loss reserves continue to develop favorably. The third quarter marks the ninth consecutive quarter of favorable reserve development. This is an incredible achievement, given recent market conditions and is a testament to our conservative approach toward loss reserves. Our increasing sales and favorable reserve development have resulted in meaningful gains to our book value per share, which had solid growth year-over-year despite the weather losses in the third quarter.

Additionally, the employment contracts for me, our President, Richard Widdicombe; and our Chief Operating Officer, Ernie Garateix, expire on November 4. The Board of Directors offered new contracts for all of us that I believe are fair and strike an appropriate balance for shareholders. After a lot of consideration, I have decided to retire from Heritage by the end of November and promote Ernie Garateix to Chief Executive Officer.

Ernie has been an integral part of Heritage's executive team since the company's inception and has tremendous experience across product management, underwriting, claims, analytics and systems. As a founder of the company, it was important for me to pick the next CEO, and I'm pleased to name Ernie as my successor.

Our co-founder, Richard Widdicombe, will continue to serve as President and Chairman of the Board.

Even though I'm retiring from Heritage, I'll continue to serve the company as an executive consultant through 2021, and shareholders should expect a seamless transition. New agreements reflecting these changes will be filed as soon as they are completed, and I am confident that our executive compensation expenses will be significantly lower in 2021 and will provide a meaningful boost to our earnings per share.

As many of you know, I'm a serial entrepreneur and love the challenge of creating new companies from the ground up. I started several companies over the years with Heritage being my most successful venture to date. It was important to me to stay with the company until the business plan I developed was fully implemented. Since inception, we grew from a single-state homeowners insurer in Florida to a top 20 homeowner writer in the United States that's actively writing in 15 states with over \$1 billion of in-force premium. We have developed an impressive double-digit organic growth engine, including a vast independent agency network and multiple national partnerships with some of the top insurance companies in the U.S.

Over the past 5 years or so, we've derisked roughly \$23 billion of Tri-County, Florida TIV, diversified the company's footprint and reduced Florida TIV from 100% of the total company to just 31%. Our in-force premiums have nearly doubled and are growing at record levels. Our reserving has significantly improved and is arguably the strongest in the peer group, as demonstrated by our ninth consecutive quarter of favorable prior year reserve development.

We've been profitable every full year of our existence even during the toughest periods of the assignment of benefits crisis in Florida and through extremely active storm years, which is the exception among our peers. Since inception, we've grown book value at an impressive 22% compounded annual growth rate, and we've returned almost \$150 million to shareholders through dividends and share repurchases. Our new business sales have set new records each of the past 5 quarters and are up over 100% year-over-year.

I am extremely proud of our operating results during my tenure as CEO and the timing of my retirement felt right, as I believe we successfully navigated through some very difficult times, established ourselves as a meaningful competitor in the property insurance sector and earned a position strength relative to our peers. I trust Ernie's judgment and ability to execute a very successful business plan, and I look forward to supporting Ernie as he makes a seamless transition to his new role.

I'd like to close by thanking our employees, directors, partners and shareholders for their support over the past 8 years. I did not build this company alone. It was a team effort, and I am forever grateful for your contributions to our company. Thank you for all the amazing memories and for making Heritage a best-in-class company.

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. We've been very fortunate that COVID-19 has had virtually no impact on our business, and much of that has to do with the efforts of our employees. Productivity remains high, and we continue to provide our policyholders and distribution partners with the service they have come to expect from Heritage. I would like to thank our employees once again for their continued flexibility, dedication and customer focus.

The weather has been a challenge in 2020, starting in the second quarter and continuing into the third. Despite the second quarter having an unprecedented 13 PCS events and net weather losses of \$26.8 million, the weather losses of \$47.3 million in the third quarter surpassed the second quarter weather losses by over \$20 million on a net basis. The net loss ratio of 86.6 was significantly impacted by hurricane and non-hurricane cat losses of \$24.5 million, which added

17.8 points to the net loss ratio and non-cat weather losses of \$22.8 million, which added another 16.5 points to the net loss ratio. The ex weather net loss ratio was also impacted by higher current accident year losses, which we believe to be an anomaly. Despite having favorable prior year development of \$5.8 million in the quarter, with the weather losses just mentioned, the company had a net loss for the quarter of \$5.2 million or \$0.19 per diluted share.

Gross premiums written for the quarter were \$278.2 million, up \$40.9 million or 17.3% from the prior year quarter. The increase reflects growth outside of Florida of 18.1% and growth in Florida at 16.3%. Compared to the third quarter of 2019, the company has added written premium in the states of California, Delaware and Mississippi. With the increased growth, we continue to evaluate our portfolio to ensure that we are getting the type of policies that will contribute to our long-term profitability.

Along with the premium growth, we are focused on making an underwriting profit and obtaining adequate rates. The 17.3% year-over-year written premium increase outpaced our policy in-force growth of 7.6%. The ceded premium ratio was 45.8% in the third quarter, down 0.7 points year-over-year and down from the second quarter of 46.6%. The decrease year-over-year reflects the increase in ceded premiums of 8.3%, which was more than offset by the increase in gross earned premium of 10.1%.

2020 third quarter net premiums earned were up \$14.4 million or 11.6%, reflecting higher gross premiums earned and partially offset by an increase in ceded premiums.

Regarding our investment portfolio. During the third quarter, we experienced stable to slightly positive market spreads and strong demand in the secondary markets, allowing us to take \$20.4 million of investment gains during the quarter. This will impact future yields in the short term, but was opportunistic for our insurance companies, and we remain committed to maintaining a low duration portfolio so that we can benefit when yields rise.

The net expense ratio was 36.1% and down from 38.9% during the third quarter of 2019. The ratio reflects reduced compensation expense, technology equipment and travel-related costs. The net combined ratio for the third quarter of 2020 was 122.6, which is up from 94.5% in the prior year period, reflecting a higher net loss ratio.

Interest expense is down slightly, reflecting a decreased LIBOR rate relative to last year. Despite the loss in the quarter, book value per share is up by over \$0.30 for the year.

In closing, I'd like to comment on our focus going forward. In 2019, we focused on our capital structure and continuing to refine our exposures in Florida and expanding our footprint into other states. In 2020, the growth of the top line was a result of those efforts, and now we are focused on getting the bottom line to expand in line with the increase in the top line. As mentioned, we are focused on writing business where we think we can make a profit and obtain adequate rates. We will take the rates needed to achieve adequate margins. Bruce and I are now available to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question today will come from Paul Newsome with Piper Sandler.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Congratulations to everyone on the change in the position. I was hoping to ask a little bit about the capital position and how you feel from a capital perspective as well as maybe an update as to how you think about capital allocation perspective.

Bruce Thomas Lucas

Consultant

Yes. I mean I'll take a stab and let Kirk jump in. We think we have a very strong capital position right now. We've got plenty of cash on the balance sheet. We are in a position of strength with respect to capital. And we're happy with where we are in this position in terms of capital allocation going forward. Obviously, we keep some dry powder back to participate in reinsurance contracts and maintain appropriate RBC ratios, et cetera. But we do feel like the balance sheet has a lot of capital on it right now that we could use and the #1 target for us for use of that would be share repurchases.

So we look at where we're trading right now and the discount to book value, and then I kind of compare that to the fundamentals of the company. When you have the exceptional growth that we've shown and you have the favorable reserve trends for over 2 years now, that's a great combination for profitability. Our forward book value projections are significantly higher than where they are now. And a good reuse of that capital is to return it to shareholders via share repurchases.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Great. Obviously, the strength of the balance sheet and the reserves has been a huge focus for you guys for the last several years. There -- it looked like there was a little -- there was a mention of a little inter-year reserve changes in development. Can you maybe talk about what that was, just so we have a sense of how the pieces are moving?

Bruce Thomas Lucas

Consultant

Yes. I mean a lot of that had to do with the number of PCS events we had in the first and second quarter and just the weather events. We did have a number of kind of companion claims that were associated with the cat claims. At this point, we haven't really determined that those are COVID-related or have any relationship to that. But it did spike a little bit in the third quarter, and that's why we do consider it to be somewhat of an anomaly. We just haven't seen that type of ramp up before. And that really was the cause of that.

And Paul, we take a very conservative approach to loss reserves, obviously, with 9 consecutive favorable quarters. So whenever we see any type of trend, we err on the side of caution. We put up the additional capital. And what usually happens is we end up releasing it. And that -- we think that gives shareholders a lot of confidence that we are reserving appropriately, and there aren't any surprises on the horizon in terms of adverse development. We think that's very important.

Jon Paul Newsome

Piper Sandler & Co., Research Division

Congratulations to everybody.

Bruce Thomas Lucas

Consultant

Thank you, Paul.

Operator

[Operator Instructions] Our next question will come from Marla Backer with Sidoti.

Marla Susan Backer
Sidoti & Company, LLC

So I'm wondering a little bit more color, if you could, on the geographic diversification efforts. So you moved into Delaware in the quarter to further expand your footprint. But in the past, we've also seen you take moves that were away from the East Coast to California, Hawaii. Any other potential more far-flung extension that you're looking at or thinking about right now?

Bruce Thomas Lucas
Consultant

Yes, it's a great question. So we did launch Delaware in the fourth quarter -- in the third quarter. And in the fourth quarter, we plan to launch Maryland. We are currently evaluating approximately 15 to 20 additional states for licensure. So we're still in the due diligence process there. We can tell you, more importantly, where we won't be. We will not be in Louisiana, and we will not be in Texas. That is not in our business plan. We have never really been bullish on those 2 markets. And the big difference maker for us in the third quarter vis-à-vis our peer groups that have significantly elevated catastrophe losses than us is the fact that we don't have a presence in those 2 Gulf Coast states.

So we're going to hold the line there. We like our portfolio. We have such tremendous runway ahead of us. We're growing top line at an incredible clip right now, up 17% year-over-year. And we have signed multiple deals to acquire tens of millions of dollars of additional premium that haven't even flown through our top line numbers yet. So I do think that you're going to see some pretty expansive growth in the company at profitable rates, but mainly within the existing footprint that we have today.

Marla Susan Backer
Sidoti & Company, LLC

Okay. And then in terms of the partnerships, obviously, that's been an important part of the strategy, the bundling opportunities and if you already spoke to this, I apologize, I jumped on a couple of minutes late. Can you give us at least directionally some sense of to what extent that had an impact on the strong growth you saw in new business in the quarter?

Bruce Thomas Lucas
Consultant

Yes. I mean partnerships are very critical for us. And we've got multiple national partners in our portfolio right now that is truly unique among our peer group. I'm not aware of anyone that has the breadth of partnerships that we have here at Heritage. And we've got several more on the horizon that I believe will be announced in the near term.

We cannot comment on what those numbers are per partner. We have very clear agreements with all of them that we will not disclose financials and what that premium volume looks like. But it's safe to say that our biggest producers are the national partners that we have. So it is impacting our growth rate. But I'd say 90% of what we're producing right now is coming from independent agents and probably 10% of it's coming from the national partnerships. But I do expect those numbers at the national level to start growing just because we've signed all of these other deals to acquire tens of millions in premium that haven't even run through the top line in-force premium numbers yet.

Operator

And our next question will come from Bill Broomall with Dowling & Partners.

William Harry Broomall
Dowling & Partners Securities, LLC

Great. If I could just switch to Florida, have you seen any run-up in the Irma claims coming up on the 3-year statute? Any trends that you kind of observed?

Bruce Thomas Lucas
Consultant

Yes. That's a great question, Bill, not really. I mean we saw a little bit of elevation in some claims that kind of came in the last, call it, 30 days or so. But nothing that wasn't already fully accounted for plus some in our IBNR numbers.

So we didn't see anything. In fact, I was very surprised that the run-up was as low as it was. I know other insurance carriers in Florida have had significantly worse run-up numbers as you approach the deadline, but that's mainly because they have a big footprint in Tri-County, where you see a lot of the, let's call them social inflation claims. We just don't have that book of business. And so it's a little different for us vis-à-vis them. We think we're in a pretty good spot, and we didn't really get any surprises out of Irma as we approach the statutory deadline.

William Harry Broomall
Dowling & Partners Securities, LLC

Great. And we know Florida, there's a lot of companies under stress. You talked about being in a position of strength. Is there any interest on your part in maybe participating, if there is some dislocation in Florida, potentially picking up policies and filling in where other companies might be -- stopped writing in state because if they have RBC issues, and you can step in at maybe a more appropriate rate? And not just Tri-County, but maybe other parts of the state as well, does that interest you at all?

Bruce Thomas Lucas
Consultant

Yes, there is always opportunities there, Bill. And I think you really touched upon the hot topic in Florida right now. There's -- I think there's a fair number of players right now who under -- are under pretty severe financial distress. And whenever there's chaos like that in the market, usually, there are some really wonderful opportunities that come out of that.

We're going to be opportunistic. We're not really looking to grow the Florida footprint right now. But if there's an opportunistic play within Florida that will generate huge returns for the company, we're absolutely going to take a look at it. And I can tell you that we're usually the first company that these guys call just based on our track record of M&A activity, both inside and outside of Florida.

Kirk Howard Lusk
Chief Financial Officer

Yes. I'd say one of the things -- you did mention a very key aspect of that, though, is at the right rate. So are we willing to just kind of go in and then take portfolios that we think are underpriced? No. But at the right price, right rate, definitely, we would look at it.

William Harry Broomall
Dowling & Partners Securities, LLC

Perfect. That's helpful. And the cash on your balance sheet is definitely growing pretty significantly. Is there any way you can maybe help us think about what kind of cash you have at the holdco?

Bruce Thomas Lucas
Consultant

We have a little over \$40 million at the holdco as of third quarter.

William Harry Broomall
Dowling & Partners Securities, LLC

Okay. And did you downstream any capital to the subs to support the growth that you've been seeing?

Bruce Thomas Lucas
Consultant

Not at this point.

William Harry Broomall
Dowling & Partners Securities, LLC

That's great. And then maybe the last one, Bruce, hopefully, you might be able to help. When we think about the topic of -- we've seen some press reports talking about the OIR looking at MGA relationships and affiliated partnership -- yes, internally affiliated kind of relationships. Can you just help us maybe frame out what's going on? I don't know if I kind of fully appreciate all the issues going on.

Bruce Thomas Lucas

Consultant

Yes. The MGA structure in Florida is unique vis-à-vis a lot of other states. And that's really a structure that was designed and has been maintained to attract capital for the marketplace with a way to generate some type of yield to the investors. You've -- I've heard this topic come up multiple times over the years, and I'm not really sure what the breadth of that review is right now.

I can tell you that I haven't seen anything negative or contrary to the current MGA structure at all. I think it would probably be something -- if I'm going to guess, something that probably happens to some of the more financially strapped companies that are having a hard time meeting minimum RBCs, et cetera. I can see that as being a pressure point for them. But for the companies who have good solvency and good underwriting portfolios, et cetera, like us, I'd be very surprised to see any pushback on the JVs.

Operator

[Operator Instructions] And this will conclude our question-and-answer session. I'd like to turn the conference back over to Bruce Lucas for any closing remarks.

Bruce Thomas Lucas

Consultant

I would just like to thank everyone for participating in our third quarter 2020 earnings call.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time.

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