Third Quarter 2022 Earnings Call Transcript

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CORPORATE PARTICIPANTS

Chris Uchida, *Chief Financial Officer*

Mac Armstrong, *Chief Executive Officer, Founder, and Chairman of the Board*

CONFERENCE CALL PARTICIPANTS

Mark Hughes, *Truist Securities*

David Motemaden, *Evercore ISI*

Pablo Singzon, *JPMorgan*

Jing Li, *KBW*

Tracy Benguigui, *Barclays*

PRESENTATION

Operator

Good morning, and welcome to Palomar Holdings, Inc. Third Quarter 2022 Earnings Conference Call.

As a reminder, this conference is being recorded.

I would now like to turn the call over to Mr. Chris Uchida, Chief Financial Officer. Please go ahead, sir.

Chris Uchida

Thank you, Operator, and good morning, everyone.

We appreciate your participation in our Third Quarter 2022 Earnings Call.

With me here today is Mac Armstrong, our Chairman and Chief Executive Officer. As a reminder, a telephonic replay of this call will be available on the Investor Relations section of our website through 11:59 PM Eastern Time on November 10, 2022.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about Management's future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties and other factors that could cause actual results to differ materially from those indicated or implied by such statements, including, but not limited to, risks and uncertainties related to the COVID-19 pandemic.

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Such risks and other factors are set forth in our quarterly report on Form 10-Q filed with the Securities and Exchange Commission. We do not undertake any duty to update such forward-looking statements.

Additionally, during today's call, we will discuss certain non-GAAP measures, which we believe are useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to their most comparable GAAP measure can be found in our earnings release.

At this point, I'll turn the call over to Mac.

Mac Armstrong

Thank you, Chris, and good morning, everyone.

I'm very proud of our third quarter results as there are further testament to our commitment to profitable growth and our execution of Palomar 2X, our intermediate term strategic plan of doubling our adjusted underwriting income while achieving a 20% adjusted return on equity. We grew the gross written premium of the business 66%, highlighted by sustained earthquake growth and incremental progress on newer lines of business such as inland marine and casualty.

We made incremental traction in our nascent Palomar front and excess property franchises amongst others. We added new talent throughout the organization in the underwriting, actuarial and technology departments. Perhaps most significant, even with the full retention loss from Hurricane Ian, a major catastrophe that severely impacted our entire industry, we generated an adjusted combined ratio of approximately 90% as well as an adjusted ROE of 10% when adding back realized and unrealized gains and losses from our investment portfolio.

We further validated the resilience in our model as adjusted net income grew over 328% year-over-year, again with the full event retention loss. Taken together, our continued strong momentum through the third quarter provides a clear line of sight to doubling our adjusted underwriting income in an intermediate fashion and at a pace that has accelerated from when the concept was first introduced in June of this year.

Turning to our financial results and strategic priorities in more detail. During the quarter, we made strong progress executing on all four components of our 2022 strategic plan. Our first priority is focused on generating strong and profitable premium growth, which we accomplished once again this quarter having increased gross written premium 66% to $253.1 million.

Our earthquake business grew 19%, led by strength in our residential earthquake product, which continues to benefit from our marketing and product development efforts, combined with the dislocation in the California homeowners market. This healthy dynamic is best exemplified by the fact that third quarter of 2022, like the first and second quarters of the year, saw record quarterly new business sales.

Importantly, the market opportunities related to the proposed changes to the California Earthquake Authority, whether it be coverage offerings or reduction in claims paying capacity have yet to come to fruition and as such, have not provided meaningful growth catalyst for Palomar's products. We remain excited at the prospects for the residential earthquake market into the year ahead.

Outside California, we continue to broaden our residential earthquake partnerships slate, whether it be through the addition of three new states to our Travelers partnership or the addition of a new relationship

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that will increase our presence in Utah at the start of 2023. While these are smaller market opportunities, these partnerships will be additive to growth in the year ahead.

Our commercial earthquake business continued to grow through a combination of exposure growth and rate increase while improving its underlying metrics through enhanced terms and conditions. Importantly, it saw intra-quarter rate increase acceleration to levels above 10%, which more than offset loss cost increases tied to our June 1 reinsurance renewal.

We believe the impact of Hurricane Ian, most notably capacity constraints in the broader U.S. property insurance market, will impact the commercial earthquake market, and therefore provide the opportunity for further rate increases and portfolio optimization in the fourth quarter of 2022 and into 2023.

Beyond our earthquake franchise, we achieved strong growth across our entire portfolio of products, highlighted by our inland marine products, which grew 58% year-over-year and our commercial all-risk product, which grew 34% year-over-year. With nearly all of the growth due to rate increases and portfolio optimization as opposed to exposure.

The inland marine department continues to perform very well across its multiple segments, including both commercial and residential builder's risk in motor truck cargo. Additionally, our newly launched casualty franchise grew 350% year-over-year.

Our real estate E&O and miscellaneous professional liability segments are standout performers as they continue to add conservatively underwritten low volatility risk to the portfolio. Overall, we're encouraged by the launch and ramp of our casualty business and the traction that our team is achieving.

PLMR-FRONT was also a significant contributor, generating 32% of our premium this quarter. I'll discuss PLMR-FRONT in a bit more detail when reviewing some of our new initiatives later in the call.

The combination of our growth in commercial lines, whether it be earthquake, builder's risk or select casualty segments and PLMR-FRONT, helped drive considerable growth in Palomar Excess and Surplus Insurance Company, our E&S business. PESIC increased its gross written premiums 181% year-over-year to $163 million as compared to the third quarter of 2022.

The accelerating growth in our non-catastrophe exposed lines of business, whether it be casualty or PLMR-FRONT, provide diversification in business mix and business model through fee income across our portfolio and ultimately will lead to further predictability in our earnings base. As such, the success and our execution toward their success are key elements of our second strategic priority, monetizing the capital investments we made in 2021. During the third quarter, PLMR-FRONT recorded $82.2 million of gross written premium, which I previously stated was 33% of total gross written premium in the quarter.

We have ramped our PLMR-FRONT business very quickly since launching it in the fourth quarter of 2021. The business line has already generated premium of $154 million year-to-date, which is at the high end of our previously updated guidance range of $130 million to $160 million of managed premiums for the full year.

As a reminder, our updated guidance range includes our Texas homeowner's business, which adds approximately $45 million of fee-generating premium to the base. Based on the year-to-date results and the overall strong performance of PLMR-FRONT, we believe we can achieve $180 million to $200 million for the full year. The growth in managed premium from PLMR-FRONT offers an attractive run rate of fee income as we move into 2023 as well as a modicum of underwriting income for the two programs where we retain a small amount of risk.

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Importantly, as we continue to expand through PLMR-FRONT, we remain disciplined through our conservative underwriting and collateral requirements to mitigate risk. I have already mentioned the solid performance of our new casualty lines in the quarter, but I'd also like to acknowledge the success of our excess property division. This line of business is led by a terrific, experienced underwriter in Joel Usry, and it concentrates on writing excess property business risk in non-catastrophe exposed regions. While it's off a small base, we are pleased to see the premium triple sequentially.

As the North American property market remains dislocated, we expect this line of business to do quite well. Progress and outperformance of our new initiatives has put us in a position where we believe we are meaningfully ahead of our Palomar 2X intermediate plan. Even if the growth may push our attritional loss ratio just slightly up.

The fee income generated by our fronting business is a meaningful lever of stability that we have created in our portfolio to generate predictable earnings, which is not only a core principle of Palomar 2X, but also our third strategic priority, delivering consistent and predictable earnings. Over the last two years, we've put into place multiple underwriting, portfolio management and risk transfer program to reduce volatility and enhance our risk-adjusted returns.

I think these efforts were most pronounced with how Ian impacted our results relative to the insurance industry broadly. Over the last few years, we have considerably reduced our continental hurricane exposure. As such, our gross and ultimate net loss from Hurricane Ian should under-index the industry due to the underwriting portfolio management actions taken since 2020.

Our exposure was limited to our commercial property products that are national in scope with an emphasis on layered and shared accounts with limited geographic concentration. While a full retention loss of $12.5 million is not ideal, you can find some solace that we have an adjusted ROE when including the impact of unrealized gains and losses of 10% for the quarter and approximately 17% year-to-date.

Diversification and profitable growth from lines of business without continental hurricane risk is now providing a considerable earnings base that enables us to have an adjusted combined ratio of 90% and an adjusted ROE, excluding unrealized and realized gains and losses of 10% in a quarter where we incur a full retention loss. This favorably compares to the third quarter of 2021 when catastrophe losses led to an adjusted combined ratio of 100% and adjusted ROE, excluding realized and unrealized gains and losses, of 2%.

Additionally, we are continually improving our underwriting and risk management controls to ensure that earn an appropriate risk-adjusted return for the higher volatility businesses that we continue to write. This approach will result in further adjustments as the market, the reinsurance market, especially, absorbs the impact of Hurricane Ian.

Our core strategic priority is scaling our organization where we have invested in technology and infrastructure that provide a dynamic platform for product innovation as well as new business development. This is very attractive to experienced underwriters who would like to build a new business as can be seen in our newer lines of business, like builder's risk in the marine, professional liability and excess property.

During the quarter, we bolstered our underwriting ranks for each of these product lines with the hiring of several industry veterans with proven track records. We'll also continue to attract analytics, technology and actuarial professionals to the team.

Before we dive into the financials, I'd like to offer a bit of commentary on the market, in particular the property segment, which has entered a new stage of dislocation due to Hurricane Ian. As the hard

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reinsurance market persists, continued rate increases, combined with improved terms and conditions, will require renewals to cover any increase in loss costs at a minimum.

As it relates to our current continental hurricane exposure, we have already reduced our PML by more than 60% over the last two years and still have some exposure in runoff. What we are left with is a national focused portfolio of property risk, with wind exposure that saw an average rate in excess of 30% in the third quarter, and that was prior to Ian making landfall.

The storm, along with other factors such as inflation, bond portfolio losses and other industry losses, will result in significant capacity reduction for not just Florida, but throughout the Southeast. The magnitude of the capacity pullback will be difficult to assess until the January 1 reinsurance renewal is complete, but our expectation is that rates for Southeast and Florida wind will move up commensurately for inflation, reinsurance cost and supply.

The capacity we commit to our E&S commercial all-risk business will take advantage of the market in a disciplined fashion with a refreshed risk-adjusted return target. If accounts don't hit those thresholds, we're fine falling back as we have numerous growth vectors.

As I mentioned earlier, we believe the commercial earthquake market will also see a level of dislocation, albeit not like that of Florida and the rest of the Southeast. The 10% rate increase we saw at the end of the third quarter will increase in the fourth quarter and into 2023.

Terms and conditions, whether it be deductibles or attachments, should also improve. Property capacity is going to be a scarce commodity in 2023, and we will judiciously use it in the primary market. As it pertains to reinsurance, we renewed our program at June 1, with pricing higher by 9% on a risk-adjusted basis, and we do not have excess of loss treaties renewed at January 1.

Our expectation is that post Ian, the hard reinsurance market will indeed persist and that backdrop informs our approach to maintain our growth and profitability targets in the year ahead. It is imperative for all of our property products, E&S and admitted, commercial and residential, to cover their loss costs through a combination of rate increase, inflation guards or terms and conditions.

Importantly, it is worth reiterating that we were already reducing our exposure to continental U.S. hurricane and other secondary perils before the storm, and our core earthquake business is a unique line of business for reinsurers given its non-correlated risk. We think the confluence of those factors, along with the large profit bank we have built up with our reinsurance panel will help us navigate this cycle.

Turning to capital allocation. Despite the cat losses that impacted our results this quarter, we remain well capitalized and in a healthy position to fund future growth as well as opportunistically repurchase shares. During the quarter, we bought over 52,000 shares at a total cost of $3 million.

To conclude, this quarter demonstrated further execution of the Palomar 2X strategic plan. We meaningfully grew written premium, we saw considerable progress in new products that add diversification to the earnings base and portfolio, and we demonstrated the resilience in our model as the full event retention did not preclude us from generating a compelling return on equity.

While the quarter's losses were elevated, we were encouraged by two factors. One: 29% of the loss in the quarter were from lines that are in runoff or being restructured and two, a good portion of the quarterly loss was driven by product written premium outperformance and in line target rate loss ratios. Chris will provide more detail on both these items.

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For the full year, we now expect to generate adjusted net income between $82 million and $85 million, a 48% increase from 2021. This range includes additional reinsurance expense resulting from Hurricane Ian, incurred in the fourth quarter, and excludes catastrophes and unrealized and realized gains and losses.

With that, I'll turn the call over to Chris to discuss our results in more detail.

Chris Uchida

Thank you, Mac.

Please note that during my portion, when referring to any per share figure, I'm referring to per diluted common share as calculated using the treasury stock method. This methodology requires us to include common share equivalents such as outstanding stock options during profitable periods and exclude them in periods when we incur a net loss. We have adjusted the calculations accordingly.

For the third quarter of 2022, our net income was $4.3 million, or $0.17 per share compared to net income of $0.2 million, or $0.01 per share for the same quarter in 2021. Our adjusted net income was $7.4 million, or $0.29 per share compared to adjusted net income of $1.7 million, or $0.07 per share for the same quarter of 2021. Our adjusted net income, excluding net realized and unrealized losses, was $9.2 million, or $0.36 per share compared to $2 million, or $0.08 per share last year.

Gross written premiums for the third quarter were $253.1 million, an increase of 66.2% compared to the prior year's third quarter. Our consistent strong growth was driven by a combination of favorable rate acceleration and increases in volume across our products. Ceded written premiums for the third quarter were $161.9 million, representing an increase of 178.8% compared to the prior year's third quarter. This increase was primarily due to quota share reinsurance driven by the growth of our fronting business, lines of business subject to attritional losses and additional excess of loss reinsurance to facilitate growth and the impact from Hurricane Ian.

Ceded written premiums as a percentage of gross written premiums increased to 64% for the three months ended September 30, 2022, from 38.1% for the three months ended September 30, 2021. As anticipated, our fronting business was the primary catalyst of this increase, slightly offset by a decrease in the XOL percentage compared to last year.

Net earned premiums for the third quarter were $77.9 million, an increase of 20.4% compared to the prior year's third quarter. This increase is due to the growth and earning of higher gross written premiums offset by the growth and earning of higher ceded written premiums under reinsurance agreements.

For the third quarter of 2022, net earned premiums as a percentage of gross earned premiums were 41.7%, compared to 55.2% in the third quarter of 2021, and compared sequentially to 50.8% in the second quarter of 2022. As a reminder, we have indicated that the expected growth of our fronting business would push this ratio over 50% on an annual basis, especially with the transition of our Texas Specialty Homeowners book to our fronting model. Though it will add consistent fee income that will enhance our ROE and bottom line.

Year-to-date, our net earned premiums as a percentage of gross earned premiums ratio was 48.4%, in line with our expectations based on the strong performance of our fee-based fronting business.

Losses and loss adjustment expenses incurred for the third quarter were $30.9 million, made up of attritional losses of $18.4 million and $12.5 million of catastrophe losses from Hurricane Ian. The loss ratio for the quarter was 39.6%, comprised of an attritional loss ratio of 23.6% and a catastrophe loss ratio

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of 16%. Approximately $5.3 million or 29% of the attritional losses for the quarter were from lines of business in runoff or restructured.

Additionally, these lines of business exceeded their planned losses for the quarter by about $2 million. That, in conjunction with the success of lines of business key to Palomar 2X, were the primary contributors to the elevated losses and loss ratio for the quarter. The results for the quarter affirm our decision to exit or restructure certain lines and focus on business essential to Palomar 2X. Considering those factors, we believe the loss ratio for the year will be between 20% and 21%.

Our expense ratio for the third quarter of 2022 was 55.1% compared to 58.8% in the third quarter of 2021. On an adjusted basis, our expense ratio was 50.7% for the quarter compared to 56.3% in the third quarter of 2021 and compared to 51.2% sequentially in the second quarter of 2022. Our acquisition expense as a percentage of gross earned premiums for the third quarter of 2022 was 14.6% compared to 22.5% in the third quarter of 2021 and compared to 18.1% sequentially in the second quarter of 2022.

The improvement was driven by additional ceding commission or fronting fees from our new fronting business that are netted within acquisition expense and overall changes in our mix of business. The ratio of our other underwriting expenses, excluding adjustments to gross earned premiums for the third quarter of 2022, was 7.3% compared to 9.4% in the third quarter of 2021 and compared to 8.5% in the second quarter of 2022.

Our combined ratio for the third quarter was 94.8% compared to 102.8% in the third quarter of 2021. Our adjusted combined ratio was 90.3% for the third quarter compared to 100.2% in the third quarter of 2021.

As a brief reminder, in concert with our Palomar 2X strategy, we introduced the metric of adjusted underwriting income. We calculate adjusted underwriting income similarly to adjusted combined ratio. We start with underwriting income and back out the adjustments that may not be indicative of our underlying business trends, operating results or future outlook. We believe that the adjusted underwriting income is the most comparable financial metric for evaluating Palomar 2X.

Our third quarter adjusted underwriting income was $7.5 million compared to a loss of $0.2 million last year. Our year-to-date adjusted underwriting income was $53.6 million compared to $36 million last year, growth of 48.7%.

Net investment income for the third quarter was $3.7 million, an increase of 67.4% compared to the prior year's third quarter. The year-over-year increase was primarily due to higher average balance of investments held during the three months ended September 30, 2022, due to cash generated from operations and by slightly higher yields on investments.

Our fixed income investment portfolio book yield during the third quarter was 2.83% compared to 2.19% in the third quarter of 2021. Our book yield on investments made during the third quarter was above 4.5%, trending higher at the end of the quarter. The weighted average duration of our fixed maturity investment portfolio, including cash equivalents, was 4.03 years at the end of the quarter.

Cash and invested assets totaled $541.8 million as compared to $467 million at September 30, 2021. For the quarter, we recognized realized and unrealized losses on investments of $2.4 million as compared to realized and unrealized losses of $0.3 million in the prior year's third quarter. Exclusive of gains or losses, we do expect our investment portfolio yield to improve in the foreseeable quarters based on the current market conditions.

Our effective tax rate for the third quarter was 17.5% compared to negative 101.6% for the third quarter of 2021. For the third quarter of 2022, the tax rate differed from the statutory rate due to the impact of the

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permanent component of employee stock option exercises. During the quarter, we purchased 52,185 share for a total of $3.90 million, under our previously announced two-year $100 million share repurchase program. We have approximately $76.7 million remaining under the authorized program. We will continue to take an opportunistic approach to share repurchases under this program when we view our stock trading at a discounted valuation, we remain focused on investing in and supporting the (inaudible)growth of our business lines as we strive to progress and execute on the framework we've provided to deliver Palomar 2X.

Our stockholders' equity was $367.8 million at September 30, 2022, inclusive of the share buyback and realized and unrealized changes to our investment portfolio compared to $394.2 million at December 31, 2021. For the third quarter of 2022, annualized return on equity was 4.6% compared to 0.3% for the same period last year. Our annualized adjusted return on equity was 7.9% compared to 1.8% for the same period last year. We remain confident in our strategy to achieve long-term growth, with sustainable and predictable earnings, even with a full retention catastrophe loss our year-to-date adjusted ROE was 15.3% and approximately 17%, excluding net realized and unrealized losses for the year.

For the full year of 2022, we are providing adjusted net income guidance range of $82 million to $85 million, including additional reinsurance expenses resulting from Hurricane Ian and excluding catastrophes and unrealized and realized gains and losses.

With that, I'd like to ask the Operator to open the line for any questions. Operator?

Operator

Thank you. At this time, we'll be conducting a question-and-answer session.

Our first question today is from Mark Hughes of Truist. Please proceed with your question.

Mark Hughes

Yes. Thank you. Good afternoon. Chris, the Specialty Homeowners business, you wrote $14 million in 2Q and zero in 3Q. What impact did that have on earned?

Chris Uchida

Yes. Mark that's a great question. When you think about it from a gross earned standpoint, obviously, the impact was minimal, right? Let's talk about the Specialty Homeowners book just a little bit. There's two pieces of that. There's the Texas portion that we have put into a full fronting model effective 6/1 of this year. There is the non-Texas Specialty Homeowners that is in runoff. Obviously, we did not write any more business in Q3.

The Texas business is already in our fronting model, so it's generating consistent fee income. But that move obviously has moved the written premium out of the Specialty Homeowners line, and we've now included it in the fronting line. From a net earned standpoint, obviously, there is an impact, there was some of that impact we felt in Q2, but there was only one month of that impact. The third quarter is the first full quarter where you see the full impact of that net earned, especially for the Texas Specialty Homeowners book being moved to the fronting model.

When you think about that from a headwind standpoint, that's probably $3 million to $4 million of ceded earned premium that has now moved out of the net earned premium because that is in the fronting model. Obviously, we do receive a little bit of benefit of that in the losses, but also you see that in the acquisition expense. But when you're thinking about from the top line, the revenue line or the net earned

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premium, yes, there is a little headwind from that, but that's as expected, moving that and, obviously, to get that fee income.

Mark Hughes

I think your guidance for the non-cat loss ratio for the full year was 20% to 21%. How do you see the trajectory of that as we think about the emergence and development of the 2.0? What should we think about next year specifically?

Chris Uchida

Obviously, the loss ratio for the quarter was higher than we would like to see it. Some of that is due to the strong growth of the lines of business that are key to Palomar 2X. Whether it be inland marine or casualty, those grew faster than we expected, definitely faster than we expected, when we presented Palomar 2X at Investor Day. We're happy about that, and that was taken into the thesis when we've said all along that the loss ratio was going to continue to tick up because of the growth in some of these lines and the overall change in the mix of business.

It's also relevant when we talk about the lines of business that we're running off. Those lines of business obviously contributed a little bit more than we would have liked in this quarter. Those lines will mostly be run off in the first half of next year, but let's call it mostly fully run off by the end of next year.

There is still some of that going to be running through there. We still expect from a mix standpoint that the loss ratio will continue to tick up. But when you think about it a little bit longer term or intermediate term, and you think about it in 2024 or 2025, when you think about the Palomar 2X model and what we presented, also assuming quota shares are the same, mix of business is the same as we presented, we'd expect that loss ratio to continue to go down from where it was. So, yes, it could go up to 23%, 24% in the more near term, but I do expect over the more intermediate term of, let's call it, two to three years that, that loss ratio will continue to tick down as the mix of business improves.

Some of those lines of business are fully run off and we get a little more consistent earnings, and predictable earnings, from some of the casualty clients, but also some of the lines subject to attritional quota share. Overall, I expect it to improve, but there is going to be a little bit of an increase and then a decrease. Hopefully, we'll see that starting to come up near the end of next year, but early in 2024.

Mac Armstrong

What I would add is that the lines, whether it's casualty or inland marine, did outpace the growth, and that's a positive thing for us. But like Chris said, that means that you pull forward a little bit the timing on the attritional loss ratio ticking up. Net-net, we are accelerating the pace of Palomar 2X because of the performance of both fee generative business and PLMR-FRONT and those lines that are expected to grow at a quicker rate than historical binary lines like Hawaii and earthquake. That is a positive in the sense that I think that it will allow us to get to the inflection point where the loss ratio does start to tick down at a quicker pace than initially forecast. That is something that I'm actually encouraged by.

Mark Hughes

Mac, you say proposed changes that the California Earthquake Authority have not yet been a catalyst to the quake business. Can you elaborate on that? Why not, and when, if they are going to be a catalyst.

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Mac Armstrong

I think ultimately, the California Earthquake Authority has not come to a conclusive decision on the majority of the changes that they're wrestling with. They have another governing body meeting in December. The topics on the table include a reduction in coverages, especially the non-structure limits. There's also discussion of them potentially going back to the traditional mini policy.

The changes in coverage, there continues to be a little bit of a kicking of the can down the line. It creates agita and it allows us to market against, but it doesn't drive something conclusive. Whether it be from the participating insurers that are members of the CEA, or some of our distribution partners that still have business that they send off there, especially something that's more of a full coverage policy.

Secondly, as it relates to the reduction in claims-paying capacity, they have stated that they are buying less reinsurance. It's to the tune of $1 billion to $1.3 billion. That's just going to come up as it renews. That's a dynamic that we actually look opportunistically upon as there might be limit that can be redeployed to our program that allows us to grow efficiently from a reinsurance standpoint and support the growth in the premium base. Frankly, it will allow reinsurers to get a participation in a more attractive and a better returning book of business.

What I would say is the coverages, it's fluid. I would expect something will shake out over the course of 2023. The reinsurance and claims paying capacity, which is a catalyst for the participating insurers as well as us as a buyer of reinsurance, that will take course over the course of the year as their program renews, and they've got a lot of different treaty dates.

Operator

The next question is from David Motemaden of Evercore ISI. Please proceed with your question.

David Motemaden

Just a question on how we should think about the reinsurance costs? I think the aggregate renews on 4/1 and the rest of the program renews on 6/1 next year. Obviously, hearing about the dislocation, I think you guys had a 9% increase last year in your reinsurance costs.

I'm wondering, it's a two-part question. What are you guys expecting for your reinsurance cost increase this year just given everything that's happened in the market? Second part, do you think you'll be able to increase your pricing on a consolidated basis considering the residential earthquake book as well, will you be able to increase your price by enough to offset the cost of reinsurance?

Mac Armstrong

That's a good question, and it's something that we are very focused on in taking stock of this reinsurance market. We've actually been in Bermuda, and we get down to Bermuda and get to lending kind of on an off-cycle basis just to catch up and give people a holistic view of all the Palomar is doing. It's afforded us the chance to get a sense of this market. It is a dislocated market and there is pullback from reinsurers or a retrenching of their property cat appetite.

I think it's important, though, for us to reiterate a few key themes. One is the property cat perils that are in the crosshairs for the majority of rate increase is going to be Southeast Wind, which obviously, we have some exposure to, but I'll come back to that because it's a very decreasing book of business. Then those that have secondary perils think about tornado, hail derecho or Midwest wind. They have delivered kind of unexpected losses.

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Even if you look at Ian, that was not an unexpected loss, but as it relates to us, we feel that we're in a very solid position. We have meaningfully reduced our excess and continental hurricane exposure. It's more than 60% since 2020. Just with the runoff of this book that we have in place, that we put into place at the start of this year, there's another 20% reduction in our PML.

As we think about what comes up for renewal at 6/1, it's really going to be a single peril or single uncorrelated peril renewal. If you talk to reinsurers, that's what they're focused on from a property cat standpoint. They are focused on trying to confine their losses to what they've historically been in business for, and that's earthquake, that could be Hawaiian Hurricane. It's the unexpected loss, a winter storm or again, a derecho in the Midwest, that puts the burden on the market and put a burden on the cost of capital.

What that means for us is as it becomes increasingly more single peril and uncorrelated with the market's peak zone, I think we feel very good about the prospects for our renewal at 6/1. With the aggregate, because the same logic applies to the aggregate, the aggregate has really mostly Hawaiian Hurricane and earthquake in it, and it's easier to model and get their hands around. There's less of the death by a thousand cuts scenario.

What does that mean? We're going to take stock of the renewals at 1/1. We haven't put out guidance for 2023 yet, but all of our internal models for over the last several years have baked in increases in this market because we thought that the hard market would persist. We feel very good that we can continue to operate, grow profitably and add a good combination of earthquake into a less degree Hawaiian Hurricane to the book next year.

As it relates to your second question, I mean, I think we can get the rate that's needed. We got in the third quarter on the Southeast Wind, a 30% rate up. That is going to accelerate. It's got to accelerate to keep up with potential loss costs and inflation.

On the quake side, we were seeing double-digit rate increases now. As I sit here in the fourth quarter, that's ticking up. And moreover, as capacity pulled back, whether it be MGA-driven capacity or multinational insurers that are putting more of their historical binding authority capacity back into reinsurance, we'll be able to drive terms and conditions as well as rate. Overarchingly, I think we can get the rate to keep up with loss costs as it relates to the admitted side of the book. The one thing that we do have in particularly in high net worth segments, and we can change the cut-off and the parameters for high net worth.

In residential earthquake, we can use our E&S company more. We've been doing that, and we can continue to do so. That's where you can recover the rates that's beyond the 8% inflation guard that we put in place on the residential quake.

I think the other thing that I would add on Hawaii, we have not only an 8% inflation guard, but we did get a 9% rate increase. Frankly we can get more rate and potentially could get more rate next year there. I think the combination of having a balance of commercial and residential business affords us the ability to pass on the costs. I think the overall quality of our book makes us feel like that we will be able to grow and certainly directionally maintain our margins.

David Motemaden

Maybe just a follow-up there. We've been hearing from reinsurers just a broader retrenchment away from property lines, which I don't know if that includes earthquake or not. Are you seeing less capacity, just full stop across property perils, on the reinsurance side?

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Mac Armstrong

We're not hearing full stop. Again, we don't have anything renewing at 1/1, but obviously, we're talking to reinsurers. I think probably seen 30 reinsurers over the last month or so of a marketing trip that was actually established before Ian. No, I think it's a matter of what their cost of capital is and what they're targeting. I think every reinsurer is looking as earthquake as a bit of a safe haven. It's not climate change impacted. It's uncorrelated from their peak zone.

Southeastern wind is a little bit of a different story. That’s why we feel good about the actions that we've taken over the last two years and that we'll have probably when it's all said and done, less than $200 million of Southeastern wind PML that we're buying limit for, which is less than 10% of our total program.

As we've grown and diversified, we can bring more casualty opportunities to reinsure. There's more that we can trade with from a broad relationship standpoint. We feel that we are uniquely positioned in that regard.

We have built up a very significant book with our reinsurers. They made money with us, a lot of money with us. I think that counts for something, too.

David Motemaden

Then just on the attritional loss ratio. Now we're thinking 23%, 24%. I think you were originally talking about a 21% to 22%, if I recall, for next year. Is that really all driven by mix where you're having just a greater portion of your net earned premiums that are just coming from these other lines, which I think you guys had outlined have a 57% attritional loss ratio, and it's just purely mix? Or is that 57% loss ratio that you guys laid out in the Palomar 2X? Has that changed at all?

Chris Uchida

That has not changed. As Mac talked about it, our view on the lines of business that are fundamental to Palomar 2X, inland marine, casualty and the like, those loss picks haven't changed. Those lines performed as expected this quarter. We're very happy with that, but the written premium and the earned premium associated with it have accelerated. From where we were at in June, we are in a different spot that has accelerated. It’s brought some of that loss ratio, call it, forward a little bit. When we look at it, and we think about 2023, yes, that does push the loss ratio up.

But the one thing I'd also say is that we've always had this runoff in our expectations. We knew that that part of the mix was in there when we've talked about this ticking up. If we can fast forward and get this out of our book, I still expect the loss ratio in total, same thing, all of those caveats this with the same quota share, same mix, to be below 20%. If we can do things faster and get that mix at the right spot by the end of 2023, maybe that happens faster. Maybe one of those lines decelerates a little bit and other line goes faster, and so maybe it stays a little higher, a little bit longer, but that's a little bit harder to predict. But overall, this mix is—or this new business that we're writing is performing as expected it's what we like to see. We're very happy with it.

We're very happy with the growth trajectory. I think when you look at it in a long-term basis and when the mix is a little more mature, we still expect that loss ratio to be below 20%. But there is still going to be some increases in a little more of a short term. The one thing I would say is I don't want people to front-run the comment where we say that $5.3 million or 29% of the loss ratio for the quarter is from these lines of business. These lines aren't necessarily gone in Q4. They're going to take a little bit of time, but most of it, the majority of it, will be gone by the first half of next year.

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David Motemaden

You guys obviously disclosed on the gross written basis, the mix. Back of the envelope, I'm calculating it's like roughly 40% of your mix will be from these attritional loss lines. Is that the right level of the mix to think about? And is that sort of a stable level? Or it sounds like you would think it would stay at a 40% mix and it's sort of going to be capped out there?

Chris Uchida

Yes. Are you doing that ex-fronting? I think if you're thinking about ex-fronting and we compared to earthquake and Hawaii kind of the binary line. Yes, I think 40% is probably the right mix there. We've said for a while, excluding fronting, that at some point in time, there's probably going to be a 50-50 mix between earthquake and other lines. I would say, in that commentary, that Hawaii's probably in there a little bit as well. But no, I think if those lines are, let's call it, 40% to 50% of the non-fronting mix, then I think that's a good mix for us.

But obviously, everything still has to continue to grow, which we are watching as well and making sure that we're fundamentally strong on earthquake growth will continue and is a key fundamental to how we're operating the business.

Mac Armstrong

Earthquake has seen good growth as we sit here today.

Operator

The next question is from Pablo Singzon of JPMorgan. Please proceed with your question.

Pablo Singzon

The first question I had is, could you speak to the slowdown in gross premium growth or binary alliance in the quarter? I think, based on my math, you grew about 33% in the first half and in the third quarter, you grew 18%. It seems like from your comments, you expect growth to accelerate once disruption from the CEA begins to play out. Also, can you comment on any impact you're seeing from insurance writers pulling out of California? I think Allstate today announced that they've stopped filing for new business.

Mac Armstrong

Yes, it's a good question. I'm happy you brought it up.

The growth did slow down sequentially from the second quarter to the third quarter for earthquake and Hawaiian Hurricane lines. I would point out that the third quarter is our largest and so it's a tougher comp. But what I would tell you is that as we sit here today, the growth year-over-year in the early part of the fourth quarter has accelerated.

Some of that's a function of, on the residential side, E&S opportunities that we're seeing and the ability to get rate there. Some of that is some partnerships that are getting more and more traction. On the commercial side, it's rate and, capacity pullback. While earthquake did grow just under 20% in the third quarter, we expect that to sustain, if not grow, faster for the remainder of the year.

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On Hawaii, we were waiting in the third quarter. We were not actively looking to grow our exposure there. We were waiting on the approval of a rate increase and an inflation guard. We did get both of those approved in August. You typically are quoting 45, if not 60 days, out ahead. What we're seeing there is, again, a reacceleration of growth in that binary segment.

We feel very good about the growth prospects for residential earthquake and then even Hawaii. we're not going to be growing exposure, we're going to be growing more just from a pure rate, but I would expect a sustained level of growth in those lines that will be a nice anchor going forward.

Pablo Singzon

Then just a follow-up on the reinsurance discussion. How much of your residential earthquake book is admitted versus E&S? How fast do you think you can shift your mix there? The context of the question is that, recognizing all these pricing levers you have, at the end of the day, your biggest exposure is still California earthquake, right, which is mostly admitted and a piece of the subject that regulator that's not granting any price increases?

Mac Armstrong

Yes. No, I mean, we do have an inflation guard, right? That's ticking up 8% a year on the admitted side. But the E&S book is around 10% right now, plus or minus. I think probably closer to 8% right now. But nonetheless, we do have the ability to increase that channel, in particular, as we look at high-value thresholds in which eligible for the traditional admitted versus the E&S from a high-value standpoint. We can look at certain producer channels. We can also look at geographic concentrations to manage that.

The admitted side does not afford the latitude. We can use the E&S company. The inflation guard gives us a decent cushion as well. The inflation guard is frankly keeping up just about with the risk-adjusted increase on the 6/1 renewal. The rest of it will be subsidized by the commercial.

Pablo Singzon

Then just switching to the results of this quarter. Maybe for Chris, how much earned premiums were associated with the runoff book in the third quarter? I'm just trying to get a sense of the AOI loss ratio ex those losses. Can you talk about the drivers of claims here? I think the main reason for your decision to exit certain lines was the exposure to cat risk, but it seems like attritional factors drove the losses this quarter?

Chris Uchida

Yes. No, that's a fair statement. Obviously, if you look at this quarter, I mean some of these lines, mostly the lines don't have a ton of cat, they do have a little bit of cat in there, so some of that was felt. But no, the attritional losses were the reason in that, if they were cat, we look at the cat payback. But the attritional loss was the main reason we made the decision to exit these lines. When you look back at Q2, obviously, we had these lines, and they were performing better, but there's some reading of the tea leaves, and we thought that this may be in there. This definitely affirms our decision to exit those lines.

These lines in total, obviously we haven't given out the breakout of the earned premium, but in total, it's probably good to think about these lines, even with this loss ratio operating in the 90% to 95% combined range. That's probably a good way to think about it. But no, they drove some of the results this quarter. It's something that we thought could happen and really did drive the reasoning behind why we wanted to exit these lines. That's what we started doing earlier this year.

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That's why the majority of it will be out by the middle of next year. We're happy with that decision. We would just wish, like some other people, that it was out sooner, but it doesn't take away from the good results we're having on the other lines of business and the growth that we're seeing in the binary lines. The growth that we're seeing in the lines are key to the Palomar 2X and the fee income that we're seeing on fronting as well. We feel good about all those things also.

Pablo Singzon

Are these lines non-Texas Specialty Homeowners? Or are they something else?

Mac Armstrong

There's a Specialty Homeowners. There's also an assumed reinsurance relationship, which is a homeowner/renter’s product. Then there is one commercial property program that we are, again, restructuring/ running off.

Pablo Singzon

Then last for me. Just given your cat experience this year, do you think the $6 million average annual loss estimate you offered before per cat still stands? Just given what happened with Ian, if you can talk about your appetite for providing risk in Florida, given that you weren't in that market in any meaningful way a couple of years ago. Thanks.

Mac Armstrong

I think there's a couple of things in there. The $6 million is the average annual loss. Ian was not an average storm. This was, I don't know if it's a 1 in 40 or 1 in 50 or a 1 in 30-year event. An event like that will over-index the average annual loss.

That all said, as I mentioned earlier, we still have line of sight on an incremental 20-plus percent reduction to our exposure in continental hurricane, which will push down that AAL and also the runoff, which is a function of the runoff of that continental hurricane exposure. Plus, one of the things that a hard market affords you is the ability to look at your book and drive further optimization.

We have rate targets. We have the ability to contract our line sizes. We have the ability to look at occupancy eligibility and age of construction. All of those will also help the AAL, our retentions, whatever it might be. The AAL will actually come down if you roll forward to next year's wind season through previously identified initiatives and then ongoing initiatives that we have right now on managing our wind exposure and taking advantage of rate and the like, will push it down further. Then again, just to reiterate, Ian, that was not an average event. That was a cat 4, cat 5 that hit Southwestern Florida. I think we feel very good about our losses only being 3% on a pre-tax basis of our surplus.

Operator

The next question is from Jing Li of KBW. Please proceed with your question.

Jing Li

My first question is on inflation. Is there any kind of changes on the current inflation guards, or are you comfortable with the current level?

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Mac Armstrong

Yes. On the inflation guards, we did increase them from 5% to 8% on our admitted residential book, so residential earthquake and admitted Hawaiian Hurricane. I think we continue to look at not just the inflation guards, but the underlying insurance to value and the ITV for all of our portfolio. We use that to look at when a policy is submitted for new business or renewal to make sure that the estimate on the replacement cost does factor in a true sense of inflation right now.

We also have the ability to leverage our builders risk business, which has what's called auditable policies that you can see, once a project is completed, what was the ultimate cost and how did that compare to the original estimate. If that was 10% or 12% higher, not only is the premium adjusted, but we can use that on a regional basis to inform what we think the replacement cost should be across all of our portfolio on a state-by-state basis.

Right now, we think it's adequate. That doesn't mean that we won't potentially bump them up. Hopefully, as the Fed gets inflation under control, there will start to be a cushion below the 8%.

Jing Li

My second question is on the fronting premiums. Fronting premiums for this quarter continue to be strong. Are there any updated thoughts for this year and going forward in 2023?

Mac Armstrong

Fronting was strong this quarter, and it has exceeded our expectations this year, and I think that gives us great visibility on a nice fee income stream into 2023. We did take up the range from $180 million to $200 million this quarter from $160 million on the high end that we gave at the end of Q2. That gives us good momentum into 2023.

We have not given a target for 2023. What I will say is that we have a nice pipeline of prospects for the fronting business. The existing clients are performing well. We've been able to bring incremental capacity to support their growth. Through our reinsurance relationships, we have been able to help them execute on a host of ways. That gives us a very nice conviction on the fronting opportunity in 2023 and beyond.

Operator

The next question is from Tracy Benguigui of Barclays. Please proceed with your question.

Tracy Benguigui

I see you've mentioned that you exhausted your $12.5 million catastrophe retention, and you're also paying reinstatement premium. Can you highlight what the reinsurance recoveries were, your gross losses? What I'm trying to get at is, I'm just trying to figure out how far in your program you might have had some losses. Then just tagging back to that discussion with reinsurance capacity, if you had a view of how those reinsurers would feel about renewing with you since they've had some losses?

Mac Armstrong

Just as a reminder, we do have prepaid reinstatements. We have a $12.5 million retention loss from this event. Then whatever is impacted in those lower layers of our reinsurance program are reinstated and so come back online.

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Now, we have not disclosed our gross as of yet. We're seeing claims come in. What I will tell you is, this is immaterially up our program. Now, that being said, for those reinsurers that are in our first layer of the program, and if it's in the first layer and ticks up into the second, we want to be mindful of their losses, and there will need to be payback there. But this is well within the first two layers of our reinsurance program and hopefully really just closer to the first layer.

Tracy Benguigui

I totally get your commentary earlier that some of the perils that you're in might be attractive to some reinsurers. But just thinking a stress scenario, where in the danger zone could you be in terms of raising retention, co-insurance, maybe reducing top layers? If you had a stretch, what would be the minimum you could think about in terms of reinsurance protection?

Mac Armstrong

Tracy, we are looking at the market closely. I think we look at our retention because that is, frankly, where there will be losses into that first layer because of Ian. Will we have to take our retention up $3 million, $5 million. We'll see how that goes. Maybe we'll do it vertically through a co-participation in that first layer.

We obviously don't want to get to a point where we're trading dollars, so the rate online is 100%. That doesn't make a whole lot of sense for us.

I think there's a couple of themes that I want to impress upon you, though, as you think about stress scenarios. Again, I made the point around earthquake being a nice diversifier. I'll make the point again that we have a substantial bank built with those reinsurers, so we've made them money. But the one thing that you are hearing from reinsurers is, they want to see retentions go up. They also are moving up programs. For us, as you get above, I'll forecast it, $175 million of limit, you go into really only binary exposures or single peril exposures.

That's where property reinsurers are looking to go. They want to go to single peril. If they take a loss from an earthquake, that's what they're in business for. It's not a circumstance where they're taking a loss in a layer that they thought was only earthquake exposed and then there was a winter storm that hit it.

What you're seeing is reinsurers moving up in the mid working levels of programs. There is actually a scenario, this is my rose-tinted view, that we're going to have excess demand in the middle of our program because it will have an attractive rate online, and it will be single peril.

I think that's a dynamic that will play itself out, whether it's excess demand or what the price is, it will be manageable for us. But I do think that it's not a circumstance where we have Midwestern hail exposure, Florida exposure, all the way through our program, so we're scratching and clawing for limit. We're actually going to be bringing something to them that's in vogue with the property reinsurance market.

I think the other thing that I need to reiterate is, we have a $2.1 billion program, $675 million of that is in cap bonds that is multiyear. They're not renewing right now. They are locked in in 2024 or 2025. Also, you think about those stress scenarios, we don't have the totality of the program renewing. The majority of the program is single peril, and the strong majority of the program doesn't have any secondary peril exposure.

Operator

We have a follow-up question from Mark Hughes of Truist. Please proceed with your question.

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Mark Hughes

Yes. Chris, what would you say is the good ratio we should be thinking about in terms of earned premium relative to written? I think this quarter was a little lower because of the new reinsurance and new quota share. When we think about Q4 and go forward a few quarters, what should that ratio look like?

Chris Uchida

Yes. I think the best way to think about it is it's going to continue to decrease, right? I think as we transition some of our business over to fee-based business, like fronting, or even some of the newer clients that have attritional exposure where we use a heavy amount of quota share to protect our risk and to help deliver more consistent earnings, the net earned premium ratio is going to continue to go down. The end of this quarter, it was, let's call 42%, 48% for the full year. I think I've said all along that I expected it to be below 50% for the full year. That trend that experience is happening, right?

Could that full year number be 45%, 46%, or potentially even lower? Maybe, but I think that trend when you think out to '23 is going to continue. Fronting has been strong. We expect that trend to continue. Mac obviously didn't really take up the range on where we performed there. The growth in the lines of business key to Palomar 2X, casualty, inland marine, have been strong. Those have quota shares with them. That's going to increase. And you can actually see that even on the net written side, right, we did see a significant portion of our written premium this quarter to reinsure.

Some of that, obviously, is XOL, Mac talked about, we did have some cost increases there. Also, if you will remember, XOL, the first quarter that you have full quarter of excess of loss is your heaviest quarter as a percentage goes because you are paying the same rate for the next 12 months. Even though we are planning on growing our book and we buy to be able to facilitate that growth, XOL is a little bit higher. But the quota share is going to drive the largest amount of that differential into future quarters when you think about the net earned. I expect it to continue to decrease on the other side of that, the fee side of that. I expect the acquisition expense, especially as a percentage of gross earned to continue to decrease as well.

You saw that trend continue Q2 to Q3 of this year. It's down to 14.6%. That trend is what we expected as well. It's still going the right direction. I think that's what I continue to expect with net earned. I'm not going to give out a specific target for next year at this stage. But I do expect it to keep going down. I think there's going to be more consistent fee income from that. But also strong performance in those lines of business is what you're seeing, and what you're seeing go through our net earned premium ratio right now.

Operator

I'd like to turn the call back to Mac Armstrong for closing remarks.

Mac Armstrong

Great. Thanks, Operator, and thanks to all who were able to join. We appreciate your participation, questions and your support. I'd also be remiss if I didn't thank all of our team at Palomar for their dedication to the business and as well as all of our customers and partners for what they do. They are critical to our success.

To conclude, we do think that this quarter really was a demonstration of the meaningful strides we're making on our path to Palomar 2X. We reached record growth in gross written premium. We monetize

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and continue to monetize our capital investments made over last year and the early part of this year, and we really did demonstrate the increasing resilience in our business model.

Overall, we have line of sight in our ability to execute Palomar 2X, and we look forward to delivering considerable value to our shareholders as we do indeed achieve those milestones. Thank you very much. Enjoy the rest of your day, and we'll talk to you next quarter.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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