Fourth Quarter and Full Year 2019 Earnings Call Transcript February 19, 2020

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PRESENTATION

Operator

Good morning and welcome to the Palomar Holdings, Incorporated Fourth Quarter and Full-Year 2019 Earnings Conference Call.

During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference lines will be opened for questions with instructions to follow at that time. As a reminder, this conference call 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 Fourth Quarter and Full Year 2019 Earnings Call. With me here today is Mac Armstrong, our Chief Executive Officer and Founder. 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 February 26, 2020.

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. Such risks and other factors are set forth in our most recent periodic report and our Prospectus filed with the Securities and Exchange Commission January 10, 2020. 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 the 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. Over the course of 2019, Palomar executed on its mission to build a diversified book of specialty property business. We remained focused on developing a suite of distinctive and flexible products delivered via an easy-to-use and scalable platform that incorporates an analytics-driven underwriting and risk transfer framework. Our results over this past quarter and the full-year of 2019 demonstrate that we are making progress on our mission and that our products are well-received by the market. But before we go into the quantitative highlights for the quarter and the year, I want to provide some qualitative perspective on 2019 as it was a momentous year.

Selected accomplishments include expanding our geographic footprint into 27 states; consummating multiple new carrier partnerships, including the largest in our history; launching two new divisions of the Company: Inland Marine and Assumed Reinsurance; making significant investments in our human capital with the notable hiring of a Chief Risk Officer and SVP People and Talent; procuring $345 million of incremental reinsurance limit to prudently support our growth; and lastly, our initial public offering in April which catalyzed several growth drivers of the business.

Turning to our results, gross written premiums grew by 68% year-over-year for the fourth quarter and 63% year-over-year for the full-year 2019. Importantly, we generated strong growth across our expanding product portfolio, not just from a few standouts. The 73% year-over-year growth of our Earthquake products during the fourth quarter demonstrates that our Earthquake franchise continues to gain traction and that we increasingly play a leadership role in the market segment. Our Non-Earthquake products grew 59% year-over-year in the fourth quarter, further proving that our product development strategy is exportable to other segments of the specialty property market. As a Company, we remain focused on developing differentiated products to serve acute market needs, and I'm pleased to report that the contribution from our newest product lines continue to grow. Specifically, our Residential Flood program grew 140% year-over-year in the fourth quarter while our recently launched Inland Marine department continued to expand its geographic footprint, product offerings, and distribution network. Overall, premiums for our Non-Earthquake products represented 30% of total gross written premiums during the quarter. In many cases, these products are in markets that are multiple times larger than the addressable earthquake market and offer significant runway for future growth and broadening of our premium base.

Additionally, we generated solid growth across both Commercial and Personal lines, exiting 2019 with a mix of 29% commercial and 71% personal lines. An attractive rate environment and expanding distribution network led to 135% growth year-over-year in the fourth quarter for our Commercial lines offerings. Our Commercial lines experienced an average composite renewal rate increase of 11.2%, during the fourth quarter compared to 9.0% in the third quarter. The accelerating rate increases was most pronounced in our Commercial Earthquake line of business which saw a composite renewal rate increase of 13.8% versus 9.2% in Q3. Personal lines offerings exhibited continued momentum and grew 46% year-over-year in the fourth quarter.

We believe that there is no stronger endorsement of the unique value that we offer to our distribution partners and ultimately the end insureds than our strong premium retention rates. Average monthly premium retention across all lines of business was 89% during the quarter, up sequentially from 87% in the third quarter and compared to 83% during the fourth quarter of 2018. Notably, we saw retention rates above 92% for our All-Risk, Hawaiian Hurricane, and Residential Earthquake business during the fourth quarter.

The composition of our book of business minimizes our exposure to attritional loss and provides considerable earnings visibility. However, we will experience some measure of loss on a quarterly basis, even when there isn't a major earthquake or hurricane in Hawaii; fortunately our commitment to managing loss exposure through market selection, underwriting, and risk transfer confines attritional loss. During the fourth quarter we had loss and loss adjustment expense of $2.2 million, and Chris will provide more detail on the losses shortly. But I will point out that even with a modest amount of loss, our loss ratio was 5.6% for the full-year 2019 compared to a loss ratio of 9.0% for the full-year 2018. Through this commitment to predictable and profitable underwriting we were able to achieve a full-year adjusted combined ratio of 63.3% and an adjusted ROE of 24.1%. We believe these results reflect the uniqueness and capital efficiency of our model, as we were able to achieve that ROE with a conservative net written premium to ending stockholders' equity ratio of 0.66x.

Risk management is a central pillar of our model, and the completion of our January 1 reinsurance renewal reflects our dedication to balancing the growth of our portfolio with conservative reinsurance protection. As previously disclosed, we renewed approximately $300 million of our core Reinsurance Program at rates flat to modestly up on an exposure adjusted basis and purchased $145 million of incremental limit to support the continued growth of our existing and new products. As of January 1, our Reinsurance program provides coverage up to $1.2 billion for California earthquake events. This coverage allows the Company to maintain a cushion above the 1:250 year peak zone probable maximum loss and significantly exceeds simulated losses from any recorded historical event. Our per event retention remains $5.0 million through May 31, 2020.

Looking ahead, we enter 2020 committed to our ongoing growth initiatives. As previously mentioned, reaching an AM Best financial size category VIII last year unlocked new distribution sources for our Commercial lines products and new carrier partnerships for our Personal lines products. With the primary proceeds from our January 2020 follow-on offering, we are now in proximity to achieve $250 million in surplus and AM Best financial size category IX, which should further unlock new growth opportunities. Our product suite remains relevant and attractive to the market. We are adding new states of operation and broadening our product offerings in existing ones. We continue to invest in technology that offers distribution partners more streamlined access to our products and improves our ability to drive scale in our business. We are invigorated by the prospects of 2020 and believe that we can grow adjusted net income between 33% and 40% for the full year.

With that, I would now like to turn the call over to Chris for a more detailed review of our financial results.

Chris Uchida

Thank you, Mac.

Please note that during my portion, when referring to any per share figure, I am referring to per diluted common share as calculated using the treasury stock method.

For the fourth quarter of 2019, our net income was $10.9 million, or $0.45 per share, compared to net income of $4.1 million, or $0.24 per share for the same quarter in 2018. For the full year of 2019, our net income was $10.6 million, or $0.49 per share, compared to net income of $18.2 million or $1.07 per share in 2018.

For the fourth quarter of 2019, our adjusted net income was $11.5 million, or $0.48 per share, compared to adjusted net income of $4.6 million, or $0.27 per share for the same quarter of 2018. Fourth quarter

2019 adjusted net income excludes expenses related to the Company's stock offerings, stock based compensation, and the tax impact of those expenses. In the fourth quarter of 2018, adjustments exclude the expenses associated with the Company's IPO and tax restructuring. For the full year of 2019, our adjusted net income was $37.9 million or $1.73 per share, compared to adjusted net income of $19.8 million or $1.17 per share in 2018.

Gross written premiums for the fourth quarter were $73.3 million, representing an increase of 68.4% compared to the prior year's fourth quarter. For 2019 gross written premiums were $252.0 million, growth of 62.7% compared to $154.9 million in 2018. As Mac indicated, this growth was driven by a combination of robust new business, rate increases, and strong premium retention with contributions across our product portfolio.

Ceded written premiums for the fourth quarter were $29.5 million, representing an increase of 35.8% compared to the prior year's fourth quarter. Our risk transfer strategy remains a critical component of our business, especially as we demonstrate sustained topline growth. The increase was primarily driven by an increase in our excess of loss or XOL reinsurance expense commensurate with our growth and our quota share reinsurance. We utilize quota share reinsurance to minimize the impact of attritional losses on our portfolio and to generate valuable fee income from ceding attractive risk to reinsurance partners. The increase in ceded written premiums was in part due to increased ceding to the quota share reinsurance partners. That said, while the total dollar amount of ceded written premium increased, ceded written premiums as a percentage of gross written premiums decreased to 40.3% for the three months ended December 31, 2019 from 49.9% for the three months ended December 31, 2018 due primarily to the increase in gross written premiums in our Residential Earthquake and Commercial Earthquake lines, which are not subject to quota share reinsurance agreements. This dynamic was also evident for the full year of 2019, as ceded written premiums as a percentage of gross written premiums decreased to 43.0% for the full year of 2019 from 53.6% for the full year of 2018. As we grow our business, we expect to incur additional excess of loss in reinsurance expense as we maintain a conservative level of overall coverage. Due to the timing of our reinsurance placements and the terms of the underlying contracts, there may be a lag between earned premium and a reinsurance placement or expense, but over time we expect the impact to smooth out and the trends to look the same. Our retention remains $5 million per earthquake or wind event, and we purchase $1.2 billion of total reinsurance coverage for California earthquake events.

Net earned premiums for the fourth quarter were $31.0 million, an increase of 75.9% compared to the prior year's fourth quarter, due to the growth and earning of higher gross written premiums offset by the growth and earning of higher ceded written premiums. Net earned premiums for 2019 were $100.2 million, an increase of 43.4% compared to 2018. For the fourth quarter of 2019, ceded earned premiums as a percentage of gross earned premiums were 47.5% compared to 53.4% in the fourth quarter of 2018. For 2019, ceded earned premiums as a percentage of gross earned premiums were 50.0% compared to 49.3% in 2018.

Commission and other income was approximately $0.7 million for the three months ended December 31, 2019 and $0.5 million for the same period in 2018. Commission and other income in 2019 was $2.7 million and $2.4 million in 2018.

Losses and Loss Adjustment Expenses, or LAE, incurred in the fourth quarter were $2.2 million, an increase of $3.0 million compared to the prior year's fourth quarter. Our losses during the quarter included roughly $0.9 million of attritional losses, equating to an attritional loss ratio of 2.5% for the quarter. In addition, we booked approximately $1.3 million of losses and LAE from Typhoon Hagibis and unfavorable development from the events that occurred late in the third quarter, including Typhoon Faxai, Tropical Storm Imelda, and Hurricane Dorian. Losses and LAE for the fourth quarter of 2018 included current year and prior year unfavorable development of $0.3 million and $ 0.5 million respectively. Combining the impact of attritional losses with major events, our loss ratio for the quarter was 7.1% compared to a negative 4.4% for the prior year's fourth quarter. As Mac mentioned earlier, our 2019 loss ratio was 5.6% compared to 9.0% in 2018.

Our expense ratio for the fourth quarter of 2019 was 56.0% compared to 64.3% in the fourth quarter of 2018. We believe our business will continue to scale over the long term.

Our combined ratio for the fourth quarter was 63.1% and compares to a combined ratio of 59.9% for the prior year's fourth quarter. Our adjusted combined ratio, which we believe is a better assessment of our efforts, was 60.7% during the fourth quarter compared to 57.3% in the prior year's fourth quarter that included a negative 4.4% loss ratio. Our 2019 adjusted combined ratio was 63.3% compared to 69.5% in 2018, demonstrating our ability to scale.

Net investment income for the fourth quarter was $1.8 million, an increase of 75.6% compared to the prior year's fourth quarter. The increase was largely due to increased interest income generated by proceeds from our IPO in April. We maintain a conservative investment strategy as our funds are generally invested in high-quality securities, including government agency securities, asset and mortgage-backed securities, and municipal and corporate bonds with an average credit quality of AA. The weighted average duration of our Fixed-Maturity Investment portfolio, including cash equivalents, was 3.49 years at quarter's end. Cash and invested assets totaled $272.8 million at quarter end as compared to $157.3 million at December 31, 2018. For the fourth quarter, we recognized realized and unrealized gains on investments in the consolidated statement of income of $1.2 million compared to a $3.6 million loss in the prior year's fourth quarter. The loss during last year's fourth quarter was principally due to a decline in the value of the Company's equity securities.

Our effective tax rate during the fourth quarter was 24.5% compared to 0.1% for the prior year's fourth quarter. The 2019 fourth quarter tax rate includes an adjustment from prior periods of $0.4 million, or approximately three points of the effective tax rate for the quarter. The increase in our effective tax rate is due to our restructuring in the early part of this year. All of our operations are now taxable in the U.S. whereas in the prior periods our Bermuda operations were not subject to U.S. taxes. Excluding any unforeseen events, we anticipate that our tax rate will settle around the 21% mark for the 2020 year.

Our stockholders' equity was $218.6 million at December 31, 2019 compared to $96.3 million at December 31, 2018. This increase was due to our earnings during the year as well as the addition of IPO net proceeds, which will put downward pressure on our return on equity in the short term while providing capacity for continued growth over the long term. For the fourth quarter of 2019, annualized return on equity was 20.4% compared to 17.6% during the fourth quarter of 2018. Similarly, our annualized adjusted return on equity during the fourth quarter was 21.5% compared to 19.6% during the fourth quarter of 2018. Our adjusted return on equity for 2019 was 24.1% compared to 22.7% for 2018 with a lower capital base.

Looking ahead to 2020, we expect to generate adjusted net income between $50.5 million to $53.0 million, which equates to a growth rate of 33% to 40% on a year-over-year basis.

As of December 31, 2019, we had 24,092,325 diluted shares outstanding as calculated using the treasury stock method. Taking into account the 750,000 primary shares issued from the January 2020 Secondary offering, there would be 24,842,325 diluted shares outstanding as of December 31, 2019. We do not anticipate a material increase to this number during the year ahead.

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

Operator

At this time, we will be conducting a question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Our first question is for Mark Hughes at SunTrust. Please proceed with your question.

Mark Hughes

Thank you very much. Good afternoon or good morning. On earned premium, if I look at your trend in written premium in the recent quarters, I might've expected a little more earn to flow through in the fourth quarter. Was more of that business signed near the end of the quarter or is there something in the ceded premium that influences that? Anything about the timing of earned premium would be helpful.

Chris Uchida

Hey, Mark. It's Chris. Yes. I would say that there definitely was strong earned premium—or excuse me, strong written premium to finish off the year, so a lot of that is going to help the prospects of 2020. Along with that, I think we've said in the past that, call it, the 50% ratio for ceded earned premium to ceded —or gross earned premium is probably a better ratio than using the gross written premium to ceded written premium ratio. That can get a little bit out of whack depending on what happened during the quarter, whether it be a large assumed deal or even significant growth. Some of that growth that you saw in Q3 and even in Q4 doesn't necessarily play out properly in the ratios. We think looking at the gross earned to ceded earned is a better ratio to pick when you're looking at modeling this out.

I think those two factors and just, as we talked about, the addition of some excess of loss during the year than needed to come on to help facilitate the growth probably started to play out a little bit in the fourth quarter. But, overall, we're happy with the prospects and we're happy with the gross written premium and how it's going to play out into 2020.

Mark Hughes

Then on the Earthquake business, clearly the California quake was—it seemed like it was a catalyst. How have you seen trends as the year has—last year progressed and as you sit at the start of 2020?

Mac Armstrong

Hey, Mark, this is Mac. Let me answer that question and I'll bifurcate it in the two components of our Earthquake business, first the Residential, and then secondly, our Commercial. The Ridgecrest earthquake was a nice driver of new business growth, in particularly in the third quarter. In the fourth quarter we continued to see strong business and that manifested itself in north of 55%; I think 58% growth in the Residential Earthquake business. But I think by the middle of the quarter it had come—Ridgecrest was less of a driver and I think the bigger driver—I think this is a net positive for us—is the continued dislocation in the California homeowners market driven by wildfires.

You have admitted, Mark, it's trying a non-renew business on a consistent fashion and I think you're talking about as much as 10% of the book is being non-renewed. That comes back into the primary market and a jump ball and up for grabs dynamic. We get to compete on that. I think that's a longer-term catalyst for growth in Residential quake. Ridgecrest, I don't know if it dissipated, but because what you do have is the circumstance we added new agents and we did add new agents over the course of the fourth quarter, and agent awareness is driven by awareness in the event itself.

On the Commercial side, I think Ridgecrest is less of a driver of it. I think, frankly, for us what was a bigger driver was us getting access to new distribution sources, and that being a function of a larger financial size category, in this case, AM Best size VIII and hopefully what will come to root when we get the AM Best financial size IX. I think just one thing to point out, if you look at the first part, and this is anecdotal, but our small Commercial Earthquake business, if you look at the first eight months of the year, our average monthly submission activity was just approximately 860 submissions a month. After August, so September through the end of the year, that submission activity nearly doubled; it was closer to 1,600 submissions a month. I think that's a bigger driver of growth for us on the Commercial side than the Ridgecrest earthquake. It just increased submission volume.

Mark Hughes

Thank you.

Operator

Our next question is from Paul Newsome, Sandler O'Neill. Please proceed with your question.

Paul Newsome

I was hoping you could give us a little bit more detail about the basic assumptions, not the details but the basic assumptions underlying guidance for the year in terms of, just in general. Then separately, does that net guidance include some assumption for realized gains and losses?

Mac Armstrong

Hey, Paul. This is Mac. Let me answer your second question first. It does not assume any realized gains or losses on the investments. I think overarchingly, we feel good about the guidance that we are providing. We're very comfortable with the range. I think the key point to emphasize is the numbers that we put forth is based on existing products and existing geographic footprint. There are no major leaps of faith. There're no assumptions on new products that aren't already in the market, no new teams that are joining us, no major partnerships that we have not already consummated. Furthermore, no acceleration in pricing beyond levels where we are today and, therefore, no leaps of faith on premium retention.

We feel that we have a very good sense of what is required from our existing products to accomplish the range that we provided. I think what you'll also see is that from a loss perspective we feel good about the loss assumption there and it's consistent with what we have done in the past where you have mini cats and attritional loss contributing to it.

That's the overarching bottom-up approach that we've taken to the model. I think the one thing that I would add is that we view this guidance as an interim marker. It's no way an ultimate goal; it's a near-term goal. Furthermore, while we've been somewhat conservative in the assumptions, that does not mean that we're not actively in new product development; we're not actively extending our distribution footprint; we're not trying to go deeper in existing geographies; nor are we not trying to drive new partnerships and expand our footprint in that regard.

That's really the overarching premise behind the guidance.

Paul Newsome

That makes sense. My second question is if you could talk a little bit about capital adequacy levels. Obviously you recently raised a little bit of capital, but you're also growing quite fast. Do you have any sense of when—assuming maybe the continued growth that we are seeing of late, how would the capital adequacy change over time?

Mac Armstrong

We ended the year around 0.66x ratio from a premium to surplus perspective. That was prior to the incremental, call it, $35 million of net capital that was brought on the balance sheet in January; that'll push us probably closer to below 0.5x. We think that for the indefinite future we are adequately capitalized. The combination of free cash flow will, in concert with organic growth, will allow us to stay ahead of a ratio of 0.9 to 0.95 times, which is a number that we think that we can get to on a steady-state basis. Anything beyond that, that's when we probably look at incremental capital. But as long as we're below that 0.95x-0.9x ratio, we think we're good.

Paul Newsome

Thank you. Congrats on the year.

Mac Armstrong

Thanks, Paul.

Operator

Our next question is from David Motemaden, Evercore ISI. Please proceed with your question.

David Motemaden

Thanks. Good morning. Just a quick follow-up on the outlook for 2020; are you guys assuming any catastrophe losses in there, like a full retention loss, or what is the assumption around cats in there?

Mac Armstrong

Hey, Dave. We are assuming kind of mini-CATs, so think about it as a similar type of loss profile to what you saw in 2019. There is not an assumption around a full retention loss. But if you look at 2019, we had losses from Tropical Storm Barry, Tropical Storm Imelda, and Hurricane Dorian. There are CATs that influence it and it's the mini-CAT component to what we've seen historically, but no full retention loss.

David Motemaden

Got it. Thanks. Mac, just a follow-up on getting upgraded to AM Best financial size IX; any sense in terms of timing around that and any other initial thoughts or traction that you guys have seen from some of the largest brokers on the possibility of getting upgraded?

Mac Armstrong

Yes, Dave. The timing, the way that would work is once we file our Q1 statutory and group financial statements in the Q, then we would automatically trigger it because it's really just a mechanical process that they do once they import your financials into their system and then the financial size category is triggered. You're talking about middle of the second quarter, and then over the course of the second half of that quarter and third quarter is when it would probably really manifest itself in the market.

Going back to what I was talking about earlier on the call, we got to financial size category VIII on the heels of the IPO and our first quarter results, and it really didn't start to bear fruit, increase submission activity in a promulgation of a broader broker network, until August, September timeframe, so the latter half of the third quarter. Conservatively, I think the benefits of the financial size category IX would probably start to really, again, come to play in a similar timeframe, so third quarter, second half of the year.

David Motemaden

Got it. Do you anticipate a similar type magnitude where I think you had said you got a doubling in submissions when you got upgraded to AM Best size VIII?

Mac Armstrong

I don't think it'll be as pronounced as it was at AM Best financial size category VIII. I do think, though, it will help us in certain segments of Commercial Earthquake and Commercial All-Risk, and particularly layered and shared accounts which, candidly, is an area where there's probably as much dislocation as anywhere, in the property market at least. That should be helpful there, but I don't think it's going to be, again, as pronounced as it was in the circumstance of getting to financial size category VIII.

David Motemaden

Okay. Got it. If I could just sneak one more in just on the Japanese typhoon losses, just taking '19 and what happened with the losses in stride, does that change your approach at all to expanding into new lines going forward? Do you see making any changes to the assumed reinsurance book as a result of the experience?

Mac Armstrong

The assumed reinsurance strategy that we put in place is really—we hired John Knutzento be our Chief Risk Officer. In addition to overseeing our Analytics Department, he is looking to build out and assume Reinsurance product. Ultimately, what we're really trying to accomplish there is get access to certain geographies that have perils that we know well. Illustratively, northeast wind where we are not licensed and actively writing business, or Canadian earthquake, that was what we were trying to do with Assume Reinsurance. We've assembled a book that has exposure to those perils plus some others, but all business that we understand.

Secondarily, we use it as a way to really get a sense of the market on a global basis and a national basis to figure out where there are segments for us to potentially go into, so it's a good tool for front-end R&D. I think, what I would say is I don't think the strategy is one that we're going to take out foot off the pedal on. I think those same principles apply that gives us access to products that we can't—or geographies where we can't access on a primary basis. It gives us a tool to do R&D, but at the same time, we hope that we can recoup some of the losses that we've incurred from that over the course of 2020.

I think the thesis remains solid and it's one that we're going to continue to impart and we hopefully get paid for the loss that we've incurred, in particularly from the Japanese storms.

David Motemaden

Okay. Great. Thank you.

Operator

Our next question is from Jeff Schmitt, William Blair. Please proceed with your question.

Jeff Schmitt

Hi. Good morning. Question on the attritional loss ratio. I think you'd said it was around 2.5%, excluding catastrophe events there. How should we think about that going forward as the business mix changes? Obviously it's probably going to go up, but could we get a sense of how you're looking at it from a degree perspective?

Chris Uchida

Yes. Hey, Jeff, that's correct; we said 2.5%, backing out some of the assumed or some of the storm activity that we call mini cats. We're not going to carve those out specifically. We've said in the past that we're only going to carve out full retention events that hit our books, and we view everything on the attritional or mini cat. But we just wanted to make sure that people could see exactly what the more recurring, or what we expect to be a little bit more recurring from a loss ratio standpoint. That's why we disclosed that number.

Like you said, as we grow into other lines of business, whether it be our All-Risk or our Inland Marine, we would expect the loss ratio to just tick up naturally over time. We think those lines of business do have attritional losses associated with them. They are going to have losses with them. We do use different types of quota shares to help minimize the impact that any of those losses can have on our book, but also help generate fee income. That fee income will help to drive down our acquisition expense over time as well.

We use a couple of different strategies that help those books, but with the growth and with those becoming a larger component of our book, I would expect the loss ratio to tick up slightly over time. It's not going to jump, call it, 5 points to 7.5, but a point, half a point over a quarter wouldn't surprise me.

Jeff Schmitt

Okay. Then looking at that NPW to GPW retention, it was a bit higher than expected, close to 60%. Did you say that was kind of driven by that new Assumed Reinsurance business? How should we think about that for 2020?

Chris Uchida

Yes. I'd say for the fourth quarter, if I'm looking at that ratio, that's going to be driven by a lot of the growth that we're seeing. Like I've said before, we buy excess of loss Reinsurance in pieces, whether it be June 1 or January 1. When you look at the excess of loss component of that, it's going to look a little bit more like a stair-step where you buy a piece of it and then it is set for five or six months or three months, depending on how much growth we're seeing.

But, when you look at the growth that we saw, that growth—so we bought excess of loss in June; then the growth on top of it, you're going to see a higher ratio that makes the ceded written look a little bit lower. That's why I think it's more important from our standpoint to focus on the gross earned and a ceded earn, which is truly a more equivalent ratio of the risks that we are on and the excess of loss being amortized over the term or that excess of loss Reinsurance.

Like I said, for the year it was right around 50%. I would expect that ratio to remain true in 2020 as well. Assuming that there's no major shift in any of our lines of business or how we're doing quota share Reinsurance. The quota share Reinsurance, jumping around little bit, is a lot more linear for the written and for the earning of it when you we see it on our books. But, as our mix stays the same, I would expect that 50% to be a better target when you look at the gross to ceded earned going forward.

Jeff Schmitt

Right. Okay. Thank you.

Operator

As a reminder, if you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions.

Our next question is from Meyer Shields, KBW. Please proceed with your question.

Meyer Shields

Great. Thanks. Good morning. One of the themes that we heard from a number of reinsurers with regard January 1 is that ceding commission rates were going down. Are you seeing any of that in the quota share contracts that you're purchasing?

Mac Armstrong

Hey, Meyer, it's Mac. That's a good question. Fortunately, we have not. We've been able to maintain the economics on the quota shares that we put into place in the fourth quarter. We didn't have much in the way of 1/1 coming up, but what we did renew, in particular in the All-Risk side, was consistent with what we had expiring.

Meyer Shields

Okay. Fantastic. Then I just want to touch a little bit more on Japan because I think I understand that a little bit less. Are you writing that on a quota share or excess of loss basis to yourself? Can you tell us what the reinsurance projections are for that particular business?

Mac Armstrong

Sure. We are writing that on an excess of loss basis. The way we've done that is we have selectively partnered with existing reinsurers that we know well, that are big participants on our program and so there's an inherent trust that we have with those reinsurers and there's an inherent familiarity that brings us a higher level of confidence. What we are doing, though, is we're just taking a percentage of their excess of loss program, if you would, so we are attaching high up in—well, depending on the reinsurance, but generally speaking, we're attaching pretty high up the PML and, as a result, the losses are fairly modest, so there's no first-dollar exposure. I think it's worth pointing out that the losses that we have had, and Chris can chime in, it's an estimate right now. There have been no claims tendered, so we're just working in concert with our partners there.

Meyer Shields

Okay. Fantastic. Then final question: I know the Insurance Commissioner in California is trying to sort of discourage non-renewals; is that impacting submission flow for California Residential Earthquake?

Mac Armstrong

Yes. Meyer, that's a good question. I think he certainly is, the Commissioner certainly is trying to discourage non-renewals and has put in a moratorium in place in selected areas. I think that constituted roughly 800,000 homes in the state, so it was a small component of it and, frankly, they're areas that are probably most exposed to wildfire. You're still seeing 10% of the average book of business, 10% of it being non-renewed, and I think that is a dynamic that when you put into context of the total size of the book that an insurer has, they can, even if they are in a moratorium for a select segment, they can find another area to non-renew that probably doesn't meet their underwriting criteria at this point.

It's not impacting us, long-winded answer.

Meyer Shields

Okay. No. Perfect. That's very helpful. Thank you very much.

Mac Armstrong

Thank you.

Operator

Our next question is from Matt Carletti, JMP. Please proceed with your question.

Matthew Carletti

Hey. Thanks. Good morning. Chris, I actually want a follow up on Jeff's question about loss ratio progression as the book evolves. Is there any corresponding expense ratio movement that we should expect in terms of whether it's commissions paid with the smaller lines of business that start growing? Separately, just an expense ratio question generally is as you get to scale and the target mix of business you're targeting, what's a good run rate expense ratio that the Company could achieve?

Chris Uchida

Yes. On the acquisition expense for the lines of business that we are growing in, naturally they have a lower acquisition expense than sort of our other lines of business. When you look at our Residential Earthquake business, it is driven by the MGA market which has a higher acquisition expense. These other lines that we're looking at or that are going right now—All-Risk, Inland Marine—are driven by the wholesale markets that just have a naturally lower acquisition expense than the MGA business.

As I mentioned, we also have quota shares for those lines of business. The ceding commission that we receive on the quota shares is netted against the commission expense, so that does help to drive down the acquisition expense a little bit more.

As those lines become a larger component of our overall book, I would expect the acquisition expense to also decrease. It's not going to drop similar to loss ratio. I don't expect it to jump up. I don't expect the acquisition expense to drop five points in a quarter, but I wouldn't be surprised to see it decrease slightly over a period of time. The other thing with that is it's also on an earned basis, so it's going to take a little bit longer for that to develop naturally through the book, but I would expect those lines to help push the acquisition expense down.

Similarly, going to just the other operating expenses or the expense ratio in general, we have not provided any type of guidance on the expense ratio, but as we look at our book, as we look at the way we've built things for growth, whether it be on the Residential lines of just the systems that we put in place, we would expect there to be more scale in the book as we continue to grow. I think the topline growth that we're seeing should exceed any growth in expenses. That's not to say that we're not going to be prudent about adding people for technology, people for process improvement, but, just naturally, the growth in the revenue is going to exceed the growth in the operating expenses. But we haven't provided specific guidance on the expense ratio is going to drop to 55 or anything like that; we just think it's naturally going to go down over time.

Matthew Carletti

That's helpful.

Mac Armstrong

Matt, just to add a little more color, if you just look, to Chris' point, on the scale, the adjusted other operating expenses was 11.6% in the fourth quarter versus 12% in the same quarter the year prior, and that's with a lot more investment in headcounts, technology, and, frankly, public company expenses. I think that's illustrative of the scale that we are starting to achieve, so I think that's probably anecdotal support.

Matthew Carletti

Right. Then if I could just sneak one more in, Mac, just a high-level question here. You've got a lot of great opportunities ahead of you in very different kind of stages of growth and incubation. As you look out over the longer term—five years, whatever you want to define that as—which business do you see as the biggest opportunity for Palomar, or potentially is it one that we haven't found out about yet and you guys have in R&D and aren't public on?

Mac Armstrong

Yes. Good question, Matt. Just overarchingly right now, I think we're seeing more opportunity in the Commercial side of our business, and there's, within those lines that we have in Commercial—Inland Marine, Commercial Earthquake, and All-Risk—there are different catalysts for each one. Commercial Earthquake, not to beat a dead horse, but that one is the prime beneficiary of our larger financial size category and I think that's going to continue to be a driver of increased submission activity. Then you couple that increased submission activity with a pretty attractive pricing environment that leads to selectivity and growth and better margin. I think we feel pretty good about the prospect there.

The All-Risk side, that's in a much larger market than the earthquake market is, and while we're getting very good growth there, we still think we're in the early stages of that operation, so I think there's a lot of promise there.

Then Inland Marine is brand-spanking new, less than one year of operation, and we have some real talent in that organization. The leader of that department has now gotten his filings into all 27 states in which we are licensed. He increased his production count from the third to fourth quarter by over 140%, so he's put a lot of infrastructure in place to really scale that organization. He's continued to add talent, so I think that one, it's really just the tip of the iceberg.

I think right now we're probably seeing more growth opportunity and promise in the commercial market, but we feel pretty good about what we are doing also in our Residential business and Personal Lines business.

Matthew Carletti

All right. Thanks, Matt. Hey, Mac, congrats on a first year as a public company, a strong one, and best of luck in 2020.

Mac Armstrong

Thank you, Matt. Appreciate it. Thanks for your support.

Operator

Our next question is from Mark Hughes, SunTrust. Please proceed with your question.

Mark Hughes

Yes. Thank you. Mac, what was your comment on pricing, Residential versus Commercial or different lines, what did you have to say? Then could you give us an update on where you kind of see things standing today?

Mac Armstrong

Yes. Our Residential business, we don't have the ability to take rate like we do in the Commercial. Most of our products have what we call inflation guard, which allows us to take rate a little bit ahead of the cost of construction and the likes. Those typically have a 5% automatic renewal increase on them. That's what we have in place right now for our Personal Lines business.

On the Commercial side, our composite rate increase was right around 9%, 9.2% for the All-Risk side and then 13.4% for the Commercial Earthquake, so very strong. I think we've touched upon it, the rate increases accelerated from the third quarter versus the second quarter and certainly did from the fourth quarter versus the third quarter. I think we feel very good about the ability to maintain rate through the course of 2020 and, frankly, that is much informed by the continued pullback of capacity from some of our competitors. Lloyd's in particular, I think that five syndicates were wound down in the fourth quarter. I think there's very strong rate integrity on our distribution network, and so alignment there. Then larger writers continue to be mindful of their capacity, and particularly in larger property schedules. We feel very good about the pricing dynamic that we're seeing today and that we saw in the fourth quarter and don't see a near-term catalyst that pushes it the other way.

Mark Hughes

How about the specialty home owners? You've still got the solid growth there, but being outstripped by other lines. How's the competitive environment or your appetite there?

Mac Armstrong

What I would say is it's more our appetite. That's a nice line of business for us and we've put it into the specialty homeowners quota share facility, so it's a good driver of fee income for us. But it's also, in the circumstance of our Texas book, it's probably our most mature line of business. We've governed ourselves in terms of how much we're going to grow. We will grow that as we extend our geographic footprint. In the fourth quarter we started to bring on more business in North Carolina to balance what we are doing in Texas, Mississippi, and Alabama, and there are other states that are on the horizon over the course of 2020. But that line of business won't grow as quickly as any of the Commercial lines, it won't grow as quickly as Flood, and it's not going to grow as quickly as Residential quake.

Mark Hughes

Thank you.

Operator

We've reached the end of the question-and-answer session and I will now turn the call back over to Mac Armstrong for closing remarks.

Mac Armstrong

Thank you, Operator, and thank you, all, for your time this morning. This concludes Palomar's fourth quarter and full-year earnings call. We appreciate the time, the questions, and, always, your support.

We feel that 2019 was a milestone year for the Company. We entered several new lines of business, expanded our geographic footprint, we strengthened our team through the addition of several highly talented industry veterans, and we generated strong financial results. Hopefully you'll see that our 2019's accomplishments provide both motivation and invigoration for 2020 and hopefully the earnings guidance that we've provided you, you'll feel very good about the prospects for 2020. Certainly we do.

We look forward to speaking with you after the first quarter. Thank you very much for your time. Have a great day.

Operator

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