Second 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

Tracy Benguigui, *Barclays*

Pablo Singzon, *J.P. Morgan*

Mark Hughes, *Truist Securities*

David Motemaden, *Evercore*

Derek Han, *KBW*

PRESENTATION

Operator

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

Following the presentation, the conference line will be open for questions. 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.

Chris Uchida

Thank you, Operator and good morning everyone.

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

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

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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. 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. Good morning everyone.

We're very proud of our strong second quarter results, a quarter highlighted by 69% gross written premium growth, adjusted net income of $18.7 million, and an adjusted ROE of 19.7%. In addition to the strong financial results, during the quarter we introduced our investors in the market proudly to Palomar 2X, our intermediate term objective of doubling adjusted underwriting income and maintaining an adjusted ROE of 20 plus percent via organic growth. It's also a philosophy that continually assesses our product suite to ensure there's enough organic growth opportunity to double the adjusted underwriting income of a business in an evergreen fashion.

As a reminder, key principles of Palomar 2X include but are not limited to profitable organic growth, a portfolio anchored by binary/no attritional lost business, namely Earthquake, continued reduction of non-binary catastrophe exposure, a conservative reinsurance strategy, free income build-out, scaling the business with technology and process, and a commitment to ESG.

The second quarter results are a clear demonstration of executing on Palomar 2X and the four strategic initiatives that we outlined at the start of the year. We wake up every day thinking about how we will double Palomar's adjusted underwriting income, and I'm pleased to say we are firmly on track to do so as our products continue to deliver strong growth, and the investments that we've made in the new lines of business are ramping up as we look to the second half of the year and beyond.

Turning to 2022 strategic priorities, we made significant progress across all four components in the second quarter. The first priority, generating strong premium growth, is abundantly clear in our record gross written premium of $218.7 million in the quarter, which equates to 69% growth over the prior year.

Notably premium in our earthquake business grew 47%, an accelerated pace from Q1. We saw continued record new business in our largest residential earthquake product and increased demand for our commercial earthquake offerings. It is important to highlight that the strong organic growth achieved in our residential earthquake line was not the result of the proposed changes at the California Earthquake Authority. Looking forward, we continue to believe that the residential earthquake production will remain strong as the California homeowners market remains dislocated and as the CEA ultimately reduces their exposure in the market.

Turning to our commercial earthquake product, the hardening reinsurance market has led to a capacity pullback and accelerating rate increases. As we procured incremental reinsurance, limited June 1, we are well-positioned to not only take advantage of the capacity constraints in the market, but also optimize our book to cover the incremental reinsurance expense and maintain our margins. While our earthquake lines

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performed at stellar levels, the strength in top line was broad based. Our inland marine product grew 98% year-over-year, commercial all risk grew 42% year-over-year with nearly the entirety of the growth coming from rate increases and portfolio optimization as opposed to exposure additions. Lastly, our newly launched Casualty franchise continues to build, with our professional liability lines growing 36% sequentially and 225% year-over-year.

PESIC, our E&S business, increased premiums 200% year-over-year, with a total of $102.4 million. PESIC's growth was primarily driven by its main products, namely commercial earthquake, commercial all risk, and builder's risk. Palomar FRONT also generated a meaningful amount of premium through PESIC. Excluding Palomar FRONT, PESIC premium still grew an impressive 107% year-over-year.

Palomar FRONT is the best testament to the success we've achieved on our second priority, monetizing investments made over the course of 2021. Palomar FRONT recorded $42.2 million of gross written premiums in the second quarter, and it's tracking well ahead of our 2022 target of $80 million to $100 million of gross written premium. Importantly, this target includes only a modest amount of premium from our Texas Homeowner's product in the quarter, a product that was converted to a FRONT team program, June 1.

We've been both impressed and encouraged at the response and interest we've received from reinsurers, MGAs, and other carriers since Palomar FRONT's launch in September 2021. Beyond the strong premium in the second quarter, we had a couple of notable accomplishments, which will drive further growth for the remainder of the year and beyond. One, we successfully expanded our program partnership with cyber insurer, Cowbell, doubling the reinsurance capacity available to our program. In addition to the expanded partnership with Cowbell, we recently announced a partnership with Omaha National, a leader in the workers compensation market. This program should prove a nice driver of incremental fee income in 2023. These two new arrangements firmly position Palomar FRONT to trend well ahead of initial expectations.

As we continue to grow Palomar FRONT, we remain disciplined in evaluating our individual fronting agreements to ensure they're performing well from an underwriting and collateral perspective. I am pleased to note that we're trending well ahead of our previously announced plan to generate between $80 million to 100 million of managed premium, and we now believe that we can generate $130 to $160 million of managed premiums this year, inclusive of the Texas Homeowner's business, which adds approximately $45 million of fee-generating premium over the next 12 months.

Moving on to our third strategic priority, delivering consistent and predictable earnings, we remain confident that the foundations built and the underwriting actions implemented over the past two years will ensure this directive. In the second quarter we further reduced the risk profile of Palomar by transitioning the aforementioned Texas specialty homeowner's business to a fronting arrangement, transferring the in-force premium to a fully reinsured fronted quota share facility. Additionally, we successfully completed our June 1 reinsurance placement. Reinsurance is a critical component to our business model, as well as our Palomar 2X framework, and we are pleased to supplement our expiring program with the risk capital crucial to support our premium and exposure growth.

To recap our June 1 renewal, we experienced an approximate 9% rate increase on a risk-adjusted basis as compared to our 2021 program. While the pricing exceeded our expectations, the outcome was favorable as we successfully maintained our $12.5 million per occurrence retention, while securing $430 million of incremental earthquake limit, as compared to our program that incepted June 1, 2021. These accomplishments are even more impressive considering the six-month treaty renewal period was the most challenging of a market as any since 2006.

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Despite encountering the headwinds of a hard market driven by industry losses and the associated impact of broad cost inflation, Palomar's strong results and efforts to realign its portfolio by reducing exposure to continental U.S. hurricane and other secondary perils was well-received by our reinsurance partners. The hard reinsurance market provides for a reciprocal industry action to increase premium rates accordingly in order to cover loss costs and maintain profit margins. While we have historically received attractive rate on our specialty lines portfolio broadly, we have utilized the reinsurance price increase to drive rate increase on renewals, and filed rate increases across our business.

Our fourth strategic priority is scaling our organization. We've made considerable progress with key hires as noted in our last quarterly earnings call, and we continue developing our platform to attract the analytical, actuarial, technology, and operating expertise to support our robust growth. As we further enhance our infrastructure by adding notable talent and expertise, our industry-leading technology has consistently provided a competitive advantage to Palomar by offering new underwriters an entrepreneurial atmosphere that fosters innovative development tactics to further benefit our platform and efficiently deliver our products and services.

At this point I'd like to spend a few minutes updating you on what we're seeing in the market from a pricing standpoint. We continue to view rates increasing across all lines with specific lines of businesses sequentially accelerating the levels of increase. In commercial earthquake, the average rate for large accounts increased to 9% on a composite basis compared to 7% in the first quarter of '22. We expect further hardening in this line of business for the remainder of '22. As previously conveyed, we're not looking to grow the exposures in our E&S all risk business as we are generating significant growth from rates. For this line of business, we experienced a composite rate increase of greater than 30% in the quarter. We continue to see a dislocation in the property market broadly as the hard reinsurance market persists, and we expect continued rate increases combined with improved terms and conditions will, at a minimum, cover any increases in loss costs for the foreseeable future.

As it pertains to inflation, in addition to the use of third-party licensed data, we leverage our builder's risk program that audits construction projects on a monthly basis to rapidly inform our perspective on the cost of materials and labor. We've incorporated these factors into our underwriting to produce accurate insurance to value and appropriate rate increases to accommodate for inflation levels. For residential earthquake, we've increased the inflation guards from a historical level of 5% to 8% this year. We've also had a 7% base rate increase in our Hawaiian hurricane product approved by the insurance department in the state. That is in addition to an inflation guard that is now 8%.

Again, we remain acutely focused on covering our loss costs and incorporating inflation into our underwriting. Our casualty lines remain nascent in their development stage, and therefore don't afford pricing commentary similar to that of our property business, but generally speaking, we're getting rating features of approximately 3% to 10% for casualty lines with excess liability having the highest average increase.

Turning to capital allocation, we remain confident that the cash we are generating from our robust premium earnings growth provide adequate liquidity for two prongs of capital deployment: one, strategically utilizing our $100 million share repurchase program, and two, funding our multiple growth initiatives. During the quarter we repurchased approximately 128,000 shares at a total cost of $7.3 million.

To conclude, the progress made in the second quarter firmly positions the Company as we look to the second half of the year in the path of Palomar 2X. We are reiterating guidance for the Full Year 2022, where we expect to generate between $80 million and $85 million of adjusted net income, representing 54% year-over-year growth, and adjusted ROE of 19% at the mid-point of range. This range factors in the additional investments in talent, systems, infrastructure, the current projected cost of reinsurance, and importantly $5.9 million of unrealized losses on equity securities year-to-date. The maintenance of

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guidance at this level implies a range of $85 to $90 million when excluding unrealized losses on equity. In essence, the reiterated range is actually a raise of $5 million from the guidance offered in Q1.

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, 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 period and exclude them in periods when we incur a net loss. We have adjusted the calculations accordingly.

For the second quarter of 2022, our net income was $14.6 million or $0.57 per share, compared to net income of $12.3 billion or $0.47 per share for the same quarter of 2021. Our adjusted net income was $18.7 million or $0.73 per share, compared to adjusted net income of $13.2 million or $0.51 per share for the same quarter of 2021. As we compare to the prior year results, it's important to remember the impact winter storm Uri had on our results for the first and second quarters of 2021. While Uri resulted in favorable debt losses in the first quarter of 2021, we did incur additional reinsurance expense, or ceded written premiums, in the first and second quarters of 2021.

Gross written premiums for the second quarter were $218.7 million, an increase of 69.1% compared to the prior year's second quarter. Our consistent, strong growth was driven by a combination of favorable rate environment and increases in volume across our products. Ceded written premiums for the second quarter were $122.6 million, representing an increase of 137.8% compared to the prior year's second quarter. This increase was primarily due to quota share reinsurance driven by the growth of our fronting business and lines of business subject to attritional losses. Ceded written premiums as a percentage of gross written premiums increased 56.1% for the three months ended June 30, 2022, from 39.9% from three months ended June 30, 2021.

As anticipated, our fronting business was the primary catalyst of this increase, slightly offset by the decrease in XOL percentage compared to last year that included the impact of Uri. We believe the ratio of net earned premiums to gross earned premiums is a better metric for assessing our business versus the ratio of net written premiums to gross written premiums. Net earned premiums for the second quarter were $80.3 million, an increase of 48% compared to the prior-year second quarter. This increase was due to the growth in earning of higher gross written premiums offset by the gross earning of higher ceded written premiums under reinsurance agreements. For the second quarter of 2022, net earned premiums as a percentage of gross earned premiums were 50.8%, compared to 52.9% in the second quarter of 2021 and compared sequentially to 54.7% in the first quarter of 2022.

As previously indicated, the launch and expected growth of our fronting business could push this ratio below 50% on an annual basis, especially with the transition of our Texas specialty homeowners book to the fronting model, though we will add consistent fee income that will enhance our ROE and bottom line.

Losses and loss adjustment expenses incurred for the second quarter were $14.4 million, made up of attritional losses of $13.9 million and unfavorable prior-period catastrophe loss development of $548,000. The loss ratio for the quarter was 17.9%, comprised of an attritional loss ratio of 17.2% and a catastrophe loss ratio of 0.7%. The loss ratio for the quarter is in line with our expectations and the evolution of the overall book of business. We continue to believe that the attritional loss ratio should be around 19% for the year.

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Our expense ratio for the second quarter of 2022 was 57.1% compared to 62.6% in the second quarter of 2021. On an adjusted basis, our expense ratio was 51.2% for the quarter compared to 60.5% in the second quarter of 2021 and compared to 52.4% sequentially in the first quarter of 2022. Similar to our net earned premium ratio, we feel it's better representation of our book of business to look at our expense ratios as a percentage of gross earned premium. Our acquisition expense as a percentage of gross earned premiums for the second quarter of 2022 was 18.1% compared to 21.9% in the second quarter of 2021 and compared to 20.2% sequentially in the first quarter of 2022.

The decrease was driven by additional ceding commission or fronting fees from our new fronting business that are netted within acquisition expenses, and overall changes in our mix of business. The ratio of other underwriting expense, excluding adjustments, to gross earned premiums for the second quarter of 2022 was 8.5%, an improvement compared to 11.1% in the second quarter of 2021 and compared to 9% in the first quarter of 2022. As we continue to invest in talent, systems, and our infrastructure, we expect our business to scale over the long term. However, those investments may result in a flattening of this ratio in the coming quarters.

Our combined ratio for the second quarter is 75.1% compared to 76% in the second quarter of 2021. Our adjusted combined ratio was 69.1% for the second quarter, compared to 73.8% in the second quarter of 2021. Reflecting on the Palomar 2X philosophy we shared at Investor Day, we are introducing a new metric that represents the dollar inverse of our adjusted combined ratio. That metric is adjusted underwriting income.

We calculate adjusted underwriting income similarly to adjusting the 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 adjusted underwriting income is the most comparable financial metric for evaluating Palomar 2X. Our second quarter adjusted underwriting income was $24.8 million, compared to $14.2 million last year. Our year-to-date adjusted underwriting income was $46 million, compared to $36.2 million last year. Net investment income for the second quarter was $3.1 million, an increase of 43.1% compared to the prior-year second quarter.

The year-over-year increase was primarily due to the higher average balance of investments held during the three months ended June 30, 2022 due to cash generated from operations and by slightly higher yields on the invested assets. Our fixed income investment portfolio book yield during the second quarter was 2.61% compared to 2.24% for the second quarter of 2021. The weighted average duration or fixed maturity investment portfolio, including cash equivalents, was 4.18 years at quarter end. Cash and invested assets totaled $552.5 million as compared to $427.8 million on June 30, 2021. In the second quarter, we recognized losses on investments in the consolidated statement of income of $4.7 million compared to gains of $300,000 in the prior year's second quarter.

We will continue to take a conservative investment approach, which may impact our recognized gains and losses from quarter to quarter. Exclusive of gains or losses, we do expect our investment portfolio yield to improve, and zero quarters based on the current market conditions. Our yield on investments made in the second quarter exceeded our overall blended yield for the quarter. Our effective tax rate for the second quarter is 20.2%, compared to 20.5% for the second quarter of 2021. For the second quarter of 2022, the tax rate different from the statutory rate due to the exercising of stock options during the quarter partially offset by non-deductible executive compensation.

During the quarter, we purchased 127,952 shares for a total of $7.3 million. Under our previously announced two-year $100 million share repurchase program, we have approximately $79.7 million remaining under the authorized program. While we continue to view our current share price as trading at a discount, and we'll take an opportunistic approach to share repurchases under this program, we remain focused on investing in and supporting the growth of our business lines as we strive to progress and

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execute on the framework we require to deliver Palomar 2X. We are confident in our strategy to achieve long-term growth and sustainable and predictable earnings.

Our stockholder's equity was $378.1 million at June 30, 2022, inclusive of the share buyback and unrealized changes to our investment portfolio, compared to $394.2 million on December 31, 2021. For the second quarter of 2022, the annualized return on equity was 15.4% compared to 13.1% for the same period last year. Our annualized adjusted return on equity was 19.7% compared to 14.1% for the same period last year. As of June 30, 2022, we had 25,737,899 diluted shares outstanding as calculated using the treasury stock method. We do not anticipate a material increase to this number during the remainder of the fiscal year.

For 2022, we are reiterating our previously provided adjusted net income guidance range of $80 million to $85 million, including $5.9 million of pre-tax unrealized losses on the equity security hold. This range is equivalent to adjusted net income of $85 million to $90 million, excluding unrealized gains and losses for the year, representing 64% year-over-year growth at the midpoint of the range. Consistent with previous guidance, these estimates do not include any losses in a major catastrophic event.

As a reminder, we expect the continental U.S. wind projected net average annual loss or net AAL were approximately $6 million as of September 30, 2022, the peak of wind season. The net AAL is an industry metric used to assess continental hurricane and severe convective storm exposure. The updated adjusted net income guidance and AAL reflect our recently completed reinsurance placement and the conversion of our Texas specialty homeowner's business to our fronting business model.

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

Operator

Thank you.

Our first question comes from the line of Tracy Benguigui with Barclays. Please proceed with your question.

Tracy Benguigui

Thank you. Good morning.

You reiterated your 2022 outlook of $80 million to 85 million of adjusted net income, but if I look at the first half of this year, you achieved just over $36 million. It seems to be tracking behind, so are you expecting the second half of the year to be better than the first half?

Mac Armstrong

Hi Tracy, this is Mac.

Yes, this is the guidance that we've put in place, and we've hit our targets to date and exceeded them. There is obviously a lot of embedded growth over the course of the year, as the premium's earned and our expenses for things like reinsurance are locked in. We feel very good about hitting the $80 million to $85 million, or the $85 million to $90 million if you back out the unrealized losses from the securities. It's just how the premium ramps and some seasonality.

Chris Uchida

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Yes, the only thing I'd add to that, Tracy, when you look at that $36 million, and if you put the tax affected unrealized losses back in, you're around about $41 million, and you do the math on that, call it to the midpoint of either one of those ranges, depending on what your starting point is, it's $46 million in the second half of the year, so we feel pretty good about those numbers, especially with the growth we've seen at the top line.

Tracy Benguigui

Got it.

You also raised your Palomar FRONT guide to $130 million to $160 million from $80 million to $100 million in premiums, and I recognize this is a capital-light line. Could more volume be accretive to your 19% ROE target, or do you need more critical scale to revise your ROE guide?

Mac Armstrong

Yes, Tracy, I think, as we outlined it at Investor Day, we're trying to maintain an ROE above 20%, and we are right there this quarter at 19.7%. Palomar FRONT, and the growth that we have in that does indeed put us in a position to pass that threshold, and our goal is to adhere to that and if not, continue to build from it. It is capital-light. We think we've got very good visibility on the revised range that we provided, especially when you factor in a good portion of that uplift is coming from an existing book of business that is transitioning to a fronted relationship in the form of our Texas homeowner's business.

So, long-winded way of saying, yes, I think it is accretive to the ROE and we have very good visibility on the revised range that we provided you.

Tracy Benguigui

Thank you.

Operator

Our next question comes from the line of Pablo Singzon with J.P. Morgan. Please proceed with your question.

Pablo Singzon

Hi, thanks.

Cap losses have been benign for you so far this year. Would it be reasonable to assume that the average loss estimate that you had referenced, so I think $6 million, if that materializes, should that be concentrated in hurricane season, so basically the second half of this year?

Mac Armstrong

Yes, Pablo, the AAL is for continental hurricane, so it would be during wind season that runs June 1 to basically November 1, but it tends to be more in the third quarter. I think it's important to point out the number that we give you is based on September 30, that's the peak of wind season, and that should be declining post that September 30 date because a lot of that comes from the specialty homeowners' book that's in runoff. We have a schedule that looks policy by policy, state by state, how that comes down, and so that number will start to tick down, October 1, December 1, and obviously into next year.

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Pablo Singzon

Got it.

Just to follow up on that comment, Mac, the Texas business being fronted, will it go through the same dynamic, basically meaning that even though you've attached everything, June this year, it will take an entire year for you to be fully off the risk there? Is that how that book should look as well?

Mac Armstrong

No, no, that's a good question and thank you for asking, and it's worth us clarifying.

No, effective June 1, all risks are transitioned into the quota share. We are ostensibly off-risk, safer above the reinsurance that bought, provided by that quota share facility, which we do have it nearing into our program, but so, no, we are in theory off-risk, effective June 1.

Pablo Singzon

Got it, and the last one for me.

I wanted to talk to your comment about the view of having a 19% loss ratio for the year. Obviously, the loss ratio this quarter was pretty good, and I think if you assume 19% for the year, you're implying a pickup in the second half. I was just wondering if you could speak to your expectations there, what will drive a sequential deterioration from here? Thank you.

Chris Uchida

No, I don't view it as a deterioration. I think that's kind of hitting the numbers on what we've kind of provided guidance for or guideposts for from the beginning of the year. We've always said it's going to be calling that 18% to 19% range. We're obviously happy with a lower loss ratio this quarter, we hit 17%. Our book of business, the loss ratio is still anchored by the binary book of business and also now by the fronting book of business. That represents about 64% of our overall written premium, so we do see that developing nicely over the coming years and periods.

But with the overall book and the runoff of some of the specialty homeowners' book that's non-Texas, we do expect the loss ratio to still hover around that 19%. Could it be, you know, 19.5% or 18%? Yes, that would be within our comfort range. We don't think it's going to run away from us. We've said that a lot, but overall, we're pretty comfortable with that pick that we gave out at the beginning of the year and sticking to that 19% for the remainder of 2022.

Operator

Our next question comes from the line of Mark Hughes with Truist. Please proceed with your question.

Mark Hughes

Yes, thanks. Good afternoon.

Mac, your point about the Earthquake Authority, I think you said you were not impacted by the CEA. Why not? Will you be impacted in the future?

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Mac Armstrong

Yes, Mark, it's a great question.

The sum and substance of it is the CEA has certainly gone out and put out public bulletins around the changes that they're making. They have stated that they're buying less reinsurance, moving it down from 1 in 400 to 1 in 350, which ostensibly is about a $1.2 billion reduction in PML. That's taking place kind of in real time. They're letting that limit potentially expire as certain reinsurance programs renew. They have not yet put into place reductions in coverages. They have raised rates very modestly, and so when I say it's not been impacting us, it's a marketing catalyst for us, but there hasn't been a dynamic where now, they are changing coverages or shedding policies.

Frankly, it's runway for us. What has been a bigger dynamic has been the dislocation in the homeowner's market. You're probably seeing it today, the continued wildfires activity in the state of California, and the residual impact that has on the insurance market. That's been a bigger catalyst. I think the other big catalyst for us, frankly, has been we continue to build our distribution network. Our distribution network in residential quake was up over 20% year-over-year, 4%, 5%, sequentially. Partnerships are getting further traction in California and outside.

So, I don't want to diminish the potential changes from the CEA. I just would say that it has not been a material driver yet, which I think is a positive.

Mark Hughes

Yes. Okay.

Then in the commercial quake business, you saw acceleration. Can you talk a little bit more about that? What's going on in terms of capacity, competition and demand? What's driving that?

Mac Armstrong

Yes, we did see some acceleration. Rates ticked up in large accounts, for instance, from 7% to 9%. There is some capacity limitation. The cost of reinsurance went up. Our rate increase on the reinsurance was up 9%. Now, if you isolate the quake, it was probably up closer to 5% to 6%, but there is an emphasis, at least internally for us, on trying to recover loss costs, post June 1 and that renewal, and I think others are doing the same.

So, I think market wide, there's rate integrity and the need to recover loss costs, and especially if you're buying your reinsurance on an all-perils basis, we have the luxury of the majority of our tower being quake. Your rate increase may be more than a 9%, even if it is loss free like we were. I think there's rate integrity, there's capacity limitations or pullback, and it's created a circumstance where we think on the commercial side, we can grow and optimize the book at the same time, which is frankly, a unique dynamic.

Mark Hughes

Chris, did you report or disclose the fronting fees that you generated in the quarter?

Chris Uchida

Hey, Mark. No, that is not something we've disclosed. We've talked about it on other calls. Previously, generally speaking, the fronting fee is going to be about 5% of the fronting premium. We earn that

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similarly to all of our risk-bearing premiums. We also talked about the fact that we do net fee as ceding commission through our acquisition expense, so you can see that trend showing up in the acquisition expense this quarter, with it continuing to go down. It was up 18% on a gross basis this quarter from about 20% in Q1.

Everything is operating as expected, and the fronting fees, and the ceding commission even from our other lines of business with attritional losses where we still use heavy quota share reinsurance, that fee income is showing up and reducing our acquisition expense as we expected.

Mark Hughes

Yes.

Mac, I liked your comment about how you're keeping an eye on the inflation in the construction area, auditing values and replacement costs on a monthly basis. How about when we look at excess liability, how do you keep an eye or try to get in front of potential inflation in that line of business?

Mac Armstrong

Yes, fortunately, we've got seasoned leadership that I think you had the chance to visit with at Investor Day, Mark. I think what we're really watching there is court activity, and trying to see as the courts reopen, what that portends and how that informs pricing, how that informs loss costs and claims management, frankly. It's a small portion of what we do, and so that's how we're approaching it from an underwriting standpoint.

I think the other side that we, frankly, are using as a tool for risk management is the quota share reinsurance. For excess liability, if we're writing a $5 million line, we are on average around 25%, depending on the program. So we're either 25% or 30% of the risk. Individually, in isolation, we're trying to manage it that way, as well as get a fee income, and then there's also the underwriting tools and claims management tools that we just referred to. It's certainly something that we need to keep an eye on as that book grows.

Operator

Our next question comes from the line of David Motemaden with Evercore. Please proceed with your question.

David Motemaden

Hi, thanks. Good afternoon.

I had a follow-up on the attritional loss ratio of 17.2% in the quarter. Can you talk about the moving pieces there during the quarter that drove the favourability versus the roughly 19% level that you've guided to for the full year? I guess I'm wondering specifically in there, if there was any tangible benefit from the one month that you had moved Texas to a fronting arrangement?

Chris Uchida

Yes, David. That's a great question. The key components of that loss ratio are, call it, the prior year development was about $500,000 of favorable development. We've talked about in the past that we are always generally conservative on how we set up the loss ratios when we go into a period, so we did have

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a little bit of favourability come back into it there. I wouldn't call it a material amount, but it was about $500,000. So let’s call it the current year loss ratio was a little bit higher than the 17.2%. Let's call it 17.8-ish percent was the current year loss ratio with that favourable development backed out.

I'd say that's in line with our expectations. As you did indicate, we do see a little bit of benefit from the Texas specialty homeowners’ book being turned into a front business, but for most of that quarter, that's still in there. It’s still got some severe convective storm period in there, which is part of our heavier season for the Texas business. But, again, quota shares operating as expected for the first few months and then moving all that book into a front is something that's going to be able to deliver consistent, profitable fee earnings over the next 12 months and into the future to have that line. And then the other homeowner’s book is kind of fully run off.

Mac Armstrong

So I think, David, it is an astute observation you make that really more for prospectively, that line of business at the end of '21, the specialty homeowners’ book was around $16 million of call it 12% of the book. It's either winding down over the course of the year, or it's converted to a front, and that was a loss ratio that's a little bit higher and obviously has the CAT exposure, so I think that just adds more stability, which in turn gives us more confidence on why we think we can maintain 19% and hopefully there's some positivity to the upside based on conservatism and prior-year estimates.

David Motemaden

Got it. Thanks. That's helpful. I guess the follow-up question is the volatility is obviously removed from moving the Texas book to a fronting arrangement, but it feels like there might be somewhat of an attritional loss ratio benefit from that as well. Is that fair to assume?

Mac Armstrong

Yes, it is.

David Motemaden

Got it. Okay and the $500,000 favorable development that you had, that was on the attritional losses? Could you just elaborate where that was specifically? What line?

Chris Uchida

Yes, I think it was on the attritional losses. We had 500 of favorable on attritional, and then let's call it 500 unfavorable on the CATs. Those are the two components, when you look at it in the table, it's almost a breakeven number for the quarter. From the attritional standpoint, there's really nothing that stood out on the capability; it was really across the board on all lines of business, whether it be especially homeowners, inland marine, flood—all the lines really performed well this quarter or developed well this quarter. We're very happy with it, and I think it also sticks with our theme of being conservative upfront. We saw that kind of play out this quarter in the development.

And then thinking on the CAT side, we did have a little bit of unfavorable development there. Nothing surprising on that, or nothing I’d call systemic, or issues that are arising there. If you guys recall from our standpoint, for a CAT, it really has to be the smaller CATs that impact our results, because the larger events go into the reinsurance tower, and so they move up or they move down, are not as impactful to our financial results. So these are, call it a small handful of claims that are getting closed out that

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developed poorly, but it's not on large events, and it's not a giant move. This is just these smaller claims just getting closed out.

Mac Armstrong

Chris, if I'm not mistaken, the majority of that 500, if not the totality of it, was from the admitted book that is run off.

Chris Uchida

That is correct. Yes.

David Motemaden

Got it. That's great color. Thanks for that.

Then if I can just ask on the two fronting arrangements, the upsizing of Cowbell and then the California workers comp, have you guys decided to retain any of those two relationships, and I guess maybe how you're thinking about that from a risk management standpoint, if so?

Mac Armstrong

Yes. We are going to take 5% on the Cowbell program and it's a modest amount. Like I said, since all along, we use this as a form of due diligence. We have the ability to learn of this segment as a fronting partner, and then if there's a chance to take risk, we will elect to or not. We did elect to take 5% there, and then on the workers comp, it's around a 4% participation as well.

Operator

Our next question comes from the line of Derek Han with KBW. Please proceed with your question.

Derek Han

Hi. Thanks.

You had really strong growth in the quarter, but just curious if your growth rates are being impacted by personal carrier partners pulling back just because of poor results? Can you also comment on the insurer tech side as they increasingly focus on profitability?

Mac Armstrong

Derek, thanks for the question.

I would say our personalized carriers pulling back, I think it's part of a broader theme of dislocation in the California homeowners' market that we've talked about, so that's certainly a contributor. What we're seeing is more and more homeowners' businesses going into the E&S market, and that's giving us the option or the ability to write E&S residential earthquake at a higher rate than we have historically as well. I wouldn't say it's been more pronounced this quarter than it has been really over the last 2.5 years.

Then on the insur-tech side, we are fortunate, we partner with some of the insur-techs, and they are very good at customer acquisition. We think we provide them a nice complementary product to round out their

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suite. We have not seen anything yet in terms of them retrenching from a production standpoint, I can't speak to how their underwriting, but it's been a good channel for us.

The one thing that I will say around the partnerships is we are continuing to execute with partnerships like Travelers, as an example, where we have performed in certain states and now are trying to broaden the relationship to move into states beyond the initial cohort. We continue to have dialogue with other carriers who want to either enter the California market as an E&S writer or are trying to manage their exposure in the state, so partnerships remains a pretty active channel for us.

Derek Han

Got it. That's helpful.

Then my second question is on inflation. It looks like you're largely maintaining your loss trends assumptions that you raised last quarter. How comfortable do you feel about that holding in the second half of this year as a lot of carriers have kind of raised their loss trend assumption?

Mac Armstrong

Yes, I think we feel comfortable with it, especially on the property side, which is the large predominance of the book. I think it's worth reiterating that we've taken somewhat of a three-prong approach to inflation. It starts with in the ITV, the inflation to value and making sure that we get the appropriate replacement cost per square foot. That's where again, we have the luxury of leveraging a host of third-party tools, plus what we do in our builder's risk book, where we have auditable policies that we get a real time assessment of the replacement cost.

That's one. Two is the inflation guard, and then three would be rate change. I'll use the State of Hawaii as an example. We are obviously going through the ITV exercise and getting that right, and then secondly, we have now an 8% inflation guard on renewal policies. Then furthermore, we have a 6.85%, I'll round up to 7% rate increase. It's a multi prong approach that we have to stay on top of. Listen, we had a 9% rate increase on our reinsurance program. We need to cover that loss cost and then some to maintain our margins, and I think we're doing a good job of it but we can't take our eye off the ball.

Operator

There are no further questions in the queue. I'd like to hand the call back over to Mac Armstrong for closing remarks.

Mac Armstrong

Great. Well, thank you, everyone and thank you, Operator. We appreciate all that were able to join us this morning. We appreciate your participation, questions, and most of all your support. I'd like to thank all of our employees for their hard work and dedication, as they really did a superb job of execution this quarter.

To conclude, I'm proud of our results in the second quarter and the progress on achieving our 2022 strategic initiatives. We've delivered consistent strong growth. We continue to monetize our new investments, enhance our earnings predictability, and have made strides on scaling the organization. Furthermore, we remain very confident in our ability to execute Palomar 2X. The combination of the considerable organic growth in the investments we've made really do position us well to double the adjusted underwriting income of the business and deliver a better than industry average ROE, and what

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that translates to is value for our shareholders and I think that's ultimately what you'll see. Thank you all, enjoy the rest of the day, and we'll speak to you next quarter.

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