Second Quarter 2021 Earnings Call Transcript
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PRESENTATION

Operator

Good morning, and welcome to the Palomar Holdings, Inc. Second Quarter 2021 Earnings Conference Call.

As a reminder, this conference call is being recorded.

I would now like to turn the call over 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 Second Quarter 2021 Earnings Call. With me here today is Mac Armstrong, our Chairman, 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 August 12, 2021.

Before we begin, let me remind everyone that this call may contain certain statements that constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about management's future expectations, beliefs, estimates, plans and prospects.

Such statements are subject to a variety of risks, uncertainties, and other factors that could cause actual results to differ materially from those indicated or implied by such statements, including, but not limited to, risks and uncertainties relating 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 and good morning everyone.

Today, I will speak to our second quarter results at a high level and then discuss our strategic initiatives and efforts to drive profitable growth. From there I will turn the call back to Chris to review our financial results in more detail.

The second quarter was a very good one and one in which we generated record written premium, solid profitability and positioned Palomar for further execution on key strategic initiatives underway or identified. As such I am eager to speak to several of Q2’s highlights:

First, our premium growth not only maintained the first quarter and 2020’s levels but actually strengthened this quarter as we grew broadly across our product portfolio suite. We grew gross written premiums by 54% compared to the first quarter growth rate of 45%. Premium growth was driven by a combination of new product launches, sustained performance in existing products, rate increases, new and existing partnerships and the extension of our distribution network. Strong premium growth products included but were not limited to Residential and Commercial Earthquake, Specialty Homeowners, Hawaii Hurricane and Inland Marine. Additionally we saw very strong traction in Palomar Excess and Surplus Insurance Company (“PESIC”), our newly launched E&S carrier which grew 43% sequentially from the first quarter of 2021.

Second, we looked to build on our success as we continued to broaden our product suite and partnership slate. During the quarter we launched several new products and partnerships via PESIC and continued to harvest existing products and partnerships, most notably those in the Residential Earthquake sector. These efforts allow us to grow new and existing lines of business, capitalize on conducive market conditions and dislocations, and diversify our overall portfolio. New products in the quarter include casualty offerings like layered and shared Excess Liability and Small Contractors General Liability. Our newest partnership with PURE Programs, announced in June, is another prime example as it allowed us to enter into the high value residential builders risk segment and compliments our commercial builders risk product offering.

Third, our successful 6/1 reinsurance renewal further demonstrated our commitment to profitable and predictable growth. We secured incremental earthquake and hurricane limit to support our growth trajectory, enhanced our already robust panel of reinsurers and kept our retention at a level below that of 2020 when factoring in the elimination of co-participations. We believe the incremental limit, manageable retention and the aggregate limit procured in the first quarter ensures earnings stability and puts a floor on our results of approximately 11% for adjusted return on equity and $41 million for adjusted net income for the year.

Fourth, we remain focused on continuous improvement as we constantly assess our products and markets to ensure we are earning adequate risk adjusted returns. We are optimizing every aspect of our business and developing tools that provide insights into the complex markets we serve as we strive to deliver predictable returns and steady growth. For instance we continue to take rate on our commercial business, run-off unprofitable segments like admitted All Risk or Louisiana Homeowners, utilize quota share reinsurance for attritional loss exposed and casualty products, and drive terms and conditions or risk attachment point. Market conditions have been favorable on a portfolio basis and we remain optimistic on the outlook through the balance of the year.

Lastly, we opportunistically bought back 239,000 shares for $15.8 million during the second quarter. Importantly, we know that we have the capital to execute our strategy for the foreseeable future and believe this action underscores our confidence in the business, our results to date, our strategy and our ability to create value.

Turning to our results in more detail, we delivered strong premium growth of 54% during the second quarter. Overall, earthquake premium grew 29% while non-earthquake premium increased 85%. Our Commercial earthquake products were up 47% driven primarily by rate and new business from distribution partners accessing PESIC. Other primary contributors were Inland Marine and Hawaii Hurricane with 239% and 140% year-over-year growth, respectively. Specialty Homeowners showed a healthy increase of 65% year-over-year. Our commercial lines premium grew 70% during the quarter and it is worth highlighting we are delivering this growth despite the continued run-off of our admitted All Risk policies which impacted second quarter premium growth by nearly 14 percentage points. As we speak here today our admitted All Risk business, which contributed 64% of the hurricane loss in 2020, has been 68% run-off.

As I previously mentioned, PESIC continued to experience strong growth as we expanded our product offerings and distribution relationships. We believe that our E&S business, which delivered $34.1 million in gross written premium and grew 43% sequentially compared to the first quarter of this year, is in the very early innings of its development and can approach the size of our admitted carrier over time. The second quarter's considerable growth was due to strength in existing property lines of business such as Commercial Earthquake and Layered and Shared National Property and further footing within our new lines like Excess Liability and Inland Marine. We are excited by PESIC's long-term prospects, and I look forward to updating you on our continued progress in future quarters.

Our focus on existing and new partner relationships continues to provide increased distribution, geographic expansion and product diversification. This concentration helped expand our distribution footprint 5.4% sequentially and 21% year-over-year. Our aforementioned new partnership with PURE Programs enables PESIC to enter another focused market, that of high value residential builder's risk insurance. We will continue to develop and seek new partnerships like PURE that enable Palomar to aggressively grow our market share within profitable markets.

In addition to our overall topline momentum we delivered strong earnings, and grew adjusted net income to $13.2 million in spite of $3.9 million of previously disclosed, non-recurring reinsurance charges incurred as a result of Winter Storm Uri. Our adherence to conservative levels of reinsurance coverage is exemplified by the successful completion of our reinsurance placement at June 1 where we procured approximately $180 million of incremental limit for earthquakes and $100 million of incremental limit for windstorms. Our reinsurance coverage now exhausts at $1.65 billion for earthquake events and $700 million for hurricane events, providing ample capacity for our continued growth. We also increased our event retention from $10 million to $12.5 million for all perils but actually reduced our true retention when factoring in co-participations. The successful 6/1 placement is emblematic of the strength and collaborative nature of our reinsurance relationships and moreover positions us to take advantage of compelling market conditions.

The underlying cost of reinsurance continues to be subsidized by the continued favorable pricing and overall dislocation in the specialty insurance marketplace. The average rate increase on renewals during the second quarter for Commercial Earthquake policies was 14% versus 18% in the first quarter of 2021. Our builders risk products saw new business come on at a blended rate increase of approximately 21% with large accounts increasing as much as 25%. As it pertains to All Risk, our new business policies are being written at an average risk adjusted rate 25% higher than our expiring All Risk business with rates increasing between 12.5-25% depending on the geography and size of the account. It is worth highlighting that it is not just in our commercial business where we are increasing rates. In coastal North Carolina the state's department of insurance a 14.3% rate increase on Specialty Homeowners policies. We remain confident that we will be able to sustain material rate increases throughout the remainder of the year. Separately, our premium retention in the second quarter was 86% for the total portfolio, excluding the run-off of our admitted All Risk business.

Turning to corporate sustainability and responsibility, I am happy to report that we are continuing to make progress on the development and execution of Palomar's ESG initiatives. We recognize that strong ESG management better serves our employees, our business partners, our environment, our communities and all our stakeholders. We are building our ESG team and are continuing to strategize and formalize our policies. I look forward to updating you on the progress of our ESG initiatives going forward.

Additionally, we announced last week the addition of Daina Middleton to our Board. Daina's nearly 30 years of experience in operational leadership, customer relationship development, branding, marketing and the use of technology and analytics to grow businesses will add significant value to Palomar as we continue on our strategic mission.

Overall, I am delighted with our results, the execution of our growth strategy and the opportunity that I see ahead. It is important to emphasize that we have the capital to fully execute our growth strategy and repurchase shares in an opportunistic fashion. As a result, we bought back approximately 239,000 shares, or $15.8 million of our $40 million share repurchase authorization in the second quarter. We will continue to be inventive as we capitalize on opportunities that maximize our growth and drive long-term value creation for our shareholders.

For the full year 2021, we continue to believe that our adjusted net income will be between $64 and $69 million. This range considers additional investments in talent, systems, infrastructure and reinsurance, both excess of loss and quota share, we have made or expect to make in the second half of 2021 that we ultimately feel generate strong returns over the next several years. Additionally, the Aggregate Cover put in place we establishes a floor of approximately 11% for adjusted return on equity and $41 million for adjusted net income for the year.

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

Chris Uchida

Thank you, Mac.

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

For the second quarter of 2021, our net income was $12.3 million, or $0.47 per share, compared to net income of $12.0 million, or $0.48 per share for the same quarter in 2020. Our adjusted net income was $13.2 million, or $0.51 per share, compared to adjusted net income of $13.0 million, or $0.52 per share for the same quarter of 2020. With the interplay between the first two quarters' losses and reinsurance premium, we believe the first half of the year is a better representation of our steady state business. For

the first half of 2021 our adjusted net income was $32.5 million or $1.24 per share, compared to $25.4 million or $1.02 per share for the same period last year. Additionally, we are pleased to report that our first half of 2021 adjusted net income was above the midpoint of the guidance provided with the first quarter results.

Gross written premiums for the second quarter were $129.4 million, representing an increase of 54.4% compared to the prior year's second quarter. As Mac indicated, this growth was driven by a combination of growth within our product portfolio, sustained rate increases, expansion of our E&S footprint, and extension of our distribution networks.

Ceded written premiums for the second quarter were $51.6 million, representing an increase of 70.8% compared to the prior year's second quarter. The increase was primarily due to increased catastrophe XOL reinsurance expenses related to exposure growth and additional non-recurring charges resulting from Winter Storm Uri. Separately, we had increased quota share cessions due to growth in the volume of written premiums subject to quota shares. Ceded written premiums as a percentage of gross written premiums increased to 39.9% for the three months ended June 30, 2021 from 36.0% for the three months ended June 30, 2020. This increase was primarily due to catastrophe XOL charges and a higher proportion of our written premiums being subject to quota shares.

Net earned premiums for the second quarter were $54.2 million, an increase of 37.9% compared to the prior year's second quarter, due to the growth and earning of higher gross written premiums offset by the growth and earning of higher ceded written premiums under reinsurance agreements. For the second quarter of 2021, net earned premiums as a percentage of gross earned premiums were 52.9% compared to 55.5% in the second quarter of 2020. As previously mentioned, with the additional reinsurance expense impacting the first and second quarter we expected pressure on this ratio in the second quarter, this ratio would have been above 56% excluding the additional non-recurring reinsurance premium.

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. As part of the recent reinsurance renewal we adjusted our participation in our attritional quotas share arrangements. With these changes, we expect this ratio to be around 53% to 55% on an annual basis, lower at the beginning of a new reinsurance placement and higher at the end with our expected growth in earned premium. The expected net earned premium ratio contemplates our new aggregate cover that will provide improved earnings visibility and increased protection should we be faced with multiple catastrophic events going forward.

Losses and loss adjustment expenses, or LAE, incurred for the second quarter were $7.2 million due to attritional losses of $8.4 million offset by $1.1 million of favorable development on current and prior year catastrophe losses. The loss ratio for the quarter was 13.3%, including an attritional loss ratio of 15.4%, compared to a loss ratio of 10.1% during the same period last year comprised entirely of attritional losses. Non-catastrophe losses increased due to [an active tornado and hail season and] growth of lines of business subject to attritional losses such as Specialty Homeowners, Flood, Inland Marine, and our newer lines of business with conservative loss estimates as we continue to grow the premium base.

Our expense ratio for the second quarter of 2021 was 62.6% compared to 58.3% in the second quarter of 2020. On an adjusted basis our expense ratio was 60.5% for the quarter compared to 54.9% in the second quarter of 2021. The increased expense ratio was driven by additional reinsurance placements with increased ceded premiums, including the aforementioned additional non-recurring ceded premium, and continued investments in PESIC talent, systems and other infrastructure.

Similar to our net earned premium ratio, we feel it is a better representation of our 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 2021 was 21.9% up slightly from 21.0% in the second quarter of 2020. This increase was influenced by the change in business mix and growth of our E&S

business. The ratio of other underwriting expense, excluding adjustments, to gross earned premiums for the second quarter of 2021 was 11.1%, improved sequentially from 11.9% in the first quarter of 2021.

Our combined ratio for the second quarter was 76.0% compared to 68.4% in the second quarter of 2020. Our adjusted combined ratio, which we believe is a better assessment of our efforts was 73.8% during the second quarter compared to 65.1% in the prior year's second quarter. Excluding the additional non-recurring ceded reinsurance premium in the quarter, our adjusted combined ratio would have been approximately 69% for the quarter, made up of a loss ratio and an expense ratio of approximately 13% and 56% respectively. We believe these ratios paint a more accurate picture of our business.

Net investment income for the second quarter was $2.2 million, an increase of 3.8% compared to the prior year's second quarter. The year-over-year increase was primarily due to a higher average balance of investments held during the three months ended June 30, 2021, offset by slightly lower yields on invested assets.

Our fixed income investment portfolio book yield during the second quarter was 2.25% compared to 2.83% for the second quarter of 2020. The weighted average duration of our fixed-maturity investment portfolio, including cash equivalents, was 3.84 years at quarter end. Cash and invested assets totaled $427.8 million as compared to $430.4 million at June 30, 2020. For the second quarter, we recognized gains on investments in the consolidated statement of income of $300 thousand compared to a $778 thousand gain in the prior year's second quarter.

Our effective tax rate for the second quarter was 20.5% compared to 21.5% for the three months ended June 30, 2020. For the current quarter, our income tax rate differed from the statutory rate due to the tax impact of the permanent component of employee stock option exercises.

Our stockholders' equity was $376.7 million at June 30, 2021, compared to $363.7 million at December 31, 2020 and $376.4 million at March 31, 2021. Importantly, the June 30, 2021 balance reflects our $15.8mm of stock repurchases. For the second quarter of 2021, annualized return on equity was 13.1% compared to 15.1% for the same period last year. Our annualized adjusted return on equity was 14.1% compared to 16.4% for the same period last year. Again, we believe the first half of the year is a better representation of our steady state business. For the first half of 2021 our annualized adjusted return on equity was 17.6% compared to 17.1% for the same period last year which included the capital raise in June of 2020.

As Mac indicated, looking ahead to the remainder of 2021, we are maintaining our adjusted net income guidance of between $64 to $69 million.

As of June 30, 2021, we had 25,992,585 diluted shares outstanding as calculated using the treasury stock method. 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

Thank you. Our first question is from Paul Newsome with Piper Sandler. Please proceed.

Paul Newsome

Good morning, congratulations on the quarter.

I was wondering if you could talk a little bit more about operating leverage, particularly with the other underwriting expenses and just give us a sense of how these may or may not grow in proportion to the clearly rapid revenues you're building.

Chris Uchida

Hi, Paul, it's Chris. Thanks for the question, yes.

When we look at operating leverage and especially, like you pointed out, the other underwriting expenses, we do think about that, and we talked about it really over the last couple of quarters that we expected that to kind of be flat to potentially up from where it was before. So we do feel that we have established let's call a good base as we've kind of built and invested. We do plan on continuing to invest, but I do expect that ratio to improve over the second half of the year and kind of into 2022. Like I said, we will still invest in new talent, new systems and making sure that we are building scale in the Organization over the long term; but even with those investments, I do expect that ratio to continue to improve, like you just saw, sequentially, especially compared to gross earned premium between the first quarter and the second quarter. In the second quarter it was about 11.1% versus the first quarter 11.9%.

So you're starting to see that scale kind of build-up, and I would expect that to continue.

Mac Armstrong

Paul, this is Mac.

Chris described that well and I think just looking at long-term, I think the other thing that will drive operating leverage is when we launch a new product, as you know, we are very conservative in how we use reinsurance, whether it's quota share or per risk. As the products get more traction, our risk appetite likely increases, which will obviously allow us to retain more and therefore drive some more further scale.

So if you really think about it long-term '22, '23, that's when you can see even more leverage coming into play.

Paul Newsome

I want to ask a similar question about net investment income, because I'm assuming that there is a little bit of leverage in there as you move E&S out of Earthquake, which is I would assume a longer-tail lines of business.

Chris Uchida

Yes.

Paul Newsome

But you also have investment income going this low interest rates, quite when the direction, maybe you can give us a sense of sort of how that should develop not next week or next quarter, but over time given the product mix change that you working on?

Mac Armstrong

Yes, Paul, it's a great point you raise.

The history of Palomar and the Specialty Property focus has led us to have a rather short duration in the investment portfolio, and frankly a rather conservative investment portfolio. Ultimately, we drive the

majority if not the totality of our income through underwriting; but as the complexion of the book changes, I think it will allow us to potentially extend our duration, change the complexion of the investment portfolio some. Illustratively we hold no equities, so that will develop over time, especially also as we have the ability with longer-tail business to extend how long we might go out on the yield curve.

That really is a longer-term phenomenon. I don't expect a material bump-up in investment income over the next two quarters. But you are absolutely right. It will afford us the luxury of potentially taking on a bit more I don't won't say risk in the investment portfolio, but just make it more commensurate with the exposure pattern.

Paul Newsome

You price in a little more in duration in yield in, but still a very conservative overall portfolio.

Paul Newsome

Great, thank you. I'll let some other folks ask questions. Appreciate the help.

Mac Armstrong

Thanks, Paul.

Operator

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

Jeff Schmitt

Hi, good morning.

Just looking at the attritional loss ratio was 15% in the quarter versus 10% last year. How much of that was driven just by kind of above-normal non-Cat weather versus the change in business mix? And could you provide any detail on how much you increased participation in the various quota shares?

Chris Uchida

Yes, Jeff, lot to unlock there, but a very good question.

When we think about that and we think about just the pure attritional loss ratio of about 15 points for the quarter, some of that was influenced by the additional reinsurance expense. As I mentioned on the prepared remarks, if you take out that reinsurance expense, that probably drops closer to about 14%. So still a little bit elevated than what we've guided you before, but I think a little bit closer in line with expectations when you think about the second quarter of the year is a little more seasonal from a loss standpoint for us on the attritional side. We do have a Tor-Hail exposure in Texas, and then some of the other Gulf states. So that was impacted the industry this quarter. So looking at those two things was a little bit elevated.

The other thing I would like to add to that is, when we think about the new lines of business, those lines of business, we do feel that we are being conservative in our loss estimates; that can be influenced by some of the inflation that we're seeing. But also on those newer lines where we don't have a lot of earned premium year and don't have a lot of history, I think we're also being conservative in the loss PIKs we're using to try and estimate those lines.

Those are some of the things influencing the quarter as we look at it. When I talked about kind of our range of loss ratio looking at it on a long-term perspective, generally I'm giving that on an annual basis, not necessarily quarter-to-quarter basis. So it can move up and down, but I do expect that to normalize a little bit.

You got a good point. On the other part with the quota shares with the 6/1 renewal, we did change our quota share participation. So that will increase the loss ratio a little bit over time compared to the guide post, I have given before. I wouldn't expect it to jump again, I think that's probably going to go up, let's call it, one to two points over time from what the guide post I gave before, which was kind of call it two to three points on the 8.5 for the year. So now we're probably talking four to five points compared to last year as that continues to grow. You don't see a lot of that in Q2 yet, because those quota shares just changed at 6/1; you'll probably see a little more of that in Q3 and Q4.

The other thing I'd add to that is, with that additional loss ratio, the one thing you're going to get, and we always talk about this, is you're going to get a little more net earned premium. So that net earned premium now is going to be between 53% to 55%. I'd even venture to say over a 12-month period that 55% might actually get to 56%. We're not going to give too much color on that, but obviously it’s always lower at the beginning when we set new reinsurance treaties, and then kind of higher at the end.

And that kind of compares to what I mentioned on the prepared remarks is that our adjusted net earned premium would have been closer to 56% this quarter versus the 52.9% with the additional reinsurance expense associated with the backup things related to Uri.

A lot of different pieces there, but I think overall with that additional quota share, or our participation of the quota share, it's going to be positive to the bottom line, because this is additional participation in lines of business that are doing well and lines of business that we're very comfortable with.

Mac Armstrong

Jeff, this is Mac. Chris did a great job answering that. I'll just provide a couple more anecdotes around the loss ratio.

I think one thing to point out was around 12% of the loss ratio, call it a point or so, was from our Admitted All Risk business that's running off. So that was a relatively a disproportionate contributor. So if you kind of normalize it, again, I think that 13%, 14% Chris was alluding to is a good number.

Then secondarily, with those quota shares, our increased participation, it's line specific. Some lines we're taking another 5% or 10%, but it kind of blends out around 5% to 7.5% of increased participation. The balance sheet supports it, the underwriting results supports it, the history in the programs support it. So it's a logical progression as we grow our balance sheet and we grow our familiarity, and frankly our underwriting results history.

Jeff Schmitt

Okay, great, that's great color. Then regarding the growth in Florida, I believe in the past you mentioned that was Builders Risk or I guess Motor Truck Cargo and then Assumed Reinsurance. Does that continue to be the case, or are you starting to rate other products there? What's your appetite to grow in that market?

Mac Armstrong

You have three of the four. So the fourth product is the National Layered and Shared Property, the All Risk Property. So we have been writing that since August of last year in the State of Florida, so the

majority of it is going to be that line with some smattering of Builders Risk, and then it's Motor Truck Cargo and Assumed Reinsurance, and those last two are not Cat exposed.

Jeff Schmitt

Got it. Okay, thank you for the answers.

Mac Armstrong

Thanks, Jeff.

Operator

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

Matt Carletti

Hi, good morning, Mac. Good morning, Chris. Couple of questions.

First one, I want to ask you a question on capital. I mean, obviously you feel comfortable and you're buying back stock, so there's excess. But the question is as we look forward with the changing mix of business, more growth of specialty lines and obviously some changes in quota share. How should we think about kind of the leverage ratio or some other metric that kind of is appropriate capital level for the company going forward versus might have been a little higher in the past given more Earthquake exposure?

Mac Armstrong

Yes. Hi, Matt, this is Mac, great question, great to hear from you.

The boundary that we have used historically is 1 times our net premiums written to surplus. As we sit here today, we are at 0.64 times. Hence, that is one of the reasons why we opportunistically bought back stock. Basically the stock that we've bought back was financed by free cash flow in the quarter or surplus that would have been built and accrued to the balance sheet. But since we are still relatively overcapitalized to those guide posts, we feel very good about our ability to execute the long-term growth strategy and maintain the premium growth that we've kind of discussed. We said 40% similar to last year. We're ahead of that: over 50% year-to-date.

But your point is well taken that as the complexion of the book changes, much like the investment portfolio, that can shift out a little bit in duration. So can the targets. Now that being said, shifting it out, is it 1.1 times is it 1.2 times? I think that's feasible and conceivable, but it's not a material change, especially when you look at how the book is coming together. Earthquake and Hawaiian Hurricane still grew 36% for the first part of the year in totality. So there still is a meaningful contributor from those capital intensive non-loss or non-attritional loss bearing lines.

Matt Carletti

Then my other question relates to specifically the Earthquake book, both Commercial and Residential. As it continues to grow, has the kind of geographic footprint where we think about the peak exposures and things like that changed much over the past couple of years, or is it largely unchanged, just growing kind of with the same mix?

Mac Armstrong

So there's a couple of ways to answer that question, Matt, and obviously we grew just under 30% on the Earthquake book, Commercial 47%, Residential 24% for the first six months of the year. Inherent in that is improved spread of risk. That's something we look at and something that we monitor very closely. We don't want all of our growth to come from one specific crest of zone, Los Angeles or San Francisco. We want that to come from across the State of California. We want that to come from across the State of California plus the Pacific Northwest, as well as the Midwest if we can get that as well.

That spread of risk drives down our unit level economics and the cost of our reinsurance. I'm pleased to report that we do continue to see that spread of risk, and I think it's best exemplified in our underlying metrics like average annual loss to premium, which is continuing to improve on the Commercial side and driving to a level that's close to low '20s in totality in the portfolio; and on the Residential side, it's in the high teens.

We are getting good spread of risk. It's going to continue to be that. It should continue to develop that way as we expand our distribution footprint, monetize partnerships and drive terms, especially in the Commercial side.

Matt Carletti

Thanks very much. Appreciate the color.

Mac Armstrong

Thanks, Matt.

Operator

Our next question is from Mark Hughes with Truist Securities. Please proceed.

Mark Hughes

Thanks. Good afternoon or good morning.

You talked a lot about the losses and the other expenses, but how about acquisition expenses. Any particular trajectory there, or is this a good run rate?

Chris Uchida

Hi, Mark, it's Chris. Good to hear from you.

Yes, so I think right now, obviously the acquisition expense did go up a little bit when you look at it over a quarter-over-quarter basis. I think right now it's a pretty good. This will probably be a pretty good run rate. It may trickle up a little bit as the quota shares that we talked about a little bit before. By participating a little more, we are going to lose a little bit of that ceding commission. So that will push the acquisition up a little—acquisition expense up a little bit.

Then also with that, we are still expanding our lines of business; a lot of the Commercial lines and the E&S lines are going to be driven through wholesaler channels, which is a little higher than retail. So that might push it up slightly. But where you saw this quarter, I think at least on a gross basis, around 21.9% I think is probably a good run rate. It could—22%, 22.5% or 21.5%, it's going to hover around there based on quarter-over-quarter mix; but overall, I wouldn't expect it to jump.

We're not changing new ventures or anything like that, a lot of Wholesale. For Commercial, there's no giant retail player or something like that that's going to push the swing of the acquisition expense. I think it should hold pretty steady.

Mark Hughes

Yes, on the Quake business, thinking about both Commercial and Residential, where do we sit in terms of the growth trajectory, growth cycle there? The Ridgecrest quake was a nice catalyst, but you maintained a lot of momentum even if that's kind of faded in the background. Wildfires I think we're catalyst. Where do we sit now in terms of the growth outlook?

Mac Armstrong

Mark, this is Mac. It's a good question.

I think we feel very good about the growth that we've had year-to-date for both those products. Residential Quake is our largest line of business. It's the bellwether line if you would. It grew 24%. The dynamic that you're talking about around dislocation in the California Homeowners market driven by wildfire remains a catalyst for the intermediate future. So what I would offer you is that I think we feel very good about the growth prospects for that line, Commercial Quake. We have rates that we're still getting and we're continuing to expand the distribution footprint. We are pleased with the growth there; obviously 47% in the second quarter was terrific.

As I said earlier Earthquake and Hawaiian Hurricane on a blended basis grew 36%. So I don't know if that's sustainable indefinitely, but I think there is a lot of momentum in those lines of business that gives us great conviction around the next few years.

Mark Hughes

Thank you.

Operator

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

David Motemaden

Thanks, good morning.

I had another question just on the attritional loss ratio. Really sort of thinking about if we've sort of hit a threshold here in terms of the impact of the mix shift and what's that's having on the attritional loss ratio. I don't know, I may have misheard you Chris, but it sounded like you had said that after we get through the call it four to five point year-over-year increase this year. I guess as we think about 2022 and beyond, should we think about the impact of the mix shift on the loss ratio as being lower than I think it was like two to three points that you had spoken about previously?

Chris Uchida

Yes, just making sure I understand your question. Feel free to jump in if I'm answering it the wrong way.

The way I think about it, first Mac talked about the growth in the Earthquake and Hawaii lines. So those are very binary lines still growing at a strong rate of 36%. So those do provide a very good anchor for the loss ratio, and those will continue to provide a good call it anchor for the loss ratio at 0% as we go forward and kind of grow and earn this premium over the next 12 months.

The mix obviously is very important to the overall loss ratio as we do look at different lines that you have attritional losses, whether it'd be the Real Estate E&O program, the Inland Marine, some of our other Casualty lines, those do you have losses associated with them. I think as I said before, we are trying to be very conservative on how we pick those lines, because they do have some of them do you have a little bit longer tail.

I do expect as those lines and as we take a little more participation in the quota share, I do expect it to I guess continue to move up incrementally. I don't expect it—there's not going to be an overnight shift where it jumps from 14% to 28%. But I do expect as that mix or as some of those lines become a greater percentage of let's call it Palomar's overall book, that there will be more loss ratio as it goes on. Thinking about, let's call it, I think it is your question past '22 right, and so I think call it a couple more points into the second half of the year based on where we were based on more of the quota share participation, but you need to think long term, I do think it will still continue to trickle up.

But with that, we are also going to probably long-term increase our net earned premium. Those lines don't have Cat XOL exposed to, or Cat loss exposure, and so we do not have to spend as much on XOL. So what I would say is you're still going to be getting a good profit margin or net income delivery from those lines of business as you have they continue to grow, and you're losing a lot of that volatility by not having Cat exposure and we're getting rid of some of that reinsurance spend on those—aside from quota shares, I'm just saying a pure XOL spend on those lines, obviously a lot less if non-existent than on some of our other lines.

Mac Armstrong

Dave just to kind of put kind of a bow around it, those zero loss or zero attritional loss lines of Quake and Hawaii are 51% of the business right now. So it's a zero loss ratio. The loss PIK varies by our certainly each line, but it's not a circumstance where every single line is going to be 40%. Flood is in the low single-digits.

So this is not going to run away from us, and even if it was 40% for every other line but Quake and Hawaii, it's a 20% loss ratio. So that and how that evolves, that's kind of an out of bound, at least over the next few years. So we think it's something that we can absolutely manage and we also think that there's great prospects for the lower loss lines. So this is very manageable.

David Motemaden

Got it. Okay, that's helpful. That explains it. Thanks for that, guys.

I guess another question I have is just wondering, there is a lot of mix shift going on. I'm wondering if we could sort of peel back the onion a little bit and if you could give us a sense on some of the non-Earthquake lines how margins are trending there, specifically on like the attritional loss ratios. Are those—are you seeing margin improvement that's being sort of masked by the mix shift?

Chris Uchida

Yes, I mean I think it's line specific. Our Builders Risk program and the Flood program are two that I would highlight that are performing very well from a loss perspective. Builders Risk is getting great rate, in addition to producing consistent results. We do have certain lines that we could see some improvement in, not to pick on one but the Motor Truck Cargo line has a loss ratio that's above its target and we think as a result we have kind of been going through an optimization and the portfolio optimization effort with respect to that and premium retentions down, but the underlying loss ratio is sequentially improving.

I think you're going to see, product-by-product, those that are hitting their target margin, I think our Specialty Homeowners is hitting its target margin in states like Mississippi and Alabama. Texas is pretty close; when you back out Uri, it's better. So we are seeing good performance in those lines, and then some that we do need to right the ship a little bit, but nothing that's gotten out of whack.

Plus, the way that we use quota share reinsurance, it really prevents us from running the temperature in the line, and that's something we've always adhered to. We're going to retain 20%, 25%, 30% out of the gates, cede off the residual amount. That affords us insulation from a shock loss. It affords us a major STS event from disrupting the results. I think all of those tools we've used have allowed us to have a pretty consistent result outside of the Cat season in the last year.

David Motemaden

Got it. Okay, great, that makes sense. Thank you.

Operator

Our next question is from Tracy Benguigui with Barclays. Please proceed.

Tracy Benguigui

Thank you. Just going back to the growth question. As you ramp up new products via PESIC, can you contextualize how many new underwriters you need to bring on board versus utilizing managing general underwriters? And are you seeing saturation amongst MGAs as new entrants, predominantly I'm thinking about recaps are trying to do the same thing?

Mac Armstrong

Yes, Tracy, this is Mac. Thanks for the question, it's a good one.

I would say is that we're doing both. We are working with MGAs, especially as we think about Layered and Shared business; and more often than not, they're going to complement what we do internally from an underwriting standpoint. So you can certainly do get operating leverage when you work with an MGA. You are basically having an oversight underwriter making sure that the underwriting guidelines are adhered to, you're hitting your target metrics, you're hitting your target return parameters.

We are also adding underwriting talent and internally for new lines of business or existing lines of business, and we have several initiatives underway this quarter that we look forward to introducing to you all after Q3. So it's a combination of the two.

But to your question, when we're getting a new product up and running on the E&S company, we try to do it in a fairly investment-light fashion. And what we have done, it's something that John Christianson, our CEO, has spearheaded is, we're calling it an innovation lab, and it's what it's trying to do is do kind of a thin client approach from a systems development perspective to roll out a new line of business; it could be one that we don't write right now, or are currently writing.

For instance, we are bringing on a new Residential E&S Flood program that's leveraging existing underwriting talent, leveraging existing systems, but it's going to be delivered through its thin client front-end that's a lower cost investment that allows us to prove the concept. Once it's proven itself, we can move it on to more of a Cadillac policy administration system, our Pega platform, that we already have for all of our other lines, and in doing so, you reduce the execution or the some cost.

I think what the long and short of it is, we're going to use both approaches. We've done that historically, we want to have both internal underwriting and program underwriting for our Property business, we're

going to gin up new lines internally that hopefully don't take a ton of investment from a talent perspective and assistance perspective; but they will cost something, and that's why when we give our guidance, we feel very good about the guidance and we also feel very good about the long-term process, because we are investing in growth, not just in '21, but in '22, '23, whether it's people talent, people systems, or other infrastructure.

Tracy Benguigui

Great. That's really great. Maybe just a follow-up on that question about the saturation amongst these MGAs. I mean, is it tougher these days to—and turn to partnership given there is a lot of others that might be trying to do the same thing, or you still have your pick, you think?

Mac Armstrong

Yes, it's a good question. I think we feel very good about, A, we have a terrific group of MGAs that we do work with, long standing history, terrific track records. Many of the relationships go back prior to the formation to Palomar. But no, we think we are seeing in the business that we want and I think ultimately, again, most of the MGA business we are doing is Layered and Shared Property where we take a pro rata participation. So it allows us to add incremental limit or replace limit in like in large tower of Property exposure. So there's not saturation circumstance.

Tracy Benguigui

Thank you.

Operator

Thank you. Our next question is from Meyer Shields with KBW. Please proceed.

Meyer Shields

Great, thanks. Is there any room to adjust the inflation guard when we're seeing the sort of building materials cost inflation that we're seeing now?

Mac Armstrong

Hi, Meyer.

The inflation guard, depending on the state, needs to be approved by the Department of Insurance. So we have an automatic 5% increase in Residential Earthquake in California on the Admitted side, a similar one for Hawaii. I will say for our more complicated risk in Residential Quake, we're writing them E&S, and by writing E&S, you can—which we always do—factor in the cost of inflation and level, and not only demand surge, but a rising cost of goods and replacement cost of goods.

I think, just overarching as you think about inflation, it's already been in our portfolio with the inflation guard that you talk about, but also how we use demand surge in setting the base level AAL for a risk. We price risk off of AAL by having demand surge, and that reflects heightened cost of labor, heightened cost of material goods when there is a catastrophe. So that lever if you would is factored into all of our unit level pricing. We think that we can adjust for it.

I think the other thing that I would add too is just the short-tail nature of our business will allow us to cycle through inflationary increases probably quicker than others that may be exposed to social inflation or just a longer tail of loss cost development. I know that's more than you asked, but I thought I'd add that.

Meyer Shields

No, that's always welcome, more than I ask, just limitation of my questions.

I know you spoke on this earlier, just want to make sure for modeling purposes, when we take out the non-recurring charge, so obviously we get a lower operating expense ratio. Is this charge not likely to occur even if we have multiple storms or other issues? And I'm taking into context the reduced exposure on Louisiana and so on?

Chris Uchida

Yes. I think this non-recurring charge that we're talking about is—a lot of this, or most if not all, is really related to Uri. So those events can happen again. I think the way we have restructured our reinsurance program now I'd say is less likely. I think there's a couple of factors. We don't have any co-powers right now, no reinstatement obviously coming into play, and then also, we have the aggregate layer more importantly that will limit how the downside impact of multiple events on our portfolio.

I think those three factors don't eliminate it completely, but I think they briefly provide that we don't feel that this is going to happen. It's definitely not something we're building into the models that we're using, because it take a unique set of events for something like that to occur again.

Mac Armstrong

Well, I think I don't foresee it happening for the reasons Chris talked about, but also the loss came from the line of business that we're exiting. More than 80% of the loss came from the Admitted All Risk business. So that's a line that were out of. So it's not to say that we couldn't see E&S losses from a winter storm like that, but it's not going to be a similar type of exposure. So it is fundamentally, it is absolutely non-recurring.

Meyer Shields

Perfect. Thank you so much. I really appreciate the clarification.

Operator

Our next question is from Pablo Singzon with J.P. Morgan. Please proceed.

Pablo Singzon

Another question on the attritional loss ratio, this time more short term. I just want to make sure I understood you correctly. So if you take 14%, 15% of the base, will it be reasonable to assume a step-up in the second half of the year just because of the reinsurance program kicking in? And I guess, should we also think about some element of seasonality, given the weather losses tend to be more concentrated the second half of the year?

Chris Uchida

Well, so I would say that for our book of business, when we talk about it, the attritional losses are usually weighted more to the first half of the year. There is going to be a lot more Tor-Hail. Obviously, we do have a significant Texas exposure for our purposes. So if you're thinking about it from an attritional standpoint, we view it as more first-half of the year type phenomenon.

So with that, I would say generally speaking, we do see loss flattening to improvement in our book for the second half of the year. Definitely you see that in Q4. With that, I did indicate that we did change our

participation in some of the quota share. So I wouldn't expect our loss ratio to go up. But I would expect it to kind of be in that range of where we were before: close to 11% to 13% to 14%. I'd expect it to blend out there.

There could be ups and downs, but I generally view the second half of the year from the attritional standpoint to be lower. Now, obviously, we are in the midst of hurricane season, but like we said, we don't build that in to our result.

Mac Armstrong

Yes, Pablo, and just to add a little more color. Again, the nonrecurring reinsurance charge, that influenced the attritional loss ratio by two points or so. So if you back that out, the loss ratio is 13%. So you can sequentially grow the loss ratio off of that base, as opposed to a higher number. So that's why Chris feels good about that 11% to 14% range he is referring to.

Pablo Singzon

Thanks for that. Then the second question just on capital. How should we think about the pace of buybacks from here and new authorization potentially, given that you've used up a good amount of the $40 million program that outstanding? And as you had mentioned, Mac, that you still have a decent amount of capital flexibility. Thanks.

Mac Armstrong

Yes, so overarching, I think we will continue to be opportunistic with the buybacks and also putting the opportunistic deployment of that capital, vis-à-vis, other investments that we're making in the business.

As I said and I'll reiterate, we feel that, based on where we are from a net premiums written to surplus ratio, that we have adequate capital to grow and execute the growth plans and grow 40%-plus for the rest of this year without incremental capital, and beyond, for that matter.

I think it's really going to be opportunistic, Pablo, and it's going to be juxtaposed against new lines of business, new partnerships, new talent that we're bringing on, and the greenfield opportunities we see. I think in the second quarter, we just saw something that was disproportionately advantageous for us when we thought respect to value, return on equity, and just free cash flow generation.

Pablo Singzon

Thank you.

Mac Armstrong

Thank you. Ladies and gentlemen, we have reached the end of the question-and-answer session. I would like to turn the call back to Management for closing remarks.

Chris Uchida

Thanks very much, Operator.

Thank you, everyone, for your participation today. Hopefully you walk away with the sense that Palomar is performing at a very high level and that we have a considerable amount, if not a ton of, conviction in all that we have in front of us. The growth is very strong, the profitable growth is equally strong. We are very focused on providing consistent earnings and look forward to sharing our results with you in the third quarter in the months to come. So be well, and thanks very much for your time.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you very much for your participation and have a great day.