PALOMAR
SPECIALTY

Second Quarter 2019 Earnings Call Transcript
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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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David Motemaden, *Evercore ISI*

Jeff Schmidt, *William Blair*

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PRESENTATION

Operator:

Greetings, and welcome to the Palomar Holdings, Inc. Second Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If you would like to ask a question today, please press star, one on your telephone keypad. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Chris Uchida, Chief Financial Officer. Thank you. You may begin.

Chris Uchida:

Thank you, Operator, and good morning, everyone. We appreciate your participation in our second quarter 2019 earnings call. With me here today is Mac Armstrong, our Chief Executive Officer and Founder. As a reminder, a telephonic replay of this call will be available on the Investor Relations section of our website through 11:59 pm Eastern Time on August 20, 2019.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about Management's future expectations, beliefs, estimates, plans, and prospects. Such statements are subject to a variety of risks, uncertainties and other factors that could cause actual results to differ materially from those indicated or implied by such statements. Such risks and other factors are set forth in our quarterly report on Form 10-Q that will be filed with the Securities and Exchange Commission today, August 13, 2019. We do not undertake any duty to update such forward-looking statements.

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

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

Mac Armstrong:

Thank you, Chris, and good morning everyone. I'm very proud of our second quarter results, highlighted by gross written premium growth of approximately 56% year-over-year, a combined ratio of 69%, an adjusted combined ratio of 64%, and an adjusted return on equity of 21%. In addition, our pre-tax income grew in excess of 46%, excluding the impact of expenses associated with our IPO, tax restructuring, stock-based compensation, and the retirement of debt. We believe these results reflect the continued execution of our strategy and the benefits of scale as we grow the Company.

Our strong performance in the second quarter was driven by balanced gross written premium growth across our product portfolio. Our earthquake products grew 57%, and our non-earthquake products, highlighted by our commercial all risk offering, grew 55% compared to the second quarter of last year.

At the end of the first quarter, we became an AM Best Financial Size Category 8 insurance Company, which has led to additional distribution sources and increased submission activity for our commercial lines products. This expanded distribution, as well as an improving pricing environment, led to growth in our commercial lines of 114% compared to the second quarter of last year. Furthermore, our personal lines products grew 42%, due in part to the rollout of national carrier partnerships.

While we expect continued gross written premium growth from our current offerings, we remain focused on developing innovative new products that address underserved markets. To that end, our recently-launched Inland Marine and Assumed Reinsurance divisions both generated written premium during the second quarter.

Turning to the market, we believe the distinct value that we offer to insureds and producers is best demonstrated by our strong premium retention rates. Average monthly premium retention across all lines of business was 88% compared to 84% during the second quarter of 2018. Our commercial lines products generated an average written premium rate increase of 5% during the second quarter and demonstrated overall average premium retention of 86%. Our personal lines products also exhibited continuing strong retention, highlighted by our residential earthquake and Hawaiian hurricane products, which both achieved average premium retention above 93%.

Thoughtfully managing our risk exposure and risk transfer strategy, especially as we experience sustained growth, remains a critical feature of our business. At June 1 we successfully renewed $470 million and purchased an incremental $200 million of reinsurance limit, expanding our excess of loss program up to $1.05 billion of total coverage. This added limit continues to allow Palomar to maintain protection beyond the 1:250 year peak zone probably maximum loss, which we refer to as PML, and to significantly exceed simulated losses from any recorded historical event.

To provide some perspective, as of June 30, 2019, a theoretical earthquake equivalent to the 1994 Northridge or the 1906 San Francisco earthquake, the two most significant historical events relative to our portfolio, would generate a gross loss of approximately $715 million or $634 million respectively. Our per-event retention for earthquake or wind events remains $5 million, or approximately 2.5%, of our surplus as of June 30, 2019.

In addition to the renewal of our core excess of loss program, we completed the inaugural placement of our specialty homeowners' facility, which I will refer to as the SHF, to provide quota share and excess of loss reinsurance specifically for our specialty homeowners business in Texas, Mississippi, and Alabama. The SHF also includes coverage for states that have been identified as expansion opportunities, and is illustrative of our strategy of generating a well-balanced combination of fee and underwriting income. Furthermore, the SHF preserves our ability to manage the attritional loss component inherent in writing homeowners' insurance.

The June reinsurance renewal experienced a bit of price tightening across the property markets. That said, we are very pleased that our non loss effective layers of reinsurance renewed flat to modestly up on an exposure-adjusted basis. Our single loss impacted layer of $10 million, attaching excess of $5 million for wind only coverage, did experience a 15% exposure-adjusted increase.

We believe these results are a testament to the unique attributes of our program and the consistent historical results we have generated for our reinsurance partners. Our panel now consists of 80 plus re-insurers who are either rated A minus or better by AM Best or Post Collateral. No single re-insurer constitutes more than 5.5% of the excess of loss limit.

The June 1 renewal is emblematic of Palomar's strategy of limiting our exposure to major catastrophes, reducing volatility in earnings, and protecting our balance sheet to capitalize on post-event market demand and dislocation. Our thoughtful approach to reinsurance not only provides loss protection, but also superior visibility into our earnings.

I would now like to take a few minutes to touch upon the recent earthquakes in southern California this past July. First off, our thoughts are with all those impacted by the July 4 and 5 events, which obviously were outside the second quarter. For those not familiar, the July 4 and 5 earthquakes were the largest southern California has experienced in over 20 years and occurred within approximately seven miles of each other. The magnitude of these events serves as a reminder of the potential destruction from earthquakes.

Due to the proximity in both location and time, as well as the definition of covered events in our reinsurance program, we will discuss these earthquakes as a single event that we are calling the Ridgecrest earthquake. I'm very proud of our team who immediately responded to support our policyholders affected by the events, making contact with those most likely impacted to ensure safety and to address immediate needs.

We previously issued press releases disclosing our exposure in the impacted areas, summarized by the following: 14 residential earthquake policies within the 30 mile radius of the epicenter, 14 total residential earthquake policies within a 45 mile radius of the epicenter, no commercial earthquake policies within a 45 mile radius of the epicenter. Fortunately, we have received a limited number of claims to date, and we do not expect meaningful losses from the event.

Historically, major catastrophe events typically lead to an increase in new business for our earthquake products, given that earthquake insurance is a voluntary purchase. This dynamic was certainly the case following the Ridgecrest earthquake. New business generated following the earthquake was stronger than historical experience from events like hurricanes Harvey, Irma, Maria, the Mexico City earthquake, and California wildfires. As an example, July 2019 new business from our Value Select residential earthquake product was approximately double that of the trailing 12 month new business average as of June 30, 2019. As we look ahead to the second half of the year, we remain focused on profitable growth.

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

Chris Uchida:

Thank you, Mac. During my portion, when referring to any per share figure, I'm referring to the per diluted common share unless otherwise specifically noted. For the second quarter of 2019, our net income was $6.7 million or $0.30 per share compared to net income of $6.9 million or $0.41 per share for the same quarter in 2018.

For the second quarter of 2019, our adjusted net income was $8 million or $0.36 per share compared to net income of $6.9 million or $0.41 per share for the same quarter of 2018. Second quarter 2019 adjusted net income excludes expenses related to the Company's IPO, tax restructuring, stock-based compensation, and $1.3 million of expenses associated with the retirement of debt, including the tax impact of those expenses. Excluding these expenses, our pre-tax income grew in excess of 46% year-over-year, as Mac mentioned earlier.

Gross written premiums for the second quarter were $58.3 million, representing an increase of 56.2% compared to the prior-year second quarter. As Mac indicated, this growth was driven by strong premium retention and new business across our product portfolio, as well as by an improving price environment, specifically for our commercial lines. Ceded written premiums for the second quarter were $24.6 million, representing a decrease of 7.7% compared to the prior-year second quarter.

Recall that during the second quarter of 2018, we ceded approximately $11.8 million of unearned premium related to our specialty homeowner business in Texas in conjunction with a shift to operating as a fronting carrier for that business, an arrangement that ended in June of this year when we took the business back on our balance sheet while placing reinsurance coverage for it through the SHF Mac described earlier. Excluding that impact, our ceded written premiums grew 36.6% compared to the prior-year second quarter.

Mac reviewed our reinsurance renewals at June 1. I would like to touch upon our reinsurance expense. As we grow our business, we expect to incur additional reinsurance expense as we maintain a conservative level of overall coverage. Due to the timing of our reinsurance placements and the terms of the underlying contracts, there may be a lag between earned premiums and a reinsurance placement or expense, but, over time, we expect these impacts to smooth out and the trends to look the same.

We currently retain $5 million of risk per earthquake or wind event, and have $1.05 billion of earthquake event coverage in place. We will continue to stress a conservative risk transfer strategy oriented towards limiting our exposure in the event of a major catastrophe and reducing volatility in earnings. Our balance sheet will be protected in order for Palomar to capitalize on post event disruption and heightened market demand that typically follows catastrophes, including the Ridgecrest earthquake that Mac described.

Net earned premiums for the second quarter were $23.2 million, an increase of 27% compared to the prior-year second quarter due to the growth and earning of higher gross written premiums, offset by the earning of ceded written premiums.

Commission and other income for the second quarter was $721,000, an increase of 14.6% compared with the prior-year second-order as we expanded our fee-related activities of underwriting on behalf of third-party capacity.

Losses and loss adjustment expenses incurred in the second quarter were $643,000, a decrease of 12.2% compared to the prior-year second quarter. Our loss ratio for the second quarter was 2.8% compared to 4% in the prior-year second quarter. The decrease was driven by ongoing efforts to manage attritional losses in our business, primarily due to the use of quota share reinsurance such as the fronting arrangement and the new SHF, while increasing our visibility to consistent earnings.

Our expense ratio for the second quarter of 2019 was 66.4% compared to 61.1% at the end of the second quarter of 2018. The year-over-year increase is largely due to expenses associated with the retirement of outstanding debt. On an adjusted basis, our expense ratio reflected significant expenses related to the building out our team and systems to capture the market opportunity in front of us that track more in line with historical averages at 61%. We continue to believe our business will scale over the long term.

Our combined ratio for the second quarter was 69.2% in comparison to the combined ratio of 65.1% for the prior-year second quarter. The adjusted combined ratio, which we believe is a better assessment of our efforts during the quarter, was 63.8%, a decrease compared to 65.1% in the prior-year second quarter.

Net investment income for the second quarter was $1.5 million, an increase of 103.4% compared to the prior-year second quarter. The increase was largely due to increased interest income generated by the IPO proceeds. We maintain a conservative investment strategy as our funds are generally invested in high-quality securities, including government agency securities, asset and mortgage-backed securities, and municipal and corporate bonds with an average credit rating quality of AA.

The weighted average duration of our fixed maturity investment portfolio, including cash equivalents, was 3.9 years at quarter end. Cash and investment assets totaled $245.3 million at quarter end as compared to $157.3 million at December 31, 2018. For the second quarter, the Company recognized realized and unrealized gain on investment in the consolidated statement of income of $493,000 compared to $255,000 in the prior-year second quarter.

Our effective tax rate for the three months ended June 30, 2019 was 21.1% compared to 0% for the 2018 comparable quarter. The increase in our effective tax rate is due to our restructuring in the early part of this year. All of our operations are now taxable in the U.S., where in prior periods our Bermuda operations were not subject to U.S. taxes. Excluding any unforeseen events, we anticipate that our tax rate will settle around the 21% mark for the remainder of 2019.

Our stockholders' equity was $199.6 million at June 30, 2019 compared to $96.3 million at December 31, 2018. This increase was primarily due to the addition of IPO proceeds which will put downward pressure on our return on equity in the short term, while providing capacity for continued growth over the long term. For the second quarter of 2019, our annualized return on equity was 17.8% compared to 32.1% during the second quarter of 2018. Similarly, our annualized adjusted return on equity during the second quarter was 21.2% compared to 32.1% during the second quarter of 2018.

I would now like to turn the call back to Mac for concluding comments.

Mac Armstrong:

Thank you, Chris. To conclude, we are pleased with our second quarter results, driven by the strong performance across all of our product lines. We continue to expand our distribution network, develop partnerships, roll out new innovative products that we believe provide a differentiated solution in the marketplace, and expand our geographic footprint, which now is 26 states.

Our strategic vision for the business is being validated by the strong premium retention that we have experienced, coupled with the growing demand for our specialty products. Additionally, the successful completion of our reinsurance program renewal at June 1 will allow us to profitably grow, minimizing downside risk, and ultimately providing strong visibility into our earnings.

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

Operator:

Thank you. The floor is now open for questions. If you would like to ask a question, you may press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. Once again, that's star, one to register questions at this time.

Our first question is coming from Mark Hughes of SunTrust Robinson Humphrey. Please go ahead.

Mark Hughes:

Yes. Thank you very much. The strength you've seen in July, did you say that was both residential and commercial, or was it just residential?

Mac Armstrong:

Yes. Hey, Mark. It's Mac. We are seeing it more in a more pronounced fashion in residential. We do see it in commercial, but I was referring to in the earnings transcript specifically to our largest residential earthquake product, and again, it gets back to residential earthquake is a voluntary product. It's not complicit with the mortgage, so you do see these fairly material surges, and certainly, in this case it's a material surge.

Mark Hughes:

Anything you can say about the duration of that, how have you seen that trend in recent weeks? What's your experience in the past with this sort of thing?

Mac Armstrong:

There is a surge that—it tends to—well, I guess specifically right now we are seeing it continue. Obviously, the first week after the earthquake it's most pronounced, but it's kind of sustained at a level the last several weeks now, but by—usually by the end of the quarter following the event, it does start to dissipate some, but what we've seen in the past is that you do kind of get a new normal, if you would, from a new business standpoint. I would think for the remainder of the year you're going to see probably higher than historical averages, but right now we feel pretty good about it being sustainable for the next couple of months.

Mark Hughes:

Then, where do you stand in terms of the impact of the partners on the earthquake business? I think some of those were just ramping up. How much of a contribution are they making, and how much more, perhaps, in coming periods?

Mac Armstrong:

Yes. If you look at some of the partners where we have assumed reinsurance relationships, you are likely to see, potentially, a bump. More of our newer partnerships like the one we have put into place with Allstate, that tends to be one where it's the proverbial hunting license, and so what we have seen following the event is more appointment of agents. You do see a pop in new business, but it's more of a, okay, there's awareness. The agents want to get appointed, get acclimated with our systems, so hopefully that translates in the future less than the kind of immediate surge that you see from the existing distribution footprint.

Mark Hughes:

Then, a final question, when we think about ceded premium ratio, I know there's a lot of moving parts there, but is there kind of some rough guidance as we think about the second half of '19 and the next year, given what you know about your—the programs you've just renewed, and then kind of the mix of business? What's the right ceded premium ratio?

Chris Uchida:

Yes. Hey Mark. It's Chris. I would say when you look at that—I'm going to touch on a couple of different points regarding that and give you—I'll give you the short answer first. I think right now if you look at our gross earn to ceded earn premium, the ratio is hovering right around 50%. I think that is probably a good mark, plus or minus 5% either direction depending on what's happening from a quarterly basis, and the reason for that, as Mac touched upon in one of the press releases earlier in the quarter, and then also in the call, is the new SHF.

That is something that we put in place for our specialty homeowners business. It's something that replaced the Texas front that started June of 2018, and so that was—that fronting arrangement expired June 1 of 2019. We were able to put the SHF in place to basically replace that fronting arrangement, and that is not something that we originally had planned on in our business model, so that is something that is new for our book of business, and so that has increased the ratio of ceded premium to gross earned premium related to that, so I think if you had looked at it earlier I would have expected that ratio to drop down to where the ceded premium was more like 40%, but with that new SHF in place, I would expect it to hover probably around 50%, and the one thing I would note with that, and if you look at it in the losses, you can really see how the fronting arrangement and how the SHF, and also other quota shares that we have around our commercial program play into the losses and help protect the balance sheet, but then also protect us from any type of volatility in earnings and sustaining those earnings on a quarter-over-quarter or year-over-year basis, so it's something we're excited about and something we think the investors will really appreciate as we are able to kind of make sure that our earnings volatility is minimal from a quarter-over-quarter basis.

Mac Armstrong:

I think the other component—Chris lays it out well—is that it drives down the acquisition expense, because you are getting a ceding commission from the quota share reinsurance partners that we are working with on—with this SHF, so that will help commensurately reduce the underwriting expenses as well.

Mark Hughes:

Thank you.

Operator:

Thank you. Our next question is coming from David Motemaden of Evercore ISI. Please go ahead.

David Motemaden:

Hi. Thanks. Just had a question just on your reinsurance coverage and the purchases that you made. What sort of growth were you considering when you re-upped your coverage for earthquake, and is there any more incremental purchases that you need to buy to get more coverage just given the expected spike, or the spike that you guys are seeing on the demand side?

Mac Armstrong:

Yes. Hey Dave. It's Mac. That's a good question. What I would say is when we bought—we procured another $200 million of limit to allow us to grow with projections that we had effective around the IPO, but also effective at 6/1, so on the heels of the surge in demand for residential earthquake, there is a likelihood that we will need to procure more limit. The timing of that is fluid, but we certainly, with growth we're going to want to make sure that we protect the balance sheet appropriately and adequately.

We have this sacrosanct rule of always wanting to be—have a healthy cushion above the 1:250 year PML, so there is—if the new business that we're seeing is sustained through the third quarter, there's a likelihood that we will buy it. The one thing that I would tell you is when you look at for residential earthquake, where we're keeping the predominance on our balance sheet, a good rule of thumb for that is you could say that we're kind of targeting a low 60s combined on that business, so you can feel pretty good about that growth that you see there, assuming there's no loss, having kind of a low 60s combined, so that would be a rule of thumb to apply, and that will reflect the cost of acquisition, as well as the cost of reinsurance.

David Motemaden:

Got it, and any sort of early indication if that—if the earthquake has caused any movement on reinsurance pricing?

Mac Armstrong:

Early indication is that it's not. As I said on the call, we have not seen much in the way of claims or losses. Certainly I don't expect anyone to have reinsurance losses. Our losses right now are inside of $100,000.

David Motemaden:

Got it. Okay, great, and then I guess just a question on commercial on the pricing side, I think you said it was up 5% this quarter, which is the same it was up last quarter. Just wondering if you could unpack that a bit, because I'm a little surprised that it didn't accelerate during the quarter. Maybe it was due to mix or something else.

Mac Armstrong:

Yes, so what I would say—Dave, this is Mac again. That's a good question. What I would tell you is it was accelerating. If you compared April to June, you were seeing an acceleration, and I think you have to remember that there's—there was a fair bit of dislocation that was starting to manifest itself in the first quarter in the commercial property market, and particularly in the E&S space, but a lot of times you still have people that had legacy MGA relationships that they were contractually obligated to satisfy for a period of time, so you still saw a few, I don't want to say less disciplined participants in the market, but you weren't going to see the rate integrity that you're seeing now, and certainly that we saw in June compared to April, so I think—we think this is sustainable and you're probably going to see a bit of an acceleration if June versus April is any guide pole.

David Motemaden:

Okay, great, and then if I could just sneak one more in for Chris just on the prior-period development, was there any this quarter that helped the loss ratio?

Chris Uchida:

Yes. Let me just flip to that page in some of my notes real quick. Yes, there was a little bit of prior-year development. I wouldn't call it material. You'll see this in the actual results in the Q, so the total losses for the quarter were $643,000. Within that number is about $92,000 of prior-period development, so not what I would call a material number, but I think just to reiterate, that low loss ratio is driven by a lot of the quota shares and special—or different reinsurance arrangements that we put in place to help minimize the impact that losses or attritional losses have on our book of business from quarter-to-quarter.

Mac Armstrong:

Yes. David, if I could just add one more comment to that, I think as we really do try to espouse this mantra of predictability and minimizing volatility in earnings, you have to also reflect back that 70% of our book of business is earthquake and Hawaiian hurricane where you know what your losses are of the day at the end of the quarter—the day after the end of the quarter, so there's a fair bit of predictability inherent in that, so when you marry that with what Chris has outlined in these quota shares that minimize attritional loss, you're not going to see big swings in losses or development, which I think lends itself to predictability.

David Motemaden:

Got it. Great. Thanks for the answers.

Operator:

Once again, ladies and gentlemen, that is star, one to register questions at this time.

Our next question is coming from Jeff Schmidt of William Blair. Please go ahead.

Jeff Schmidt:

Hi. Good morning everyone. For gross premiums written last quarter, there was this new residential quake partnership, I think added $8 million to premiums. Was that just a Q1 event, or did that add any to Q2 premiums?

Mac Armstrong:

Hey Jeff. It's Mac. Well, the good thing about that, I think as we talked about on the last quarter's earnings call, it added $8 million premium. There was $6.5 million of—approximately $6.5 million of unearned premium that bolstered us. What you see now in the second quarter is kind of steady state performance from that partnership, so it's probably composed of approximately $3 million of gross written premium, so it was not like a material bump again. It's just now part of this—the—for lack of a better term, the base that we have.

We did bring on a couple of other partnerships. One I touched upon earlier with Allstate, which is more of (inaudible) used this term, hunting license, where basically we have the ability to sell our products to their agents, and particularly residential earthquake and Hawaiian hurricane. Another one was with a smaller California homeowners company that was looking to us, looking to find the product specialist who would allow them to focus more on wildfire and the attritional line of homeowners insurance and not have to focus on earthquake, but satisfy the required mandatory offer that the California Department of Insurance mandates.

Jeff Schmidt:

Okay, and then it looks like the growth of those commercial products is obviously really high, both the quake and the all risk. Can you maybe talk about that competitive landscape? Are there fewer competitors on that commercial side, and are those bigger markets than the residential, or what's your prospect there?

Mac Armstrong:

Yes. Jeff, this is Mac. Let me bifurcate the two. I think, over-archingly, one of the things that we touched upon in the IPO that was going to be helpful for our commercial lines of business was improving our financial size category to a financial size category 8, and that has, indeed, opened up distribution sources for our commercial earthquake, and you saw that in the quarter commercial earthquake grew I think 110% plus, so that was one driver of it. I think you couple that, again, with what we were talking about earlier, which is the improving price environment, that's allowed us to get scale, as well—or improve our scale in commercial earthquake, so certainly opening up new distribution sources, a healthy price environment, it's driven by certain people pulling out of the commercial earthquake market, or just trying to get—drive rate, so that's one contributor to it.

The commercial all risk, I think we continue to see improving rate, and furthermore, a broadening of the distribution base, but I think what it really comes down to there is there has been some pull out of that market, and our product is unique. We offer brokers and wholesalers or retail the ability to offer their clients an admitted insurance product that has the flexibility in pricing and coverage of an E&S product, so I think that's—really just continues to resonate in the market, and to your question around the size market, yes, the all—commercial all risk market is a much larger market than commercial and residential earthquake, so we think we've got room for growth there and we're pleased that that's growing close to 140% year-over-year.

Jeff Schmidt:

Right, and then for attritional losses, obviously really low, 3% in the quarter, more like 2% in the first half, how should we think about that in the second half excluding major events? Is there seasonality there? Could it be under 5%, or is it going to be more like 10% or 15%?

Chris Uchida:

Yes. Hey Jeff. It's Chris. That's a good question. We're not going to give guidance on what we expect the loss ratio—or specific guidance on what we expect the loss ratio to be quarter-versus-quarter. I would say that we've talked about it, and I'll reiterate it, that we've put given quota shares in place for our specialty homeowners business and for our commercial all risk business that help minimize the impact losses we'll have on our overall portfolio in earnings, so I do think that 2% or 3% for the year and for the quarter is a very good loss ratio.

I do expect that, over time, it will start to go up just naturally as our overall books of business from the specialty homeowners business and from the commercial all risk lines and the Inland Marine or builders (inaudible) that Mac mentioned before. Those lines do just have attritional losses associated with them. As those books a business become a larger component of our overall portfolio of risks, loss ratio will start to just creep up naturally. I don't expect it to jump up to 15%, but I would expect it to naturally increase with the growth in those lines of business, but I don't expect there to be any, I'll call it, shock losses or anything like that that are going to come with it, but there is—because it's homeowners and some of it is in Texas and the southeast, and the same with the all risk, there is some seasonality around it.

I would say it's probably more around the tornado season than anything else, but it's going to follow your traditional homeowners or commercial property seasonality, so maybe I'll call it fire season around Christmas and Thanksgiving, or sometimes some spike around those types of losses, but nothing that I would call just spiky in nature, and should be relatively smooth quarter-over-quarter, but increasing slightly over time just as those lines increase.

Jeff Schmidt:

Yes. Okay. Thank you.

Operator:

Thank you. Our next question is coming from Meyer Shields of KBW. Please go ahead.

Meyer Shields:

Great. Thanks. I want to follow up on Mark's question with regard to the post California earthquake demand surge. What can you do to ensure that the persistency over time of this new demand is higher than it has been in the past for earthquake underwriters?

Mac Armstrong:

Yes, Meyer. It's Mac. That's an interesting question. I think what we typically hope for is—we have very strong retention in residential quake, so we feel—it's in and around—it's north of 90%, so we feel if we get a consumer to procure it, we think we'll have a lifetime relationship with that customer, lifetime value of the customer will be fairly lengthy, so what is important to us to hopefully sustain it is see not only a surge from demand from policyholders that are part of the existing distribution footprint, but hopefully it entails us adding more producers, so you get calls from new producers who want an appointment with us, who want access to our value select or flex choice, or even our heritage products, so hopefully what we're going to see is increasing amount of producers in our distribution plant, and that will allow us to hopefully sustain it for a lengthier period of time, and this goes back to one of the encouraging things about this new—our new partnership we have with Allstate is that we have 500 agents that we appointed kind of—and probably two-thirds of those were on the heels of the Ridgecrest earthquake, so if we do a good job converting them and helping them sell the product, we should be able to sustain.

Meyer Shields:

Okay. Fantastic. That's helpful. Second question, if we take out the non-recurring and the non-essential expenses, it looks like other operating expenses were flat sequentially about $5.5 million. Is that a good run rate for the rest of the year?

Chris Uchida:

Hi Meyer. It's Chris. Yes. Obviously we're not giving specific guidance on this, and looking at that number I think you outlined it well. Obviously you've got to take the adjustments out. I would think that we're—when you look at 2019, and Q2 specifically, that was the first quarter that we were operating as a public Company. Some of those expenses are not, I'll call it, fully baked into the quarter, so I would expect the true dollars to increase slightly. I think if I had to measure and guess, I would probably say that Q3 is going to be a better indicator of what I would call our at scale operating expenses from a dollar standpoint should be, but I wouldn't expect Q2—or the Q2 dollars of expenses to increase materially from where they are and as you outlined, and I would also say that, from a pure scale standpoint, I would still expect that the growth in written and earning of that written, and then offset by ceded premium, the growth in the revenue side of it will still exceed the growth in the expenses, so I would expect to see a little more scale in Q3, and then that developing in the future—in future periods, I guess.

Meyer Shields:

Okay. Fantastic, and then one last, I guess big picture question. Are you hearing any whispers of new competition for any of your products?

Mac Armstrong:

Hey Meyer. This is Mac. What I would tell you right now if you—we're not seeing much in the way of new entrants. I think if you look at—if you bifurcate it by product line, like let's talk about the wind products that we have, the all risk, Hawaiian hurricane, there still is probably more of a capacity pullback driven by some of the dislocation in the E&S market, and then our flood products, we're seeing very strong growth. We don't see new entrants there.

We've got a pretty unique model, focusing on inland flood, that we have developed, so we're very encouraged about the growth are, albeit it's smaller line of business, and then when you look at earthquake, and particularly in the residential earthquake, which at 50% plus is our largest line, California insurance companies are much more focused on wildfire exposures than they are earthquake exposure right now, so you are seeing a lot of new entrants that are coming in to the California homeowners market that are trying to come up with the proverbial better mousetrap to assess wildfire exposure and wildfire risk, but what they're looking for is—more often than not, they want to find a partner to take the earthquake exposure off the table, so we actually think the dislocation in the California homeowners market driven by wildfire loss is a beneficiary to us because we can be a partner for them because more often than not they're shopping for a reinsurance budget to buy cover for wildfire, not earthquake, and they don't want to spend the money on earthquake. They want to spend the money on the wildfire coverage, so we can be a beneficiary there and they can benefit from our expertise, so long—it's a long-winded answer. We are not seeing new entrants right now; more to the contrary.

Meyer Shields:

Thank you very much. That's perfect.

Operator:

Thank you. Our last question today will be coming from Mark Hughes of SunTrust Robinson Humphrey. Please go ahead.

Mark Hughes:

Yes. Thank you. Just again, on the reinsurance arrangements you've got in place, the SHF, it sounds like the—we talked about the reinsurance model, the ceded premium probably a little bit higher now based on things you put in place, and likewise the volatility around the loss is lower, and presumably the absolute level of losses would be at a lower level kind of compared to what the model looked like pre-IPO. Is that fair?

Chris Uchida:

Hey Mark. It's Chris. Yes. No, I think when we look at what we planned for 2019 originally and earlier in the year, or the end of last year even, we expected to—that fronting arrangement for (inaudible) especially homeowners book to end on June 1 of 2019. The SHF, for all intents and purposes, is very similar to a pure fronting arrangement. We do have a small portion of risk, less than 20%, that we participate on, but like you said, we do expect that to help keep the loss ratio low from a pure percentage standpoint, and also from a dollar standpoint, so I would agree that it's not something that we originally planned for, but I think the overall losses from a ratio and from a dollar standpoint are going to be lower than we would have told you at the beginning of the year we were thinking about.

Mark Hughes:

Then the ceding commission also is an offset to expenses as well. Is that correct?

Chris Uchida:

That is correct, so if you look at acquisition expense, I would expect the ratio to be a little bit better, because we are getting more ceding commission throughout the year, and just when you look at Q2, obviously there's only one month of the three that would that have been taken into account. I think you will notice it more in Q—or excuse me, Q2 one month, but you'll notice it more in Q3 when you have a full three months of SHF, which is something that we did not contemplate at the beginning of this year.

Mark Hughes:

Very good. Thank you.

Operator:

Thank you. At this time, I'd like to turn the floor back over to Mr. Armstrong for closing comments.

Mac Armstrong:

Thank you very much, Operator. That concludes our second quarter 2019 earnings call. We appreciate your time, and moreover, your continued support of our Company. We look forward to speaking with you in October/ November, and wish you all the best. Thanks very much.

Operator:

Ladies and gentlemen, thank you for your participation. This concludes today's conference. You may disconnect your lines at this time and have a wonderful day.