Fourth Quarter and Full Year 2020 Earnings Call Transcript February 25, 2021

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PRESENTATION

Operator

Good morning and welcome to the Palomar Holdings, Inc. Fourth Quarter and Full Year 2020 Earnings Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference line will be opened up for questions with instructions to follow at that time.

As a reminder, this conference call is being recorded. I would now like to turn the call over to Mr. Chris Uchida, Chief Financial Officer. Please go ahead, sir.

Chris Uchida

Thank you operator and good morning everyone. We appreciate your participation in our Fourth Quarter and Full Year 2020 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 March 4th, 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 annual report on Form 10-K that will be 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 fourth quarter results at a high level and then discuss our initiatives to expand our business and drive profitable growth before turning the call back to Chris to discuss our financial results in more detail.

During the fourth quarter, we executed upon several notable initiatives that further position Palomar for consistent earnings growth in the years ahead:

First, we grew gross written premium 31.0%, including growth across existing and new product lines, expanding upon our position as a specialty insurance leader;

Second, our newly launched E&S carrier which we refer to as “PESIC” accelerated its traction in the fourth quarter. Our efforts with PESIC represent a logical extension of our business and enable us to address a large and attractive market opportunity;

Third, we consummated several new partnerships during the quarter, most notably a Residential Earthquake partnership with The Travelers Companies. Partnerships like these continue to be a meaningful source of growth for Palomar as well as an important validation of the value that we provide to the market;

Fourth, we acquired the renewal rights to Geovera’s book of Hawaiian residential hurricane business. This transaction allowed us to solidify our position in an attractive market where we already provide our producers and carrier partners a differentiated product, technology platform and financial stability;

Fifth, we continued to refine our underwriting strategy and implement measures that emphasize risk adjusted return, catastrophe payback and earnings predictability. As such we made the decision to exit Commercial All Risk on an admitted basis, specialty Homeowners in Louisiana and put into place a host of other underwriting changes. We are committed to the continuous improvement of Palomar across all

dimensions of the business and believe that the underwriting changes made during the fourth quarter reflect this commitment;

Finally, we continued to emphasize the protection of our balance sheet and our earnings base. To that effect, subsequent to year end, we secured $25.0 million of aggregate excess of loss reinsurance limit (“Aggregate Cover”) to put a floor on our ROE, combined ratio and earnings base. Ultimately minimizing the impact of losses from multiple severe catastrophe events.

Turning to our results in more detail, we delivered gross written premium growth of 31% in the fourth quarter and approximately 41% for the full year. Our full year growth consisted of an 87% increase in our non-earthquake offerings, growth of 52% for our Commercial Earthquake business and 14% growth on a same-store basis for our residential earthquake business. We continue to expand our product portfolio, launching four new products and PESIC in 2020 and are encouraged by the traction these newer products have quickly established. For example, our Inland Marine division grew premium by over 500% year-over-year, albeit off of a smaller base.

Our Commercial lines premium grew 95% year-over-year, a function of new distribution sources, expanded geographic footprint, incremental product traction and most importantly sustained pricing increases. Our fourth quarter Commercial policy average rate increase on renewals was 16% versus 14% in the third quarter demonstrating sustained rate integrity in the commercial property market.

Our book experienced premium retention rates of 84% during the fourth quarter, a rather strong result when factoring in the amount of non-renewals of All Risk and specialty Homeowner’s policies in the quarter, and 87% for the full year 2020. Premium retention for our Residential Earthquake and Hawaii Hurricane lines of business remain the strongest across our portfolio, both in excess of 92%. We believe these results are a testament to the unique value our products offer insureds and distribution partners.

As we think about our evolution in 2020 and what is to come in the years ahead, PESIC is a key pillar of our progress. This natural extension of our business truly enables us to extend the breadth and reach of our product suite. PESIC provides us the flexibility to enter new programs and new market segments in an expedient fashion and in some cases permits us to enter lines of business or geographies we were previously precluded from as an admitted insurer. PESIC also gives us the opportunity to participate in national property layered and shared business for Commercial Earthquake, Commercial All Risk and Inland Marine business. PESIC’s 128% sequential growth in the fourth quarter demonstrates its potential.

Strategic partnerships continue to be a key growth driver for Palomar. Over the course of 2020 we executed new partnerships in our earthquake, flood and commercial lines of property business on behalf of both Palomar Specialty Insurance Company and PESIC. These relationships enable us to enter new lines of business as well as deepen our standing as the go-to residential earthquake partner for major national insurance carriers. Subsequent to quarter end, we joined forces with Travelers to provide residential earthquake products to their agency partners in Missouri, Indiana and Utah. This partnership began in earnest last month and is emblematic of our strategy. We are pleased with the initial reception that our products have received by Travelers’ clients and producers and look forward to extending the

relationship into additional geographies as the year progresses. Although these relationships take time to develop, we believe the investments will serve the Company well as we provide valuable technology-enabled solutions to other insurance carriers.

I'd also like to briefly touch on our newly launched Real Estate Errors and Omissions program. This is a class of business where our team has long-standing experience and distribution relationships. We believe it is a strong addition to the Palomar product suite and heralds our careful and targeted expansion into casualty business. We are pleased with the progress this admitted offering has produced over the past few months.

As previously mentioned our country experienced a historic string of severe weather events during the second half of this year which resulted in a meaningful impact on our financial results. As always our immediate reaction was to ensure that our policyholders and business partners received the support they deserve. Once this was complete, our focus turned, to utilizing the lessons that we learned to improve our financial results and our business overall. We rigorously examined our product performance and underwriting guidelines and evaluated the available returns in specific market segments and geographies. As such we opted to exit admitted Commercial All Risk in totality and Specialty Homeowners in Louisiana. These collective actions reduce our gross losses from the historically active 2020 wind season by 70%. With the launch of PESIC we shifted our approach to writing layered and shared All Risk accounts on an E&S basis, materially altering our exposure and participation on an individual risk and aggregate portfolio basis.

As it pertains to our reinsurance program, in October we announced the procurement of backup coverage for our $20.0 million excess of $10.0 million layer. The layer will remain in place until June 1st 2021. As it relates to the $25.0 million aggregate cover placed earlier this year, it incepts April 1st and has an attachment point of $30.0 million, providing coverage for qualifying events within our per occurrence retention. This coverage applies across all perils including earthquakes, hurricanes, convective storms and floods above a qualifying event level of $2.0 million in ultimate gross loss, recovering on a first dollar basis once above the threshold. Simplistically speaking, the aggregate kicks in after three full retentions or after the accumulation of losses from a multitude of $2.0 million ultimate gross loss events. The actions taken demonstrate our commitment and focus on remaining agile, preserving our ability to invest in our core markets and most importantly, to achieve the requisite payback from a catastrophe for Palomar, our shareholders and our reinsurance partners.

2020 was a trying year yet one of accomplishments. We grew rapidly and maintained our profitability but more importantly we got better as a company. The hard lessons learned over the second half of the year and the swift actions of our team to adapt, learn and improve during the pandemic embolden the numerous paths for growth that lay ahead. I would like to spend a few minutes on our team, who are at the core of everything we do and what fuels us forward. To this extent, we had several notable additions to our world class leadership team including Angela Grant, who joined us in November as our Chief Legal Officer, the promotion of Michelle Johnson to Chief Talent and Diversity Officer, and the addition of Mark Brose as Chief Technology Officer. At Palomar, our most vital strength is our talent, which we continually invest in while also promoting diversity and inclusion in the workplace. I would also highlight the launch of

our inaugural Sustainability and Citizenship report which we plan on releasing annually. The report represents our commitment to exceeding traditional environmental, social responsibility and governance standards as we strive to build a workplace grounded in ethical behavior, compassion, and equality. I'm proud of the strides that we have made toward creating economic opportunities and promoting social justice.

Turning our attention to 2021 and the future prospects for Palomar, I would like to start by addressing the severe weather activity throughout the country this past week and in particular Winter Storm Uri in Texas where Palomar has had a considerable market presence. First off, I want to tell our policyholders in Texas that our thoughts are with them, we stand ready to support them and we are here to help them rebound. Secondly, I want to remind our stakeholders that Palomar protects its Texas business, residential and commercial alike, with not only catastrophe excess of loss coverage that responds should our gross loss exceed $10 million but also with underlying quota share reinsurance where there is first dollar participation that helps manage attritional loss. Unlike the hurricane losses that impacted us in Q3 and Q4 of 2020, both commercial and residential quota shares will respond to this event on a ground up basis within our retention, and as such we do not expect to incur material losses from the storm.

We believe we are well positioned to further support continued profitable growth. Palomar's ability to innovate, adapt to market conditions and to maintain our profitability through strong risk management are differentiators that will enable us to capitalize on new and existing market opportunities. We are investing to support this growth and are confident that we will continue to scale our business while diversifying our product mix. We are excited with the prospects for the year ahead as well as our ability to deliver attractive results for all of the Company's stakeholders. For the full year 2021, we believe that our adjusted net income will be between $62 and $67 million. Additionally, we believe that with our Aggregate Cover in place we have established a floor of approximately 10% for adjusted return on equity, 80% for adjusted combined ratio and $39 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 fourth quarter of 2020, our net loss was $1.8 million, or $0.07 per share, compared to net income of $10.9 million, or $0.45 per share for the same quarter in 2019. For the full year 2020, our net income was $6.3 million, or $0.24 per share, compared to net income of $10.6 million or $0.49 per share in 2019.

Gross written premiums for the fourth quarter were $96.1 million, representing an increase of 31.0% compared to the prior year's fourth quarter. For 2020 gross written premiums were $354.4 million, growth

of 40.6% compared to $252.0 million in 2019. As Mac indicated, this growth was driven by a combination of new products, accelerated rate increases, expansion of our E&S footprint, and extension of our distribution networks.

Ceded written premiums for the fourth quarter were $53.8 million, representing an increase of 82.3% compared to the prior year's fourth quarter. The increase was primarily due to an increase in reinsurance expense commensurate with our growth. During the fourth quarter the Company also incurred additional reinsurance expense associated with the losses sustained in the third and fourth quarter of the year while maintaining the Company's $10.0 million retention. In the fourth quarter we fully utilized the original reinsurance layer providing $20.0 million of coverage in excess of $10.0 million. The exhaustion of that layer resulted in an expense acceleration of $4.1 million of the remaining cost that would have normally been recognized in 2021. This layer was fully utilized, including a reinstatement, due to historic weather activity in the second half of 2020. Additionally, at the beginning of the fourth quarter we placed a backup layer to provide equivalent coverage through June 1, 2021 if the original layer was impaired. This backup layer cost $6 million, $2.2 million of ceded written premium in the fourth quarter. A portion of this backup layer was utilized during the fourth quarter, resulting in reinstatement premium of $759 thousand, but the full layer remains in place for wind storms, earthquakes and other events such as Winter Storm Uri through its expiration.

As Mac mentioned, and evident in our recent announcement, our risk transfer model remains a critical component to our strategy as we seek to pair sustained topline growth with conservative levels of reinsurance protection. The aggregate cover we recently placed effective April 1 of this year is emblematic of this strategy. As a reminder, our Cat XOL program provides coverage once a loss exceeds our current retention of $10 million. Our retained losses from qualifying events will contribute to the new aggregate cover that kicks in at $30 million.

Net earned premiums for the fourth quarter were $38.9 million, an increase of 25.6% compared to the prior year's fourth quarter, due to the growth and earning of higher gross written premiums offset by the growth and earning of higher ceded written premiums that include the additional and accelerated reinsurance expense described earlier. Net earned premiums for 2020 were $155.1 million, an increase of 54.7% compared to 2019. For the fourth quarter of 2020, net earned premiums as a percentage of gross earned premiums were 45.2% compared to 52.6% in the fourth quarter of 2019. The decrease was significantly due to the reinsurance acceleration charge, backup layer expense, and reinstatement premium incurred in the fourth quarter of 2020. For 2020, net earned premiums as a percentage of gross earned premiums were 51.4% compared to 50.0% in 2019.

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 we stated last quarter, we expected the net earned premium ratio to decrease in the fourth quarter with the placement of the backup layer. This was further decreased by the reinsurance expense acceleration and the reinstatement premium. We continue to expect this ratio to be around 52% to 54% 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 the new aggregate cover that

provides increased protection and improved earnings visibility if we face multiple catastrophic events similar to what we saw in 2020.

Commission and other income was approximately $803 thousand for the three months ended December 31, 2020 and $654 thousand for the same period in 2019. Commission and other income in 2020 was $3.3 million and $2.7 million in 2019.

Losses and loss adjustment expenses, or LAE, incurred for the fourth quarter were $17.2 million including $14.5 million of catastrophe losses and $2.7 million of non-catastrophe attritional losses. We define catastrophe losses as certain losses resulting from events involving multiple claims and policyholders, including earthquakes, hurricanes, floods, convective storms, terrorist acts or other aggregate events. This definition captures the catastrophe losses from the third and fourth quarters and Hurricanes Harvey and Florence from previous periods. The loss ratio for the quarter was 44.2%, comprised of a catastrophe loss ratio of 37.2% and an attritional loss ratio of 7.0%, compared to a loss ratio of 7.1%, comprised entirely of attritional losses, during the same period last year. Our 2020 loss ratio was 41.3%, comprised of a catastrophe loss ratio of 32.9% and an attritional loss ratio of 8.4%, compared to 5.6% in 2019, comprised entirely of attritional losses. The increase in the attritional loss ratio between the two years is in line with our expectations.

Our expense ratio for the fourth quarter of 2020 was 68.6% compared to 56.0% in the fourth quarter of 2019. The increased expense ratio was driven by additional reinsurance placements with increasing ceded premiums and continued investments in PESIC.

The ratio of other underwriting expense, excluding adjustments, to gross earned premiums for the fourth quarter of 2020 was 10.0% compared to 10.5% for the fourth quarter of 2019. This ratio was 10.2% for the full year of 2020 compared to 11.6% for 2019.

Our combined ratio for the fourth quarter was 112.8%, and compares to a combined ratio of 63.1% for the prior year’s fourth quarter. Excluding the catastrophe losses in the quarter, our adjusted combined ratio was 73.8% for the fourth quarter, compared to 60.7% in the fourth quarter of 2019. The increase is primarily from a higher expense ratio as previously discussed and in line with our expectations. We believe that this ratio is a better measure of our results for comparison purposes, and offers a better sense of our business on a steady-state basis. Our adjusted combined ratio excluding catastrophe losses for 2020 was 67.5% compared to 63.3% in 2019.

Net investment income inf the fourth quarter was $2.3 million, an increase of 29.0% compared to the prior year’s fourth quarter. The increase was largely due to a higher average balance of investments held during the three months ended December 31, 2020 due primarily to cash generated from operations as well as proceeds from the Company’s January and June 2020 stock offerings. We maintain a conservative investment strategy as our funds are generally invested in high quality securities, including government agency securities, asset and mortgage-backed securities, and municipal and corporate bonds with an average credit quality of A2/A.

Our fixed income investment portfolio book yield during the fourth quarter was 2.3% compared to 2.9% for the fourth quarter of 2019. The weighted average duration of our fixed-maturity investment portfolio, including cash equivalents, was 3.96 years at quarter end. Cash and invested assets totaled $456.1 million at quarter end as compared to $272.8 million at December 31, 2019. For the fourth quarter, we recognized realized and unrealized gains on investments in the consolidated statement of income of $245 thousand compared to a $1.2 million gain in the prior year's fourth quarter.

Our effective tax rate during the fourth quarter was 23.1% compared to 24.5% for the prior year's fourth quarter. The 2020 fourth quarter, the Company's income tax rate differed from the statutory rate due to the tax impact of the permanent component of employee stock option exercises. Excluding any unforeseen events, we anticipate that our tax rate will settle around the 21% mark for the 2021 year.

Our stockholders' equity was $363.7 million at December 31, 2020, compared to $218.6 million at December 31, 2019. For the fourth quarter of 2020, annualized return on equity was negative 2.0% compared to 20.4% during the fourth quarter of 2019. Similarly, our annualized adjusted return on equity during the fourth quarter was negative 1.4% compared to 21.5% during the fourth quarter of 2019. Our adjusted return on equity for 2020 was 3.0% compared to 24.1% for 2019.

As Mac indicated, looking ahead to 2021, we expect to generate adjusted net income between $62 to $67 million. This adjusted net income guidance considers the impact of Winter Storm Uri in Texas.

As of December 31, 2020, we had 26,245,339 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

Our first questions come from the line of Matt Carletti with JMP. Please proceed with your questions.

Matt Carletti

Hey, thanks, good morning. A couple of questions. Mac, maybe start with one centered on growth. Appreciate your comments about seven new partnerships being signed in the quarter. My question is, could you help us gauge your excitement or optimism for the growth path going forward? Specifically, what's the potential for those new partnerships, how should we think about the timing and the ramp of those, and then really, with the bottom line question of, as you look at 2020 and what was a very strong 40% or so gross written premium growth rate, do you feel that's sustainable, do you feel that's something that can be built upon, or is the model maturing a bit and there'll still be strong growth but maybe we shouldn't think about those numbers?

Mac Armstrong

Yes, Matt, good to hear from you and thanks for the question.

Definitely want to address this because I think it's important to say that we feel very good about our growth prospects into 2021 and beyond. When you look at our growth over the course of 2020, it was strong, but with the addition of new products, the new carrier, and new partnerships which you touched

upon, we do believe that a growth rate that's—we're not going to provide premium guidance, per se, but we do think that a growth rate that we achieved in 2020 is sustainable.

We think that that is directionally very achievable and I wouldn't mind just giving this a little more color on the fourth quarter top line growth because ultimately when we went through the exercises and the underwriting changes that we put into place in the fourth quarter, we focused on profitability, and as a result we made changes that would have slowed the growth in certain lines of business.

Clearly, commercial all risk, exiting that business in the middle of the quarter on an admitted basis and pivoting to the E&S layer and shared focus, exiting specialty homeowners in Louisiana, that you could argue—that sacrificed seven points of growth, and just what our average new business was in a month. But it also took away the potential losses of 70% of our losses that we incurred from the wind season of 2020.

We also looked at certain of our lines like commercial earthquake to make sure we were getting the same targeted return. Even with earthquake where you have a circumstance where you see no attritional loss, you do have underlying target metrics and there were certain accounts that we opted to walk away from that weren't going to achieve our targeted returns. If you compartmentalize that, that was probably around seven points of growth within commercial earthquake and then just one little nuance on commercial earthquake is that there is around $1.2 million of premium that hides in national property in the E&S book that is earthquake premium that could have been recut, reconstituted, and would have pushed up the earthquake growth rate to closer to—commercial quake closer to 23%.

The only thing I would highlight too is on residential earthquake, our same store growth was 15%. Our largest product, value select, was north of 20% in the fourth quarter. It's a long winded way of saying when you look at just the underlying trends in earthquake plus factor in the growth from the E&S company, new partnerships that we have in builders risk, certainly for national property, some of our new casualty lines, the real estate E&O, the new earthquake partnerships with someone like a Travelers, our flood partnership with Torrent, and then also the Hawaiian hurricane renewal rights deal, which didn't kick in till the first quarter because there is a lag from the timing of the deal to when you actually deliver the renewal notice, there are multiple growth drivers that gives us very good confidence about sustaining growth equivalent to that of 2020 for the full year in 2021.

The last point I'd make is we're two months into the year and we're seeing very good growth, earthquake, Hawaii, you name the line.

Matt Carletti

Great, that's very helpful. Thank you.

Then just one other question, a more of an underwriting approach question. Particularly as we think about some of the newer partnerships that have been announced, so I'm thinking of things that have a little larger limits to them like the excess liability partnership or the Builders Risk Partnership, can you just give us a little inside baseball on how you approach those sorts of partnerships where maybe there's, in some of those, there's a little more tail involved, there's little larger limits involved. I'm sure reinsurance is probably part of the answer, as well as just old fashion underwriting, but any color you could give there would be great. Thank you.

Mac Armstrong

Yes, absolutely. Well, first off, we want to underwrite it on a net line basis, so we're looking at what is the unit level profitability, irrespective of reinsurance. Because if you do it that way, you have the ability to supplement your risk and your underwriting appetite with reinsurance. Those lines that you touched upon, the newer partnerships in builders risk, the new partnership that we've done in the casualty arena, those

have quota share reinsurance supporting them. Typically we would only end up being 20% to 25% of the risk, much like we've done with all of our attritional loss lines and that's why we have the confidence that we do around the results in Texas. We have underlying quota shares working side by side with us.

Those new partnerships, we’re going to wade into those markets, have a very disciplined underwriting appetite, have incremental reinsurance supporting us, and in doing it in a market that is conducive to naming your terms and conditions. It is still a fairly favorable market from a pricing and terms condition standpoint.

Matt Carletti

Great. Thank you for the color and best of luck in ‘21.

Mac Armstrong

Thanks, Matt.

Operator

Thank you. Our next questions come from the line of David Motemaden with Evercore ISI. Please proceed with your question.

David Motemaden

Hi, thanks, good morning.

I had a question, Mac, just a bit more on the growth during the quarter and specifically the residential earthquake growth where it slowed a bit and I think I caught that you had said 14% to 15% same store growth in residential earthquake. You guys have historically had very good retention in this line, so I guess I'm just wondering maybe if you could touch on new business trends and was that just running a little bit light in 4Q? That seems like it might be temporary based on the comments that you just made, but wondering if you could just expand a bit on the residential earthquake growth of about 6% year-over-year in the quarter.

Mac Armstrong

Yes, absolutely, Dave, and again, what I would say is that the same store growth was 15% and our largest product, value select, grew 20% in the quarter. There's really two specific things that influenced and impacted the growth and it wasn't new business. It was actually some of our assumed reinsurance partnerships.

We had one partnership with the carrier that exited the line in Utah that we stopped doing business with that actually in the fourth quarter gave us a little bit of a onetime unearned premium bump, so that was roughly a four-point aberration in the fourth quarter of 2019. Then the other thing was we had one other assumed reinsurance relationship with a homeowners writer in California that has materially changed its appetite due to wildfire. We have supported them on the earthquake side and they're still a very good partner, but they have changed the size of the risk they want, their non-renewing policies because of the wildfire exposure in the state of California.

What I look to, again, is our core products, value select, heritage, flexpoint, those grew 20%-plus. You had two legacy partnerships, for lack of a better term, that have been wound down. One was wound down, one has come back some considerably. Then again, as I said, if you look at the start of this year, new business is strong. We feel very good about sustaining the growth rate that you saw, 15%-plus in 2020, on the residential earthquake side in 2021.

David Motemaden

Great, thanks, that's really helpful.

Maybe a quick follow up on that, great to hear about the partnerships, adding seven in the quarter and great to hear about the Travelers partnership in Missouri, Indiana, and Utah. I guess I'm just wondering if you have any line of sight into expanding that relationship to include some other states like California, Washington, Oregon? I guess, is that an ongoing conversation that you guys are having?

Mac Armstrong

Those are ongoing conversations. I think what we're focused on right now is executing in those first three states, getting our systems well integrated with their agents, getting our marketing team to train their marketing reps as well as their producers on the product itself. We entered into this arrangement with the hopes of expanding it well beyond those three states. I hope to report that there is expansion over the course of 2021. We're going to walk before we run and get it right because this is an important deal for us.

David Motemaden

Got it. That makes sense, thanks.

I guess just shifting over to reinsurance, it was great to see the aggregate that you guys put in place earlier this month. I'm wondering if you could maybe just touch on other parts of the program and just on the reinsurance renewals at 1/1. What rate increases you guys experienced and then also maybe just give your outlook on how you expect the reinsurance rates to progress over 2021, especially now? It sounds like the specialty home facility is clearly working as you had intended, but I believe that renews at 6/1. Just wondering, I guess as well, specifically on the specialty home facility, how you're thinking about the renewal on that?

Mac Armstrong

Sure. What I will tell you, Dave, so we did not have any reinsurance renewing at 1/1. The majority of the program renews at 6/1, but we did go out in place the aggregate earlier this year 4/1 and we did it in January, as you know, and we had a good experience. We have some great reinsurers supporting us. It was priced and in line with our expectations, and as it relates to 6/1, the broader cap program renews. We are in the market now. We have a terrific panel of reinsurers that, the strong majority of which will not have incurred losses, so I think we feel good about the placement. The guidance that we put in place reflects some rate increase and it's a digestible rate increase when looking at the primary market and what we can get there.

On the specialty homeowners facility, I think it first and foremost, what it starts with is we need to do a very good job of servicing our policyholders. One, to make sure that they're not disrupted in their homes; they’re back in their homes with full utility. Two, that we’re responsive and also not putting ourselves a position where there's leakage from a claims handling expense, or overall malaise in servicing the business, and if we do a good job of that, we feel that we will be able to successfully renew the specialty homeowners facility at 6/1.

Up until this month, that program had done very well and it has done very well historically. We've got a great group of reinsurers supporting us, and so we think we'll be able to get it to a place where we’re very confident in that and we take around 22.5% of the risk there. We might be able to dial that up or down some, but I think what it first comes down to is just being very transparent with our reinsurers, being very responsive to our policyholders, and getting these claims serviced and closed as quick as possible.

David Motemaden

Okay, great, thanks. That makes sense.

Operator

Thank you. Our next questions come from the line of Mark Hughes with Truist. Please proceed with your question.

Mark Hughes

Thank you. I know you said that Texas is not material, but in thinking about your guidance of 62 to 67, I do wonder whether there might be a million or two that you assume from the winter storms in that guidance. I know you said it was inclusive of Texas. Is Texas zero or is it perhaps a couple million?

Mac Armstrong

Yes, Mark, this is Mac and it's a fair question. I mean, we will have some loss. It's going to be on the lower end. It will be within that range. If I had the handicap right now, it'll be within that range that you specified, and so that's why we feel that it's immaterial. But it's still too early to tell. The guidance that we put out there reflects the losses from Texas, and that's all we can say because it is early stages, certainly in terms of adjudication. The volume of claims is dissipating some but we're still seeing them so until we get our two hands around that, the range of the net is what you outline.

Chris Uchida

One thing I'd add around that guidance as well is that we talked about it on the call and mentioned earlier this year is that, that also includes the new cost of the aggregate, which is new to our program, but will definitely help create more visibility and consistency of earnings. But also, as Mac mentioned in his prepared remarks, create more of a floor for what our adjusted net income will be for 2021. I think that will just help prepare but there is additional cost associated with that included in that guidance that we're providing.

Mark Hughes

Mac, you gave some numbers talking about that floor specifically. I think the 10% ROE, 80% adjusted combined ratio, did I hear that properly? Then I think you provided a third metric that I did not hear.

Mac Armstrong

Yes, the numbers were approximately, the floor, 10% ROE and 80% adjusted combined ratio and adjusted net income of $39 million. For what it's worth, if—based on the underwriting changes that we've made, if 2020 were to repeat itself again with the same type of storm, same location, the range that we would have, the floor wouldn't be $39 million. It would be closer to $41 million to $46 million but the full utilization of the aggregate would be a $39 million adjusted net income.

Mark Hughes

Understood, and then the PESIC, I think you mentioned 128% sequential growth. I mean, you might have given the 3Q number last quarter, but what was that contribution in the fourth quarter?

Mac Armstrong

The gross written premium? Let me give you the exact number. It was in and around $21 million.

Mark Hughes

Then what do you think about the ramp on that? Obviously 128% sequential. Where is that going, what kind of ramp should we anticipate on that, roughly?

Mac Armstrong

I think long term we think that the premium in PESIC could be equivalent to what we have in the admitted company. We have internal targets, we're not going to guide to them this year, but we—the new partnerships that we've announced in builders risk, in excess liability, those in E&S, there's great momentum with what we're doing with AmWINS, as well as the National Property, as well as in commercial quakes, so there's a lot of things in the hopper. We feel very good about the long-term prospects. I don't know if we're going to grow sequentially 130% a quarter, but we're going to grow pretty nicely in the E&S company.

Mark Hughes

Thank you.

Operator

Thank you. Our next questions come from the line of Jeff Schmitt with William Blair. Please proceed with your questions.

Jeff Schmitt

Hi, good morning. The commercial all risk book that you exited, I think in the past you said it was about a $9 million book and—but it did cost you seven points of overall growth in the quarter, I believe, which implies maybe it was a bit larger. What was the size of that book and will that come out fairly evenly this year as policies non renew?

Mac Armstrong

Yes, hey, Jeff, it's Mac. I think it was 9% of total premium, not $9 million. What I would tell you is, sequentially, that book of business declined from, call it, $12.5 million or so in the third quarter. It declined probably by about 50%, so it's going—on a sequential basis. It's going to wind down rapidly over the course of the year. It's going to be offset by growth on national property and the E&S company, so that—it'll probably end up being—looking slightly flat to down modestly as categorized as commercial all risk, but it will be all E&S versus the admitted. We're rolling off close to 8% to 10% a month and the limit comes down commensurately as well.

I think a good indicator of that is if you just look in the fourth quarter when we disclosed this, how much of our Texas premium declined sequentially and that was a function of commercial all risk being wound down in that state. The admitted commercial all risk being wound down in the state. Then the only thing that I would add is that if you look at the business that we're bringing on, on the layered and shared national property business, the metrics are considerably better, not necessarily from a pure rate perspective, but from a pure premium perspective in the AAL to premium and some of the other metrics that we track, it's considerably better. It's close to 38% better from a theoretical or underlying profitability standpoint, so it will help with our margins. It will reduce our cost of green insurance and it will enhance our spread of risk.

Jeff Schmitt

Got it, okay, that's great color. Then, looking at the other line in premium, it's actually ramping faster than flood, almost as fast as builders risk. Is that all the Real Estate E&O product, or I thought that was new? Or, what is in that and what are the growth prospects of that?

Mac Armstrong

There's a few things in there. There's real estate E&O. There are some new E&S assumed reinsurance relationships. We are starting to write non-property assumed quota share reinsurance with a team that's long-standing market experts and so that's another component to it. That could be for a line like—mostly casualty events. The other right now is going to be really more of our casualty business until we've got a good start in ramping that up.

Jeff Schmitt

Is that casualty in terms of with a property, like a commercial property, a commercial package product?

Mac Armstrong

Yes, some of it could be packaged, some of it could be a just a pure liability product. Some of it could be the real estate agency which is a professional line.

Jeff Schmitt

Got it, okay. Thanks for the answers.

Operator

Thank you. Our next questions come from the line Tracy Benguigui with Barclays. Please proceed with your question.

Tracy Benguigui

Thank you. Just want to circle back to Uri. There are a lot of estimates that seem to be pretty varied and the largest vendor catastrophe modeling firms haven't provided their view yet, so I'm just wondering, as you were thinking about your outlook for the year, it seems to be in a tight range, how you think about the industry loss size of this event and if you could also just walk us through the mechanics of your reinsurance because I realize it's not linear? Or maybe I could follow up on that question.

Mac Armstrong

What I would tell you, Tracy, and we can follow up on it, I think we've talked about, since we've been public, that we use four attritional loss lines like Texas homeowners or our specialty homeowners facility, we use quota share reinsurance and so we're taking 22.5% of the risk with recoveries on a first dollar basis. But we have quota shares in place for the specialty homeowner's business. We have them in place for the all risk business, as well as builders' risk and Inland Marine. We have three separate quota shares in place to support us from an attritional loss standpoint.

Those are inside of our retention, and then once the aggregate loss is above $10 million, that's when it's triggered by our cat program. We have the ability to recover from multiple vehicles; our quota shares from the three individual lines plus our cat program. As it relates to the size of the event, it's too early to call but

for us the fact that we have those four reinsurance programs working to our benefit, it gives us very good confidence that the losses are going to be immaterial.

Chris, I don't know if you offer anything else, but I think that's really the sum and substance of it and we can give you a full, Tracy, offline breakdown of how all of this work.

Tracy Benguigui

Yes. You previously mentioned the 22.5% for specialty homeowners, but if you could walk us through what your retention is for commercial property and also if your estimates take a view that you will blow through your occurrence tower?

Mac Armstrong

We will not blow through our occurrence tower. We will not have $600-plus million loss from Uri. It will be nowhere near that. It could go into the first layer of our reinsurance program. It's still early to tell. As I said earlier, the claims have dissipated, or the pace of claims tendering has dissipated considerably over the last few days. It's a manageable, identifiable number. Our All Risk, on average, we're taking about 20% of the attritional loss and same thing on the builders risk, and it's 22.5% on the specialty homeowners.

Tracy Benguigui

I appreciate you laying that all out. There was a lot of discussion on growth. Maybe on the flip side you had mentioned, reiterated, not new news, on some businesses that you have exited. I'm wondering if there's any other areas where you're not meeting your risk adjusted returns on capital that may look less attractive right now, that you're revisiting?

Mac Armstrong

Right now, beyond the commercial all risk and the specialty homeowners in Louisiana, we look at it on a state by state and an account by account basis. That's the beauty of having the E&S company or having the ability to modify rates even on the admitted side. There's no line of business. There could be zip codes. There could be certain classes that we're going to take rate on, but that's just good underwriting, but so there's no broad brush.

Tracy Benguigui

Thank you.

Operator

Thank you. Our next questions come from the line of Meyer Shields with KBW. Please proceed with your question.

Meyer Shields

Great, thanks. First, I think, Mac, you mentioned seven new deals. Should we think of those, outside of Travelers, as being the typical earthquake hotspots?

Mac Armstrong

Yes, that's fair. It's going be a mirror where we have filings in place, existing presence and distribution, but that's right.

Meyer Shields

Okay, and those are also up and running as of January 1?

Mac Armstrong

They are, yes, in varying degrees. Some of them are in pilot phases. Some of them are in training phases in a single state, so there's a lot more to come in terms of penetration, training, and adoption.

Meyer Shields

Okay, that's helpful. Second, I was hoping you could just go through the reinsurance program associated with the growth in Florida just because it's been a tricky state in the past.

Mac Armstrong

Sure. We have a separate tower, the North Atlantic Hurricane Tower, that covers us for the Florida exposure and some of the Florida exposure that we brought on was part of motor truck cargo. Some of it is the assumed reinsurance that doesn't have cat exposure. The new Florida business that we brought on that's tied to our layered and shared property, there is a standalone facility that we have that attaches at $10 million, and then at some point the broader cat program, it will the benefit of the broader cat program, but our PML's in Florida right now are very modest.

Meyer Shields

Okay, and then I'm assuming it was in accidental, but I was wondering whether you've given any thought to disclosing how Palomar looks at AAL?

Mac Armstrong

In terms of how we look at our average annual loss?

Meyer Shields

Yes.

Mac Armstrong

The average annual loss that we build—our reinsurance program is priced as a multiple of the AAL, the same way we price our premium. I think if you're trying to figure out what a cat load is, what we—I think our best offering to you is we have put the aggregate in place, put the floor. If there are three retentions, after three retentions it goes into the aggregate so that there is—a lot would have to happen. We saw it happen in 2020 but 2020 is going to look very different than 2021 just because of our underwriting appetite. The CAT load, if it's one event, if it's—that would be—I don't know how you want to do that, Meyer. When we look at AAL, we use it to look at the underlying pricing, how we pay for our reinsurance, and the lower the AAL, the cheaper our reinsurance is, and so that the higher our net earned premium is.

Meyer Shields

No, I understand. I know it's not a question you can answer. We have something for the model.

Operator

Thank you. Our next question is coming from the line of Paul Newsome with Piper Sandler. Please proceed with your question.

Paul Newsome

Thank you and good morning.

I was hoping you could talk a little bit about the outlook for the attritional layer in loss ratio. Obviously you have a business mix change happening with the new E&S business, which I assume would have higher attritional losses, but there's been a lot of changes in both reinsurance and pricing, so should we continue to expect a gradual increase in the attritional loss ratio or should just—how should we think about that and how that may be changing in the last three to six months?

Chris Uchida

Yes, no, I can handle that one, Mac, but I think you described it well. I think there's really no change in the philosophy that we've been giving over the last year, that we do expect the attritional loss ratio to continue to tick up. As you can see for the full year of 2020, it didn't jump. We went from 5.6% for 19' to about 8% for 20—or, sorry, 8.5% for 2020. Some of that is also a little inflated just because of the amount of additional reinsurance expense that we had to take in the fourth quarter. That pushed the loss ratio up slightly. These are all in line with our expectations through the year that it was going to go up.

Obviously, we are still expanding some of those lines, especially homeowners line, is still growing. As Mac mentioned, we are rotating out of our admitted all risk, but going into another all risk or a layered and shared all risk program. I will say that the attritional loss profile of that book is a little bit better than our historic book or our historical admitted book, so we do expect to see some improvement there, but there are lines expanding, such as Inland Marine, all risk, they're going to be layered and shared all risk, especially homeowners. We'll still have attritional losses, so we expect it still to tick up but like I said before, it's not turning into 20% overnight. This is going to be 8.5%, moving up to maybe 9% next quarter or things of that nature, but it's—as you know, loss ratios aren't perfect. They are a little bit seasonal, so there's going to be some bumps and valleys in that. But on an annual basis, we don't expect it to jump to 20% or anything like that. Maybe a point or two each quarter or over an annual period.

Mac Armstrong

Right, I think what I would add, Paul, is if you look at the fourth quarter, it was 7%. It was flat year-over-year. Again, to Chris's point, it's very gradual.

Paul Newsome

Yes, that's great. Then on the reinsurance side, are there any products where you are either expanding or contracting the use of quota share that might affect net to gross respectively over the next year or two?

Mac Armstrong

Not in a material fashion. Our participation in our flood product has picked up modestly over the last few years. But it's not like we're going to start to take 100% of that book. We're still feeding out 60% of it.

Chris Uchida

Yes, and like I said, obviously when we talked about it on the call or on the prepared remarks in the call, I indicated that our net earned premium should remain around that 52% to 54% mark. That includes our

thoughts on our participation in the quota shares, the increased expense of the Ag., and then also any reinsurance that we place on the June 1 renewal.

Paul Newsome

Thank you very much.

Mac Armstrong

Thanks, Paul.

Operator

Thank you. Our next questions come from the line of Adam Klauber with William Blair. Please proceed with your question.

Adam Klauber

I had a couple questions on the expense ratio quarter-over-quarter, obviously jumped up, went from—sorry, year-over-year, 54 to almost 67. How much of that is the reinsurance?

Chris Uchida

Yes, there's a significant amount of that that is being driven by reinsurance. When you think about how that ratio is calculated—probably let's call it about a 12% hit to those ratios. When I look at the expense ratio, it was 56 last quarter, on adjusted basis 53.6 or 54 and it's now, adjusted, is about 66.7. If you were to back out some of those reinsurance charges for the year, that gets you below 60. When we do a reinsurance charge what I'm talking about is the expense acceleration of $4.1 million and then the reinstatement of the backup layer, about $760,000. You take those out of your net earned—or add those back into your net earned. That lowers the ratio to be within our expectations for the year—or for the quarter where we did talk about the fact that, as we change the quota shares back in Q2, we increased our participation and then also changed the structure where we had a lower feeding commission. But that also helped drive up the improved net earned premium. The expense ratio definitely is inflated. I'd call it about 7.5 to 8 points it's inflated from—purely from the acceleration and additional reinsurance in the quarter.

Adam Klauber

Okay, that's helpful. So this is more directional than exact, but so '19, the expense ratio is 57; '20, up to 59, but again, had a lot more reinsurance expense. As we think about '21, again, you get the aggregate coming in, you've got some additional reinsurance cost so we look at that higher level 59 or with the additional reinsurance, could be going up from what we saw in 2020.

Chris Uchida

I think it should. I think one thing we've talked about is the investment we're making in PESIC. I think over the last couple quarters we've said that the expenses or the ratios will probably flatten out a little bit over Q4 and then into Q1 of this year. I think it's going to stay at that level, let's call it, for maybe a quarter or two, but then we do expect, let's call it, by the end of or probably second half of 2021 that we will start seeing that scale come back into the model as some of those investments take hold.

I think Mac talked about, we will continue new investment in people. We talked about Angela Grant and other folks that have joined the team. We're continuing to invest there and then also on some of the other things that will help PESIC grow. That scale, we do expect to continue to be in there and I think you can

even see it when you look at the other underwriting expenses on a gross basis. I mean, compared to gross earned, if you look at the other underwriting expenses, with the adjustments included, last year it was 10.5% and this year was 10%. There is still improvement in those layers or in those ratios we look at on a gross basis, which is generally how we look at it internally because it takes out the noise that any type of reinsurance expense is going to put into those ratios.

Adam Klauber

Okay, thanks. Then going back to some of the premium growth. Again, the commercial all risk will be a bit of a drag, it sounds like more in the first half. How big is the Louisiana homeowners that you're running off, and then also on the commercial earthquake, sounds like you did some re-underwriting fourth quarter? Is there any of that going forward or is that probably more of a check the fourth quarter type hit?

Mac Armstrong

Adam, it’s Mac, good questions. First, on the Louisiana homeowners, it's very modest. It’s plus or minus $1.5 million, so that will not have much of an impact, if any. On the commercial quake, I would say it was specific to the fourth quarter. As I said, we're seeing very good growth to start the year and what I would add is we're seeing very good growth to start the year with our target metrics being hit. We're getting rate increases, we're improving terms and conditions so we feel very good about commercial earthquake growth at this point.

Adam Klauber

Then, sorry, just one more question on residential. I think you said one of your partners is not doing one in California. I think one other thing depressed that somewhat, growth in the fourth quarter. Will we see some of that carry over in the first half or is that more of a fourth quarter issue?

Mac Armstrong

That was the fourth quarter issue. One was a onetime unearned premium bump that we received and then those can happen as we bring on new partnerships but that was the partnership that was dissolved fairly quickly after a short term arrangement, and then the other one has run itself over the course of 2020 so they've stabilized what they want in California homeowners.

Adam Klauber

Okay, and then more of an overall, on the E&S, if that’s okay. Again, still very new two quarters in. You’re building up some partnerships there. Is the momentum in that property market still building as much as you saw through six months ago? Or is there any planing out or flattening of that momentum?

Mac Armstrong

No, we’re still continuing to see rate increases and we feel good about that for the remainder of the year. In the fourth quarter our average rate increase was around 16%. I don't know if I want to say that for the rest of the year we’ll average a 16% rate increase, but we will get rate and it's rate on top of rate at this point, which is a good thing. I think we feel very good about the rate environment and it being sustained certainly in a positive fashion through the rest of this year and probably into the early part of next year too.

Adam Klauber

How about the level of opportunities coming in the door? You had over 100% sequential growth. Do you see any change in that environment anytime soon?

Mac Armstrong

No. We're seeing a lot of different new partnerships, new markets to enter. We have to be somewhat mindful of bandwidth and how we allocate our time and resources, and making sure that these new arrangements can hit our target returns. There's no shortage of opportunities out there in this market.

Adam Klauber

Okay, great. Thanks a lot.

Operator

Thank you. There are no further questions at this time. I would like to turn the call back over to Mac Armstrong for any closing comments.

Mac Armstrong

Great. Thank you, Operator. Thank you all for your time this morning.

This concludes Palomar's fourth quarter earnings call. We appreciate your participation and questions, and always, your support.

We believe 2020 was a significant milestone in our Company's short history. We launched a new E&S carrier, grew in both new and existing lines of business, added talent to our team, and most importantly, adapted swiftly to market conditions and challenges. We are excited for the opportunity to continue to showcase our results and growth initiatives over the course of 2021.

We hope everyone continues to remain safe and healthy. Thank you very much, and we'll speak to you after the first quarter. Have a great day.

Operator

Thank you for your participation. This does conclude today's teleconference. You may disconnect your lines at this time. Have a great day.