PALOMAR
SPECIALTY

First Quarter 2019 Earnings Call Transcript

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C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

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P R E S E N T A T I O N

Operator:

Good afternoon, ladies and gentlemen, and welcome to the Palomar Holdings, Inc., First Quarter 2019 Earnings Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be open for questions with instructions at that time. As a reminder, this conference call is being recorded.

Now I would like to turn the conference over to your host, Mr. Chris Uchida, Chief Financial Officer. Thank you. You may begin.

Chris Uchida:

Thank you, Operator, and good afternoon, everyone. We appreciate your participation in our first 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 section of our website through 11:59 pm Eastern Time on May 23, 2019.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meeting of the Private Securities Litigation Reform Act of 1995. These include remarks about future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risk, 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 on May 17, 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 a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to the most comparable GAAP measures can be down in our earnings release.

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

Mac Armstrong:

Thank you, Chris, and good afternoon, everyone. Before I get started, I'd like to take a moment to thank all of those people who helped us through our initial public offering, which culminated in our first day of trading on the NASDAQ stock market on April 17, 2019. The hard work of our employees and advisors and the loyal support of our customers and partners contributed to the success of our offering and as a result, we were able to raise approximately $87 million in net proceeds to support the strategic plan of the Company.

This capital infusion will let Palomar to take full advantage of the numerous growth opportunities, including geographic expansion of our specialty property product footprint, entry in to new specialty lines of insurance, and stroke-of-the-pen measures, such as increasing our participation in selected existing lines of business. We see considerable white space for expansion and are excited by the opportunity that lies ahead.

Turning to today's call, I would like to provide a brief overview of our Company and our growth strategy for those Investors who were unable to hear our story during the IPO roadshow. I will then briefly review the highlights of our first quarter performance, before handing the call over to Chris for a more detailed discussion about results. From there, we will open the call for your question.

To start, we founded Palomar in 2014, because we saw a unique opportunity to write profitable business in several specialty property insurance markets, including residential and commercial earthquake, commercial all risk and Hawaiian hurricane. We believe that these markets were largely underserved, with few direct competitors focused exclusively on specialty property risk. In many instances, these incumbents were mispricing the risk and limiting the coverage available to insurers. As a result, we strongly believed that we would develop products to better meet the specific needs of both commercial and residential insurers and once we rolled out these products, we would ultimately capture substantial market share.

To take advantage of this opportunity, we invested significant time and resources, both human and systems, in developing an analytically-driven product framework that creates innovative and unique product offerings. We are licensed as an admitted insurer in all 25 states where we operate, allowing us to provide our customers the certainly of admitted insurance products, typically in the form of a state guaranteed fund backstop, and to eliminate certain administrative requirements for our distribution producer.

In addition, we offer specialty property products with flexible features, broad pricing capability, and coverages that are not typical standard products, but rather the E&S market. By offering our customers the ability to choose deductibles and other a la-carte coverage options, we believe we have created products that are attractive to not only those customers who have existing policies from our competitors, but also for those customers who have not historically bought insurance in our focused markets, most notably California Earthquake, where we are currently the fifth largest writer of business in the state.

Importantly, our specialty property product had a strong competitive mode, and they have been approved by individual state regulators, and are supported by proprietary data analytics and pricing models. We employ a highly granular and analytically-driven underwriting process to assess and price each risk that we write. As part of our process, we have developed sophisticated proprietary modeling tools that utilize extensive geospatial and actuarial data, enabling automated pricing of risk at the geo code location or zip code level. As an example, our 2016, residential earthquake rate and policy from filing with the Washington State Department of Insurance had over 20,000 distinct pricing zones that take into account nuanced regional differences in soil types, liquefaction potential and distance from known fault.

In contrast, most competing earthquake insurance rates filings in Washington are based on broad territorial pricing zones that ignore the aforementioned earthquake risk characteristics. We believe our analytically driven underwriting process, combined with the decades of specialty property underwriting experience embedded within our Management team, provide better oversight of our exposure and ultimately, a competitive advantage. This competitive advantage should result in attractive underwriting margins and superior risk-adjusted returns for our Shareholders as we continue to scale our business.

As we have refined our product framework and underwriting process, we have made substantial progress diversifying our business by product, market and geography. As we launch new products, we looked about certain attributes of existing products, illustratively granular pricing, flexible coverage, distribution network or system. In 2014, our first year of operations, all of our premiums related to earthquake insurance. For the year ended December 31, 2018, 67% of our gross written premiums were related to earthquake insurance. Additionally, we have looked to build a balanced portfolio of commercial and residential business to insulate us from shifting dynamics in the insurance market.

At year-end 2018, 77% of our gross written premiums are attributable to residential business and 23% of our gross written premium were attributable to commercial business. As our book of business grows and continues to diversify, we further use data analytics to manage risk at a portfolio level and inform our risk transfer strategy. Our risk transfer strategy is premised around three concepts. One, capital loss potential from a major event. Two minimizing earnings volatility; and three, positioning the Company to capitalize on post-event demand for our products.

To manage our exposure to catastrophe events, we utilize several risk mitigation strategies, most notably treaty and facultative reinsurance. Our reinsurance program enhances our business by reducing our exposure to potential catastrophe and shock losses as well as reducing volatility in our underwriting performance, as we only retain $5 million of risk for catastrophic events. Importantly, our use of reinsurance not only provides loss protection, but also superior visibility into our earnings.

Another critical component to our success in the market is our proprietary technology platform. One benefit of being a newly formed insurance Company is the ability to build an operating platform that incorporates state-of-the-art technology and best practices derived from our team's extensive experience. Our technology philosophy is premised around providing ease of use to our distribution partners, portfolio management integration, knowing our risk as well as scalability. Our internally developed Palomar Automated Submission System, known as PASS, acts as the point of sale interface for our products, enabling our distribution partners to rapidly quote and buy (phon) policies via the automated processing. Of note, several of our products enable our distribution partners to quote, sign and issue policy in less than one minute.

Our systems also permit us to run detailed proposal analytics for internal and external constituents, including distribution partners, carrier partners, and reinsurers. We believe that this real time access to data and analytics offer advantages in distributing our product, managing our risk, and purchasing reinsurance. Importantly, we also pre underwrite several of our products into our policy administration system, which allows us to minimize underwriting errors and scale these lines of business. Our technology platform has been a key factor in expanding our distribution network and moreover growing the Company.

Our differentiated product and easy to use systems combine to generate high satisfaction from our producers and policyholders. This is demonstrated by our strong policy renewal rate, which offer visibility into future revenue. In 2018, our lines of business experienced average monthly premium retention of 84% with our largest volume of residential earthquake above 93%, and Hawaiian hurricane line at 100%.

Looking forward, our growth strategy is to diversify our book of business by extending our geographic reach, broadening our distribution plan, and expanding our product portfolio. Today we are licensed in 25 states, California and Texas representing our largest exposures at 56% and 19% of our gross business premium respectively at quarter-end. We also have applications for certificates of authority submitted in three states and have notable new geographic extension initiatives underway, including the expansion of our specialty homeowner and flood products into several new states.

Our first quarter results provide further evidence of the successful execution of our growth strategy and the competitive advantages Palomar possesses. During the first quarter, our gross written premiums grew approximately 59% year-over-year. This strong performance was paced by our residential earthquake products which grew by 75% during the quarter, as well as our commercial all risk product, which grew approximately 158% for the same period. Other strong performing products included our Hawaii hurricane, flood and commercial earthquake line.

One particular driver of growth in the first quarter was the continued success of our carrier partnerships strategy. We worked with over 20 other insurance companies to select Palomar to provide specialty property insurance products to their customer base. In the first quarter, we consummated a new partnership with a homeowner's carrier, whereby Palomar assumed a diversified book of residential earthquake business that fit our underwriting criteria, via an assumed reinsurance agreement. The partnership added approximately $6.6 million of in-force premium in the first quarter.

Additionally, during the quarter, like others in the market, we saw an improving pricing environment in the commercial line segment of our business. On the whole, our average commercial accounts increased approximately 5% in renewal on the first quarter, though it varied by product, geography and whether the account was loss affected. This healthy pricing environment translated in sequential improvement in our monthly premium retention for the commercial lines and the book of business on the whole.

Our commercial earthquake product saw average monthly premium retention of 80% in the first quarter compared to 74% full year 2018, and commercial all risk was 92% in the first quarter compared to 81% in 2018. Average monthly premium retention in the first quarter across all lines of business was 86% compared to 84% in 2018.

During the first quarter, we also made two new strategic hires. As previously announced, we hired Robert Beyerle as Senior Vice President of Underwriting. Robert spent the last 16 years at Great American Insurance Group, most recently, as Divisional Senior Vice President of Company's property and Inland Marine Division. Robert is leading Palomar's new Inland Marine Division and his first product is a builder's risk program that we expect to have live in the second quarter. It will provide a new source of commercial lines growth and diversification while at the same time leveraging existing Palomar infrastructure.

The second key addition to our team, Jonathan Knutzen, joins Palomar as our new Chief Risk Officer subsequent to quarter-end. Jon joined us from TigerRisk, where he was a partner, leading the firm's Property Specialty and Reinsurance Solutions practice. Jon will wear multiple hats at Palomar in his role as Chief Risk Officer, including contributions to the data analytics team and refining our assumed (phon) reinsurance strategy. The addition of both Robert and Jon further reinforce Palomar's commitment to growing their commercial specialty lines of business in a disciplined and analytically informed fashion.

Lastly, we continue to generate high returns as our business model is benefiting from scale. While the first quarter will show we generate an annualized return on equity of a negative 58.2%. That is primarily a function of the $23 million non-cash stock-based compensation charge that we incurred in the quarter related to our IPO. When adjusting for this one-time expense, we delivered an annualized first quarter adjusted ROE of 35.7%, which compares to an annualized 27.7% ROE for the first quarter of 2018.

Our results are a testament to our high retention differentiated product, thoughtful risk transfer strategy and our commitment to predictable earnings. I would now like to turn the call over to Chris for a more detailed review of our financial results.

Chris Uchida:

Thank you, Mac. During my portion, when referring to the per share figure, I'm referring to per diluted common share, unless otherwise specifically noted. For the first quarter of 2019, our net loss was $14.4 million, or a loss of $0.85 per share, as compared to net income of $5.6 million or $0.33 per share for the same quarter in 2018. For the first quarter of 2019, our adjusted net income was $8.8 million, or $0.52 per share, as compared to net income of $5.6 million or $0.33 per share for the same quarter of 2018. First quarter 2019 adjusted net income excludes (phon) the $23 million stock compensation charges that were incurred related to the IPO, as Mac discussed, plus other minor one-time items, including the tax effect of those items.

Our diluted book value per share at the end of the quarter was $5.99, which was an increase of $0.33 per share from December 31, 2018, and an increase of $1.11 per share on March 31, 2018. Our diluted tangible book value per share at the end of the first quarter was $5.95, which was an increase of $0.33 per share from December 31, 2018, and an increase of $1.11 per share from March 31, 2018.

Gross written premiums for the first quarter were $54 million, representing an increase of 58.8% as compared to the prior year's first quarter. This growth was driven by new business across multiple lines, strong policy retention rate and continued geographic expansion, as we're now an admitted insurance carrier in 25 states across the country. As Mac previously mentioned, our increase in gross written premiums was largely driven by the strong performance of our resident earthquake product, commercial office product, specially homeowners products and the addition of new partnership.

Ceded written premiums for the first quarter were $26.1 million, representing an increase of 89.7% as compared to the prior year's first quarter. The increase in ceded written premiums was primarily due to increase ceding of written premium related to our Specialty Homeowners operations in the State of Texas. Ceded written premiums related to excessive (phon) loss reinsurance also increased based on higher exposure from the growth of our overall portfolio for the respective periods. Net earned premiums for the first quarter were $18.4 million, an increase of 2% compared to the prior year's first quarter due to the growth in earnings of higher gross written premium offset by the growth and earning of higher ceded written premiums.

Commission and other incomes for the first quarter was $586,000, an increase of 8.5% compared to the prior year first quarter, as we expanded our fee-related activities of underwriting on behalf of third-party capacity. Our expense ratio for the first quarter of 2019 was 192.1% compared to 61.5% at the end of the first quarter of 2018. The year-over-year increase is largely due to stock compensation charges and one-time expenses related to our IPO as Mac discussed.

On an adjusted basis, our expense ratio reflecting significant expenses related to building out our team and systems to capture the market opportunity in front of us, but track more in line with our historical average at 65%. We continue to believe our business will scale over the long term.

Combined ratio for the first quarter was 193.8%, and compared to comparative combined ratio of 66.7% for the prior year's first quarter. The adjusted combined ratio, which we believe is a better assessment of our efforts during the quarter, was 66.7%, flat compared to the prior year's first quarter. Losses and loss adjustment expenses incurred in the first quarter were $316,000, a decrease of 66.3% compared to the prior year's first quarter. The decrease was driven by lower losses for the quarter, including modest prior year loss development compared to the amounts recorded through the end of 2018. The decrease in the loss ratio was driven by the improvements in the attritional losses for the period, including the transition of our Texas Homeowners program to a funding arrangement during the second quarter of 2018.

As of the first of this year, we retained approximately $5 million of risk per cat event and have $850 million of per event coverage in place. We continue to emphasize a conservative risk transfer strategy oriented toward limiting our exposure in the event of a major catastrophe and reducing volatility in earnings. Furthermore, we protect our balance sheet in order to capitalize on post-event market demand and dislocation.

Net investment income for the quarter was $1 million, an increase of 55.6% compared to the prior year's first quarter. The increase was largely due to a higher average balance of investments during the first quarter of 2019. Importantly, we take a conservative approach as our funds are generally invested in high quality securities, including government agency securities, asset and mortgage-backed securities and municipal and corporate bonds that have an average credit quality of double A.

The weighted average duration of our fixed maturity investment portfolio, including cash equivalents, was 3.9 years at quarter end and 3.9 years at December 31, 2018. Cash and invested assets totaled $159.2 million at quarter end as compared to $156.9 million at December 31, 2018. Effective January 1, 2018, the Company adopted new accounting standards, which prescribed several changes, including eliminating the available for sale classification of equity investments, and requiring changes in unrealized gains and losses, and the fair value of equity investments to be recognized in net income.

For the first quarter, the Company recognized realized and unrealized gains on investment in the consolidated statement of income of $2.4 million. The majority of the gains will monetize during the quarter through the sale of our equity indexed fund and the rotation into index funds that invest solely in corporate debt and fixed income securities. At quarter end, we have no exposure to the traditional equity market.

The effective tax rate for the three months ended March 31, 2019 was negative 1% and negative 0.1% for the comparable quarter—for the 2018 comparable quarter. For the quarter ended March 31, 2019, the income tax expense increased $151,000 due to positive taxable income during the quarter that was partially offset by the benefit from the reduction of a valuation allowance on our deferred tax assets.

Following the completion of our IPO in mid-April, we had a total of 23,468,750 shares of common stock outstanding. Stockholders' equity was $101.9 million at March 31, 2019 compared to $96.3 million at December 31, 2018. For the first quarter of 2019, annualized return on equity was a negative 58.2%, which compares to 27.7% for the prior year's first quarter. However, over the same period, annualized adjusted return on equity increased to 35.7% from 27.7%. The increase in the annualized adjusted return on equity was due to improvement in the underwriting performance and a higher return on the investment portfolio.

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

Mac Armstrong:

Thank you, Chris. To conclude, we use an analytically driven framework that results in differentiated products and, ultimately, superior underwriting. This framework has enabled Palomar to rapidly grow premium, capture market share, and importantly, put us in position to scale the business.

Our strategy is best validated by the strong market acceptance of our products and the associated 75% compound annual growth in gross written premium from 2014 to 2018. The first quarter further exemplifies this dynamic with gross written premium approximately 59% year-over-year. Additionally, our analytically driven underwriting and risk transfer strategy helped to drive our performance this past quarter. We believe it will continue to limit downside risk and provide strong visibility into future earnings growth going forward. Our team sees numerous opportunities for profitable growth and are excited by our future prospects.

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

Operator:

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

Our first question here is from Mark Hughes from SunTrust. Please go ahead.

Mark Hughes:

Yes, thank you very much. Good afternoon.

Mac Armstrong:

Hey Mark, Mac Armstrong here, how are you?

Mark Hughes:

Good, Mac. Question on the other expenses, and Chris, you might have touched on this. You clearly did very well at the top line. I think your other underwriting expenses were pretty similar to what you had discussed at the time of the IPO. If you continue to outperform at the top line, do you think the absolute level of expenses will kind of hold steady with what you thought previously? Or should we see some lift, if you do get that faster top line growth?

Chris Uchida:

Hey, Mark, yes, this is Chris. That's a great question. When we look at our other operating expenses, obviously, when you look at the quarter, there are the two main things in there that we need to back out, you need to back out the stock compensation expense and then also some of those one-time expenses related to the tax restructuring for the IPO.

With that, I would say that we do expect the business to scale over time. We think that we have invested a lot in the systems and the people. We think that those operating expenses, from a pure dollar standpoint, will definitely flatten out, and definitely in comparison to the top line growth that we are seeing. We're not giving specific guidance on where those numbers are going to go. But we definitely feel that we've built a business that's going to continue to scale over the long-term.

Mac Armstrong:

Yes, Mark, this is Mac and I'll just add a little more color to what Chris just said, just maybe an anecdote. For instance, we brought on Robert Beyerle to lead our Inland Marine department, and he generated no written premium in the first quarter. He was really focusing on developing rates, developing products and investing in system infrastructure. We're going to start to get a return, not just on the fixed costs, but there are also—we've also made investments in revenues or premium generative items too.

Mark Hughes:

Understood. On the commercial all risk, that was a strong contributor to growth. Is there some seasonality to that business? How much more momentum do you think you have? Where are we in terms of your kind of roll out on the commercial all risk?

Mac Armstrong:

Yes, Mark, this is Mac, that's a great question. We were very pleased with how that line of business performed. As Chris highlighted, it grew in excess of 150%. I think it's good to just provide a little backdrop of what's driving that growth. As you may recall, in the end of the third quarter, we entered into a new partnership where we had two quota share reinsurers supporting us and taking 60% of the risk on. The first quarter really reflected us being in the market broadly with those two quota share participants, Swiss Re and Ren Re, that offered us the ability to write larger limits, but not change our risk profile.

The first quarter kind of is emblematic of where we think the program kind of is and has the potential to even grow beyond as we broaden the distribution footprint and benefit from a higher financial size category post the IPO. I don't think there's much seasonality that's driving it. I think it's really just reaping the benefit of the broader limit that we can put in the market, as well as the broader distribution—the bigger limit, rather, and the broader distribution.

Mark Hughes:

Final quick one, on the investment gains, was the tax rate on that similar kind of flat, negative 1%, or was there different tax rate you might think about for the gain?

Chris Uchida:

No, for those gains—Mark, this is Chris, again—yes, we would say that the tax rate for the quarter, reflects a couple things. It reflects the release of the valuation allowance; the overall growth that we had in the first quarter allowed us to release the federal deferred tax asset valuation allowance. That was obviously driving that rate down. We also have the stock compensation in there. That's another big driver of the change in the rate. I would say that everything else on the book is probably averaging about 21% to 22% effective tax rate, if you back out those items. There's a little more detail on that when the full 10-Q comes out, or I guess we'll file out later today, but I don't think you guys will be able to see it until tomorrow.

Mark Hughes:

Very good. Thank you.

Mac Armstrong:

Thank you.

Operator:

Our next question here is from David Motemaden from Evercore. Please go ahead.

David Motemaden:

Hi, thanks for taking my questions. Just was wondering if you have a view, or what you guys are seeing in the reinsurance market, because you have a few layers renewing on June 1. Just wondering what you're seeing in terms of rates on some of those treaties that are going to be renewing up here in the next few weeks?

Mac Armstrong:

Hey, Dave, this is Mac, thanks for the question. I guess what I would tell you is we're not—we can't offer perspective on what's going on right now in the market because we are in the midst of the market. We have two different kind of treaties, renewing. One of the two treaties we have in the market is finalized and the other is near. We would expect to issue an 8-K on the reinsurance placement once, indeed, it does come to completion. What I would say is a good indicator in our eyes is to look to what happened at the 4-1 renewals, where you had a lot of loss effective business, in particular in the Japanese market, come up for renewal and loss-affected business did see an increase. But non-loss affected layers or lines of business did not see much in the way of an increase, if maybe a modest one.

I think that is a good indicator of what we would expect. I think it's worth reiterating, the majority of our program is very unique and distinct and it's, frankly, not loss impacted. If you look at our—what's up for renewal, 6-1, outside of our 10X to five layer, there is nothing that's been loss affected, and it's driven by Residential Earthquake in Hawaii Hurricane. Again, we are really the only buyer of reinsurance that has prevailing exposure—with prevailing exposure is Earthquake and Hawaii Hurricane.

We feel 4-1 is a good indicator, and that's what I'd point you to for now. We'll let you know, as soon as it's wrapped up, what we saw.

David Motemaden:

Okay, great. Then there were a few severe weather events, wind events in the Southeast U.S., Texas, Mississippi and Louisiana. Just wondering if you have any initial view in terms of any losses that you guys may have from those events?

Mac Armstrong:

Yes, Dave, this is Mac again. What I would tell you is nothing that's material at this point. It's worth reiterating that in Texas, the majority of our book, we act as a front. While there could have been damage in the residential segment of our book, we're really not on risk there, because we do act as a front. But going back to it, the severe weather activity, we've been mindful of it, we've had claims, but nothing that's material.

Chris Uchida:

One thing I'd add is, Mac was talking about with the funding arrangement that we put in place in Texas, you can see in the quarterly results that the losses for 2019 performed a lot better than the losses in 2018. I think if you didn't factor in the fact that in 2018 the first quarter loss results reflected a prior year benefit about $1.5 million. That Texas front and the reinsurance arrangements that we put in place to minimize the volatility in earnings really shows a lot more if you weigh that in. You're talking about $300,000 number versus a number that's closer to $3.4 million with the $1.5 million added to it.

David Motemaden:

Okay, great. Then just my last question, just thinking about your rating at A.M. Best and just wondering, following the IPO, if you guys have any visibility in terms of when you think that might be changed, at A.M. Best?

Mac Armstrong:

Hey, Dave, this is Mac. What I would say is we're focusing right now on the A minus 8 size—financial size category, so an A minus 8 rating. That is really triggered by the size of your capital base and surplus. Once the 10-Q is filed, we will have reached that threshold, which will put us in the A minus 8 rating. As relates to the long term rating of the Company, I think we want to continue to execute to put us in position for a change in outlook and then subsequently an upgrade in the rating. I think we'll try to get back to A.M. Best to walk them through the first half of the year's results in the summer and then go back for annual review. But it's really the financial size category that's more germane to us being able to right—opening up commercial distribution sources.

David Motemaden:

Okay, great. Thanks for the answers.

Chris Uchida:

There's one quick correction, I said $3.4 million. It should have been $2.4 million for the total losses in first quarter of 2018. Sorry about that.

Operator:

The next question here is from Jeff Schmidt from William Blair. Please go ahead.

Jeff Schmidt:

Hi, good afternoon, everyone. Question on the $8 million residential earthquake book that came over from a homeowners carrier. Was that kind of a one-time thing or do you expect more premium from that relationship?

Mac Armstrong:

Hey, Jeff, it's Mac, yes. That's a great question. I think that that partnership, first and foremost, we were thrilled to bring that on to the books. We think it's an ringing endorsement of our partnership strategy. It's one that we had chased after for a long time and it shows that people are coming to view us as a specialty property specialist, for lack of a better term. But so embedded in the $8 million from that partnership is $6.5 million or $6.6 million of unearned premium that is one-time, but the Delta in there is kind of recurring. We believe that, that partnership, a good way to look at that is if you take that unearned premium and double it, that's a good proxy for the recurring premium base associated with it.

I think it's also worth pointing out that the Residential Earthquake business grew 74% in the first quarter, even excluding this UEP pop if you would, the unearned premium transfer pop, it grew 36%. Very healthy organic, same-store growth.

Jeff Schmidt:

Are there other books that could come over from that relationship? I guess what I meant more for is that…

Mac Armstrong:

That relationship is going to—that is specifically a Residential Earthquake partnership. That doubling the $6.6 million, that is kind of a good frame of reference for that specific partnership. We have partnerships with over 20 companies at this point. We continue to pursue incremental partnerships. It's been a great channel for us. We think it will remain a great channel. There are a lot more in our pipeline. They're very hard to handicap when they will come on because it is such a long sales cycle and then a long on-boarding process. There are multiples of them out there. We just don't predict when they come online.

Jeff Schmidt:

Got it. Okay, and then looking at some of the smaller products, Hawaii hurricane and flood. Obviously you're pretty early stage there, but do you expect to ramp those kind of like the commercial all risk, I mean, can they be ramped that type of rate?

Mac Armstrong:

Yes. This is Mac again, Jeff. What I would tell you is the Hawaii hurricane grew approximately 38%, quarter—year-over-year, excuse me, in the first quarter. We think that is a terrific growth rate. The one thing that will govern our ability to grow at the same rate as we did in the All Risk, is the size of that market, but we think that we can continue to grow it at an attractive level.

The flood, which grew in excess of 100% year-over-year in the first quarter, we think that one will continue to grow at a nice rate and could start—the thing that we are excited about that product is you kind of have a bit of a regulatory option on it, in the sense that we are growing that on a state by state basis, on an agent by agent basis, but there could be some type of a regulatory shift which would allow—that would allow the NFIP to potentially re-underwrite its book, would allow greater options for banks to accept private market flood, in particularly Fannie and Freddie. We like to view that as kind of a nice blocking and tackling product that's growing at a very nice rate, but has great upside potential if there is some type of regulatory change.

Jeff Schmidt:

Okay, and then any update on new products in development, the Builders Risk or Inland Marine?

Mac Armstrong:

Sure, Jeff, this is Mac again. What I would say, the Builders Risk and Inland Marine, we spent the first part of—the entirety of the first quarter working on rate filings, system development, distribution partnerships, building out a distribution network to put us in a position where we think that we will write business in Q2. We would expect the Builders Risk to start to see some premium in the second quarter. Then Inland Marine, in particular, contractor's equipment and installation floaters and things of that sort would follow from there. But we’ve got pretty good traction as related to rate filings and state approvals and the like.

Jeff Schmidt:

Okay, thank you.

Operator:

Our next question is from Meyer Shields from KBW. Please go ahead.

Meyer Shields:

Great, thanks. Two questions on acquisition expenses if I can. The first is whether the unearned premium transfer or just the initiation of that relationship, does that involve any unusual level of acquisition expenses? Second, how should we think about that particular line item scaling or being affected by continued scale up?

Chris Uchida:

Yes, so I think the acquisition expense is—just specifically to that one partnership, the unearned premium transfer that comes on, does have acquisition expense associated with it for that. It is earned very similar to that premium. Let's call it $100 of premium is earned, there's acquisition expense, or similar percentage of that to any other type of business. Whether it be—if it's a 20% acquisition expense for a piece of business, that would be $20 of expense. It's earned pro rata, very similar to how that premium will be earned over time. I wouldn't call it anything unusual, or specific that's going to cause a pop or a drop in acquisition expense. It should just be smooth as the unearned premium is.

Mac Armstrong:

Meyer, it's Mac. On the second question that you asked, I would say, as we continue to grow the All Risk, that's going to help drive down the acquisition expense. You'll see in the 10-Q that the acquisition expense in the first quarter of '19 was 17.1% versus, I think it was 23% in the first quarter of '18. That reflects the fact that we are getting ceding commissions from these quota share partners that we use as a contract expense, the acquisition expense. That will allow us to drive the acquisition expense down on a prospective basis as All Risk continues to grow, and more of these of quota share arrangements increases the percentage of the overall premium.

I think the other component is the acquisition expense on All Risk, as well as our commercial earthquake, can be a little bit lower, so it's commercial business growth. We should see the acquisition expense tick down from that dynamic as well.

Chris Uchida:

The other big portion that's in there is the Texas front, first quarter of 2019, compared to the first quarter of 2018. That front was put in place in June, on June 1 of 2018. This is the first time you're seeing that show up. That's also helping to drive the overall acquisition expense down as that includes the ceding commission from those quota share partners.

Meyer Shields:

Okay, fantastic, that's very helpful. Chris, I didn't catch whether you disclosed the impact of prior year reserve settlement on losses in the quarter.

Chris Uchida:

We did not disclose that in the earnings release, but it will be in the Q. I can tell you that for 2019 it's a minimal increase in prior year reserves. I think it's about $38,000. But like I said earlier, you really, if you look at comparing quarters, the 2018 quarter has about $1.5 million of beneficial development. It's reduced by $1.5 million. When you're comparing apples to apples, you can really see how well 2019—or how good 2019 looks compared to 2018 with those quota shares in place and minimizing the overall net losses that we have to recognize on our books.

Mac Armstrong:

Yes, this is Mac. The good thing about it being $38,000, we can tell you to the claims which one they were, and they were handful. It's a pretty modest amount, like Chris said.

Meyer Shields:

Completely got it. Thank you so much.

Operator:

Our next question is from Sue Lee from Barclays. Please go ahead.

Sue Lee:

Hi, thanks for taking my question. How would you see your business mix and catastrophe exposure as well kind of evolving over time as you guys add these new products and expand into other space?

Mac Armstrong:

Hi, Sue, this is Mac. Yes, that's a good question. We continue to look at diversification as a sound strategy for several purposes; one, insulating us from swings in the broader insurance market. Two, not being overly concentrated in a specific region or product. We're going to want to continue to espouse that philosophy. I think, kind of directionally, we've always said we want a balance of commercial and residential business. I'd like to see our commercial business, especially with the current pricing environment, increase as a percentage of the total book of business. I would expect that to happen, especially on the heels of us reaching the new financial size category, and rolling out new products like Builders Risk and Inland Marine. I'd like to see commercial business increase as a percentage.

Similarly, I think if we continue to look at other geographies outside of California; California is approximately 53% or so of our total business. We wouldn't mind seeing that come down. But at the same time, we love the fact that that's really residential earthquake is our bellwether programs and products. We have a ton of conviction in what we're doing in that segment. But I'd like to see us diversify and California come down as a percentage of total business over the long-term.

Sue Lee:

Great, and then would you guys envision any sort of change to your reinsurance strategy as you grow and scale?

Mac Armstrong:

That's a terrific question as well. What I would say is there's some sacrosanct principles and it starts with where we're projecting to. We want to make sure that we always have a cushion that is beyond the 1 in 250 year PML. That is something we will not deviate from. I think the one thing that we will continue to look at as we grow capital through earnings, and certainly on the heels of the IPO, is just how we participate in that. That could inform how we participate in quota share reinsurance arrangements, it could inform how we participate in reinsurance arrangements, and then also what our retention is.

We like having the optionality that a bigger balance sheet affords us. That will be a little more fluid. But again, fundamentally, to use the term, the sacrosanct principles maintaining a cushion above the 250, the 1 and 250 year PML that is.

Sue Lee:

Great, and then if I can just sneak in one last one, just in terms of that A-minus 8 category that you guys are looking to get from A.M. Best. Any sense of how much additional distribution you could get through some of the big alphabet broker houses and how you guys think about that?

Mac Armstrong:

Sue, this is Mac. That's a good question. What I would say is, it's a little too early to handicap. I can tell you anecdotally we have some distribution sources that have been kind of nipping at our heels asking about when that was going to be triggered. Others, we've kind of let them know. They're saying, terrific, that's great. But I think a good rule of thumb is, is if you look at the normal quoting process for our commercial business, it's anywhere from 60 to 75 days out for certain lines, and maybe a little bit inside of that for others. I don't see us really reaping the benefit of broadening that distribution until hopefully the third quarter or maybe even the fourth, because some of it's going to be incumbent upon us to go out and market to people too.

Sue Lee:

Got it, understood. Thanks for the answers.

Operator:

Our next question is from Paul Newsome from Sandler O'Neal. Please go ahead.

Paul Newsome:

I'm almost out of questions. The only follow-up I had was, is there any change in sort of how you think of the business mix prospectively with the new people on board, does that change your plans? Or is it just the same plans you have through the IPO?

Mac Armstrong:

Yes, hey Paul, it's Mac. I would say, no, I don't think it's going to change vis-à-vis pre the IPO. As we get traction in Builders Risk, we could pivot to different geographies based on what the distribution is telling us. But I don't think it's going to be any departure from the specialty property focus.

Paul Newsome:

Thanks. That's only I had left. Appreciate it.

Mac Armstrong:

Thank you.

Operator:

As a reminder, if you'd like to ask a question, it is star, one. The next question here is from Mark Hughes from SunTrust. Please go ahead.

Mark Hughes:

Any update on the commercial quake? Just sort of curious that was—you saw that good growth there but a little lower than your other lines, the pricing, competition, demand?

Mac Armstrong:

Mark, yes, you're right. It looks like—this is Mac—it looks like it is lower growth. I think quarter-over-quarter, it points to 12%. But it's worth pointing out that in the first quarter of 2018, we terminated one distribution partnership that resulted in us non-renewing in Q1 '19 over $1 million of premium. If you exclude that, and kind of do it on a same-store basis, it's 26% growth, pretty close to our other lines. I will tell you, that's the line that we think there's the greatest potential upside for growth on the commercial business because of the A-minus eight financial size category. I think we might see a bit of a lift. But I view it—we did pretty well growing 26% on a same-store basis, if you would.

Mark Hughes:

Got it. Thank you.

Operator:

This concludes the question-and-answer session. I'd like to turn the floor back to Mr. Armstrong for any closing comments.

Mac Armstrong:

Terrific. That concludes Palomar's inaugural earnings call. We hope you walked away with a keen sense of what we believe was a strong quarter. But moreover, we hope that you got a keen sense of how this quarter was emblematic of our near-term and long-term strategy. The Management team of Palomar is really excited about what the future holds. With that, thank you and see you next quarter.

Operator:

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