Fourth Quarter and Full Year 2022 Earnings Call Transcript

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PRESENTATION

Operator

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

As a reminder, this conference call is being recorded.

I would now like to turn the call over to Mr. Chris Uchida, Chief Financial Officer.

Please go ahead.

Chris Uchida

Thank you, Operator, and good morning everyone. We appreciate your participation in our Fourth Quarter 2022 Earnings Call. With me here today is Mac Armstrong, our Chairman and Chief Executive Officer.

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 February 23, 2023.

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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 related to the COVID-19 pandemic. Such risks and other factors are set forth in our quarterly report on Form 10-Q filed with the Securities and Exchange Commission. We do not undertake any duty to update such forward-looking statements.

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

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

Mac Armstrong

Thank you, Chris, and good morning, everyone.

I'm very pleased to report our strong results for the fourth quarter and the full year of 2022. I am proud of our team's achievements over the past year and most notably delivering record gross written premium growth of 65%, record adjusted net income of $71.3 million, and an adjusted ROE of 18.3%, even with the negative impact of Hurricane Ian.

Full year results reflect stellar execution of Palomar 2X, our strategy to profitably grow the Company, deliver predictable earnings, and achieve an ROE in excess of 20% while maintaining industry-leading profit margins. Over the course of the year, we made demonstrable progress in achieving the long-term objectives of Palomar 2X, as we enhanced our position in existing products, launched new lines of business, and invested in underwriting, technology, actuarial, and data analytics infrastructure to both sustain and catalyze our growth.

Our vision remains unchanged as we strive to build a premier specialty insurance company. Our vision is reinforced by the growing team of 195 professionals who continue to operate at an incredibly high and productive level.

Turning to the fourth quarter. Our strong results were highlighted by 60% written premium growth, a 22.4% loss ratio, and an adjusted ROE of 22.4%. Importantly, our premium growth was strong across all products, Property, Casualty, and Fronting. Our core earthquake business grew 40% with residential earthquake growing 26% and commercial earthquake products growing 66%.

The continued dislocation in the earthquake market has been amplified by the hard reinsurance market, which affords us the ability to both grow and optimize our book of business with rate increases and improved terms and conditions. Beyond our earthquake franchise, inland marine grew 82% as compared to the fourth quarter of 2021, largely driven by our builder's risk products.

Our recently launched excess property book grew 60% sequentially as it constructed an attractive book of business with negligible catastrophe exposure.

Similar to our Property products, our Casualty business saw strong growth in the quarter. Casualty lines grew 147% year-over-year, highlighted by 233% growth in our newly-launched professional liability lines,

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and 35% growth in excess liability. Importantly, all the casualty products are performing in line with our expectations from a loss perspective.

We are thrilled with the success of the Palomar FRONT business. During the quarter, it generated $69 million of premium, versus $11.5 million in the prior year. Palomar FRONT delivered $223 million in managed premium in 2022, well in excess of the original guidance of $125 million to $145 million provided a year ago. The managed premium from Palomar FRONT offers an attractive and growing fee income stream as we move into 2023.

Beyond the sound financial results generated during the fourth quarter, our team successfully navigated the choppy waters of the global insurance market as the industry digested the impact of inflation, weakened balance sheets, and Hurricane Ian. From an underwriting standpoint, we continue to find balance between exposure growth, rate increases and enhanced terms and conditions for all products, but most notably our property book of business.

Our E&S risk book saw an average rate increase of 40% with exposures decreasing approximately 35% year-over-year. Our inland marine book saw regional variance in pricing with builder's risk accounts seeing new projects priced 15% above the prior year. Our growing casualty books saw exposure growth with disciplined rate action. For instance, our most mature casualty line, real estate agents E&O, saw an 8.5% rate increase in the fourth quarter.

As it pertains to earthquake, we continue to focus on taking advantage of the opportunities in the residential earthquake market as well as the emerging capacity of limitations in the commercial earthquake market. To that end, we successfully renewed our commercial earthquake quota share, modestly increasing the cession percentage, and locked in an incremental $52.5 million of California earthquake limit to support growth in the quarter. The risk-adjusted pricing on these reinsurance buys was approximately 30% above the expiring terms. While the pricing certainly reflects a hard reinsurance market, this increased favorably compares to those seen in headlines or other lines of business and reflects the quality of our reinsurance program, both the exposure, and reinsurer panel.

Importantly, this purchase allows us to sustain our strategic focus of profitable growth in the earthquake market. In an effort to keep pace with the increased cost of reinsurance, we will continue to push rate on our commercial book beyond the 16% we saw in the fourth quarter, increase our inflation guards, which now stand at 10%, and further utilize our E&S company for residential earthquake.

Additionally, we will look to strike diversifying and reinsurance-efficient partnerships such as the recently consummated deal with Bear River Mutual where we are assuming ex-California earthquake risk on behalf of a regional carrier in Utah.

Looking to the year ahead, we remain focused on executing Palomar 2X. First off, though, let me state that we believe that the cost of our core excess of loss reinsurance renewal will be manageable. It will be up year-over-year, likely at levels similar to what we saw in December and January, but the capacity is there to support our growth. As such, we will continue to grow in the earthquake market.

We've also identified 4 key strategic initiatives in 2023 that are central to Palomar 2X. One, sustain our strong profitable growth trajectory; two, manage the dislocation in the global insurance market; three, deliver predictable earnings; and four, scale the organization.

I am pleased to report that we are already making strong progress on all these initiatives. Selected examples include the January announcement of a new fronting partnership with Advanced AgProtection, a leading crop MGA, following the United States Department of Agriculture naming Palomar one of the

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14th approved crop reinsurers in the country. Looking ahead, we believe this could be a sizable business for Palomar in the long term.

Separately, in addition to the incremental reinsurance limit to support our growth in earthquake, we put in place a new quota share for our motor truck cargo product, a non-catastrophe exposed property line at attractive economics from blue-chip reinsurance partner.

Additionally, we are supporting a handful of outbound reinsurance treaties with a few long-standing trading partners and continue to look at ways to find mutually beneficial ways to work with our reinsurance panel. We are further reducing our continental wind exposure and we are working to get the 250-year probable maximum loss below $100 million this year. This effort will help mitigate rising reinsurance costs and volatility in the earnings base.

Lastly, we continue to make additions to our terrific team of professionals in areas such as casualty underwriting, data analytics, and treasury and investments.

We will continue to balance our capital allocation with a focus on investing in our growth initiatives and remaining opportunistic with our share repurchase program when our shares trade at a level we feel undervalues the business. As a result, we repurchased 222,217 shares at a total cost of $11 million in the fourth quarter, and a further 79,469 shares at a total cost of $3.8 million thus far in 2023.

Turning to our Full Year 2023 guidance, we expect to generate adjusted net income of $86 million to $90 million, which includes $2.5 million of net catastrophe losses from recent California flooding.

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, referring to any per share figure, I'm referring to per diluted common share as calculated using the treasury stock method. This methodology requires us to include common share equivalents such as outstanding stock options during profitable periods and exclude them in periods where we incurred net loss.

Additionally, beginning in the fourth quarter of 2022, we have modified our definitions of adjusted net income, diluted adjusted EPS, and adjusted ROE, to adjust for net realized and unrealized gains and losses. We have modified the current and prior period figures accordingly.

For the fourth quarter of 2022, our net income was $18.8 million or $0.73 per share, compared to net income of $16.6 million or $0.64 per share for the same quarter last year. Our adjusted net income was $21.1 million or $0.82 per share, compared to adjusted net income of $17.6 million or $0.68 per share for the same quarter of 2021.

For the full year of 2022, our adjusted net income grew to $71.3 million or $2.77 per share, compared to adjusted net income of $52.4 million or $2.01 per share last year.

Our fourth quarter adjusted underwriting income, which we believe is the best financial indicator for evaluating Palomar 2X, was $23.5 million compared to $19.9 million last year. Our full year 2022 adjusted underwriting income grew 37.8% to $77.1 million compared to $55.9 million last year.

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For the fourth quarter of 2022, our annualized adjusted return on equity was 22.4% compared to 18.2% for the same period last year. We remain confident in our strategy to achieve long-term growth at a predictable rate of return. Even with a full retention catastrophe loss, our adjusted ROE was 18.3% for the full year of 2022.

Gross written premiums for the fourth quarter were $239.1 million, an increase of 59.5% compared to the prior year's fourth quarter. For the full year, gross written premiums increased 64.8% to $881.9 million. Net earned premiums for the fourth quarter were $82.2 million, an increase of 21.2% compared to the prior year's fourth quarter.

For the fourth quarter of 2022, our ratio of net earned premiums as a percentage of gross earned premiums was 38.9% compared to 55.2% in the fourth quarter of 2021, and compared sequentially to 41.7% in the third quarter of 2022, decreasing as expected from the overall growth of fronting and lines of business that use quota share reinsurance. For the full year of 2022, our ratio of net earned premiums as a percentage of gross earned premiums was 45.5%, in line with our expectations based on the strong performance of our fee-based fronting business.

Losses and loss adjustment expenses incurred for the fourth quarter were $18.4 million, made up of attritional losses of $16.6 million and $1.8 million of prior period catastrophe loss development, primarily Hurricane Hanna and Winter Storm Uri. The loss ratio for the quarter was 22.4%, comprised of an attritional loss ratio of 20.1% and a catastrophe loss ratio of 2.3%. Attritional losses for the quarter include many catastrophe events such as Hurricane Nicole and Winter Storm Elliott. The loss ratio for the year was 24.9%, comprised of an attritional loss ratio of 20% and a catastrophe loss ratio of 4.9%.

Our acquisition expense as a percentage of gross earned premiums for the fourth quarter was 12.7%, compared to 22.2% in the fourth quarter last year and compared sequentially to 14.6% in the third quarter of 2022. Additional ceding commission and fronting fees drove the improvement.

The ratio of other underwriting expenses, including adjustments to gross earned premiums for the fourth quarter was 6.9%, compared to 9.2% in the fourth quarter last year and compared sequentially to 7.3% in the third quarter of 2022. Our adjusted combined ratio was 71.4% for the fourth quarter compared to 70.7% in the fourth quarter of 2021. Our adjusted combined ratio for 2022 was 75.6% compared to 76.1% last year. Excluding catastrophe losses, it was 70.8% compared to 73.9%.

Net investment income for the fourth quarter was $4.4 million, an increase of 81.6% compared to the prior year's fourth quarter. The year-over-year increase was primarily due to a higher average balance of investments held during the three months ended December 31, 2022, due to cash generated from operations and by deliberately shifting invested assets from lower-yielding investment assets into higher-yielding investment assets. Our yield in the fourth quarter was 3.3% compared to 2.2% in the fourth quarter last year. Our yield on investments made in the fourth quarter was above 5%.

During the quarter, we repurchased 222,217 shares of our stock for a total of $11.1 million, under our two-year $100 million share repurchase program. We have approximately $65.6 million remaining under the authorized program.

For the full year of 2023, we are providing an adjusted net income guidance range of $86 million to $90 million. This range includes approximately $2.5 million of net catastrophe losses resulting from the recent California flooding events but does not include any additional catastrophe losses for the year.

On a gross earned premium basis, we expect our net earned premium ratio and acquisition expense ratio to continue to decrease in 2023 from where they were in the fourth quarter of 2022.

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

Operator

Our first question comes from Mark Hughes with Truist Securities. Please proceed.

Mark Hughes

Chris, you mentioned you expect the earned to written to continue to decrease from the fourth quarter level. Any guidance on what that might look like for 2023?

Chris Uchida

Yes, as we have said and we have said for 2022 as well, we do expect the net earned premium ratio to continue to decrease. It was 38.9% in Q4 with the growth in fronting and other lines of business subject to quota share. We do expect that ratio to keep going down. I would expect for the year, that's probably going to be within the mid-30s, but it's just going to go down sequentially.

That takes into account the quota share business, but also the additional excess of loss reinsurance costs that we will be expecting at 6/1 of this year.

Mark Hughes

Then the quake business. How are you balancing the reinsurance buy here? Clearly, you have some view on how much capacity you will need to support growth and presumably you could grow even faster depending on how you approach the reinsurance market.

Do you have your vision of what the growth is going to be already dialed in, Mac?

Mac Armstrong

Yes, that's a great question, and it's something that we're really accutely focused on. I think stepping back, as I mentioned in my remarks, there is a dislocation in the earthquake market, both residential and commercial, and we are taking advantage of that. Taking advantage of it through rate, through enhanced terms and conditions whether that's deductibles or attachment, and furthermore, further utilization of the E&S company and particularly in the admitted side of the business.

The guidance that we provided does reflect solid growth in earthquake. It could be a lot more, but we do want to balance reinsurance capacity availability. What we have seen as 1/1 unfolded and as 2023 has commenced, is that there is capacity to support at least the growth that we are forecasting.

There was a lot of talk in the fourth quarter about the CEA and their reinsurance renewal. Frankly, I think that was something that we think that they are telegraphing. They had communicated that they were going to buy less limit at a Board meeting in the fourth quarter, and that did come to fruition. I think it was roughly $1 billion of less limit that was procured. That was part of their focus on bringing their capacity down to the 1 in 350 from their previous level.

That has freed up capacity that we can take advantage of. There have been a few earthquake programs that were rolled into all perils programs, so that also frees up capacity. There have been some large national programs that had underlying quake in them that were non-renewed or delayed. We do feel that there is ample quake capacity to support our growth.

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Our guidance reflects pricing that is up along the lines of what we saw when we bought incremental limit in the fourth quarter in January, but it is there to support our growth at a healthy level. Then again, we're going to continue to take rate and enhance terms and conditions and use the E&S company to make sure we're getting the rising reinsurance costs covered.

Mark Hughes

Chris, the attritional losses came in better than last quarter, and I think better than you might have guided to in your commentary within the quarter. Could you talk about that?

Chris Uchida

Obviously, we are happy with a better loss ratio and it is a little bit better than we expected when we projected out in the middle of December. When we looked at the numbers in October and November, there was some frequency and severity that was coming in. Fortunately, December came in a lot better than we expected and was able to bring that loss ratio back down to what we would expect a normalized loss ratio for the year.

It doesn't change our view on guidance. We still expect a loss ratio of 22% to 24% for 2023, with hopefully, that tailing off at the end of the year and into 2024, so no real changes there. But like you, we're happy with a good loss ratio, but it's within the parameters that we would expect.

Operator

Our next question is from Paul Newsome with Piper Sandler. Please proceed.

Paul Newsome

A quick follow-up on your comment on reinsurance and earthquake.

If you wanted to grow an earthquake faster, do you think there's capacity beyond what you are currently contemplating? Or is there some limit given the capacity out there?

Mac Armstrong

Just to elaborate on it. We have obviously forecasted growth in earthquake this year and there is capacity to support that growth. We do not want to overstep into the market because we obviously want to maintain the guidepost that we always have with respect to earthquake and making sure that we keep our tower in line, or if not above the 250-year peak zone PML, which is California quake. We also don't sacrifice too much margin for the sake of bringing on business that may not be generating the right risk-adjusted return.

That being said, in a market like this, our underwriting expertise, the vehicles that we have, whether it's the E&S company or the standard company, both commercial and residential appetite, we want to maintain a leadership position. Market cycles change. This is what some are calling the hardest reinsurance market since Andrew, maybe since Katrina, Rita, Wilma. We can navigate it.

It's going to position us well in the long-term to have a market leadership spot in quake. We're going to grow in quake. We're not going to grow egregiously, but we think we can grow and maintain the same type of reinsurance that we've always had in place.

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Paul Newsome

Any thoughts about the non-attritional losses, the catastrophe loss exposures prospectively in addition to what you've already said?

It sounds like you tried to pull the P&L down, but the business is also growing. Just anything that would be helpful as we think about this moving forward.

Mac Armstrong

With respect to the continental hurricane exposure, we are going to bring the PML down from $250 million at the peak of wind season in 2022 to $100 million at the peak of wind season in 2023, and we are well underway.

We've also made underwriting changes that are reducing our line size and avoiding concentrations in county levels, and obviously on a regional basis as well, and putting AAL caps in at a county level basis. What that is going to allow us to do is manage the reinsurance cost for all perils, which frankly, is the most expensive in cat XOL right now. It's going to also add predictable earnings in the sense that our AAL is going to meaningfully come down too.

We are getting a rate which will help with the attritional loss ratio for that line of business. As I mentioned, it was in excess of 40% in the fourth quarter, and it's moving higher in the first quarter of this year. But all that growth, in that line of business with that all risk business, is going to come from rate with commensurate exposure reduction.

Paul Newsome

How should we think about any potential retention changes on the cats as well?

Mac Armstrong

With respect to the retention, Paul, I think the fact that we are reducing our PML meaningfully on the all-peril side will help with the retention.

We've always said that we want to keep the retention and the parameters of our retention less than 5% of surplus and meaningfully less than quarter of pretax earnings. Maybe call it 1.5 months or 2 months of pretax earnings. The reduction in the PML will allow us to maintain that.

One guidepost that we've seen in the market is that reinsurers want to see a retention that's equivalent to a 1 in 10-year event, or in line with the 10-year event on the exceedings probability curve. That correlates to around a $15 million to $17.5 million level as we currently sit right now.

We'll see how that's priced out and whether or not we want to trade dollars, but I think that's a good construct to operate from now.

Operator

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

Tracy Benguigui

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When I hear commentary by your competitors, the outlook on casualty is pretty cautious, and I realize this is a greenfield operation fee, or not a huge piece. But you are making notable strides on growth, it was up 147% in the quarter.

With that backdrop, do you think 2023 is a year to grow casualty? If so, at what parts of the casualty market do you think you can grow and achieve attractive risk-adjusted return?

Mac Armstrong

We do think we can grow in casualty, but like you allude to, it's got to be in specific targeted segments. I highlighted on the call real estate E&O. We like that line of business. We have a long-standing history that frankly creates Palomar in that market. We did see rate there. It was up 8.5% in the fourth quarter.

On the other side of the equation, we do have a D&O book. It's not a large book, but we are writing some there, and we're focusing more on private company D&O where you're still seeing 5% up on renewals, at least that's what we saw in the fourth quarter, versus the public side, which is 5% down.

We want to be targeted there. Professional liability, miscellaneous professional liability, general casualty, which is kind of flat to plus 5%, that's what we saw in the fourth quarter. Those are probably the segments that we're going to go deeper in.

Then we are talking to a handful of underwriters that can help broaden the franchise in casualty. It might be a new segment that we enter into, but it will be very specific.

Tracy Benguigui

When I think about your fronting business, an important piece is achieving the fee income in the ceding commission. Are you seeing a compression on ceding commissions? Would that compression limit your growth trajectory for fronting business?

Mac Armstrong

We are consistently renewing our fronting programs throughout the year. Ultimately, the pressure on the ceding commissions might fall back more on the distribution partner, not on the fee that we get. We get a 5% to 7% fee that's based on us taking potentially some tail risk. Obviously, lending our balance sheet from collateral and managing collateral, and then also the licensing associated with a given product.

We have not seen any pressure on our structure. I think the fact that most of our fronting business is non-property also lends itself well to sustainability of that margin. On the whole, the fronting business has terrific visibility on growth into 2023. We added a new partnership in Advanced AgProtection, and we believe that we should sustain the margins and have a nice visible fee income stream to grow in 2023.

Tracy Benguigui

You said tail risk. I thought you ceded 100% of those premiums. Are you assuming any tail risk, or this is just helping MGA manage tail risk?

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Mac Armstrong

Ultimately, we have the specialty homeowner's business that is all reinsured out, and they buy beyond the 250-year PML. But we do put some excess amount into our program just for conservatism sake, so there is tail risk there.

Operator

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

David Motemaden

First question I have is on the AAL expectation for 2023. If I think about peak wind season, I think it was $6 million in the third quarter of 2022. But it sounds like you guys are reducing the PML pretty substantially, well over 50% is what it sounds like for third quarter 2023.

Any color you could provide there on what the AAL is as we head into 2023?

Chris Uchida

No, obviously Mac talked about it. We are meaningfully decreasing our PML. We are going to see a requisite reduction in our AAL expectations as well. Based on a like-for-like view of our reinsurance structure, that number would be in the force when we project out to September of 2023, so you are seeing a requisite reduction in that average annual loss calculation.

We like what we're seeing there, and we hope that it reduces the overall volatility and the catastrophe exposure that we have.

David Motemaden

Then following up on that. I think the catastrophe loss was obviously a bit higher in the third quarter of 2022 from Ian, which wasn't a normal year. But when you guys look at that loss, is that like a 1 in 50-year event for you guys, or 1 in 200-year event?

I'm just trying to get a gauge for triangulating with what you're doing with PMLs going forward and what an Ian-like event would mean going forward as well.

Mac Armstrong

Ian was, Dave, a 1 in 50 year, if not a little bit above 1 in 50, on our model results in EP curve. I think that Ian is developing in line with our original ultimate, if not some cautious optimism that it will come in below that.

The one thing that I'll say is the underwriting actions that we have taken in the reduction to PML puts Ian well below. The 50-year is much lower today than what it was in September, and it will be much lower in September of 2023 than what it is.

I think what you would see is Ian like-for-like would be equivalent from a retention perspective, if not lower at the end of 2023.

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David Motemaden

Then, Chris, I just wanted to follow up a little bit on the attritional loss ratio outlook for '23.

I don't want to be splitting hairs here, but I think it was 23% to 24% on the attritional loss ratio when you spoke about it last quarter. Now, it sounds like you guys are calling for 22% to 24%, maybe a little bit better on the low end.

But maybe just talk about, has your view changed at all given the commentary that you made. It sounds like it may have but just wanted to double-check.

Chris Uchida

Yes, I think there is. Obviously, this quarter showed that there is a little more favorability there, but you are correct, we did say 23% to 24%. I'd just say no material change in that outlook. But I think when people look at us from a quarterly standpoint, there is a concern when it moves around a point or two, so I did want to give a little bit of a leeway there.

Remember, when for a quarter, a point of loss ratio is only about $800,000 of net loss. It's not a big number in the grand scheme of things, but I want to make sure that people are considering that on a quarterly basis.

But that annual target for us, when we think about it is still, call it, 22% to 24%, which is well within the same guidepost, I would say, that we talked about before.

David Motemaden

Still, the view is that could drift up a little bit as we head into 2024?

Chris Uchida

No, I would say the other way around. I expected 2023, it's going to obviously go up from where it was in 2022. I would expect by the end of 2023 that there is going to be favorable pressure to push that loss ratio down by the end of the year.

Operator

Our next question is from Andrew Anderson with Jefferies. Please proceed.

Andrew Anderson

Some pickup this quarter in residential earthquake growth. I think in the past, you mentioned you haven't seen the proposed changes that the CEA really earned into results. Do the changes made in the last quarter with the reinsurance program give any greater clarity to the timing of that impact? Would any impact from CEA business be included in the guidance for 2023?

Mac Armstrong

The actions the CEA took, or the actions taken following the market downgrade specifically, AM Best downgrading them, didn't impact the fourth quarter. I think it has the potential to be a nice catalyst for sustained growth into 2023 and to 2024.

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Ultimately, what we are seeing right now is improved production from CEA member companies that also have a trading relationship with us, like an Allstate or our farmers. We are also starting to have conversations with other participating insurers that are exploring their options for alternative solutions.

It's helping us in the high-value segment as the CEA is further sub-limiting high-value accounts. The good thing about that is those high-value accounts are now moving more to our E&S company, which gets a better risk-adjusted return at a higher rate than what it does in the standard market.

CEA action is definitely informing the confidence that we have in the growth that's in the guidance for '23, but there is no step change function like a large matriculation out of the CEA by participating insurer that we pick up from.

Andrew Anderson

Inland marine growth this quarter picked up again pretty strong. Can you help us think about the growth profile in this business? It sounds like builder's risk. I would have thought perhaps in like a tougher economic backdrop, it could be a bit more pressured. But maybe this isn't the case with anything you are currently seeing in results.

Mac Armstrong

Yes, Andrew. It's astute that you would think builder's risk, because it is tied to homebuilders, would have some pressure on it in this environment.

I think there is a few things that are offsetting that, rather. One is we continue to expand geographically, whether it's through hiring new underwriters that have regional focuses or it's broadening distribution in the states that we had not been as active in. But furthermore, a lot of what we are writing there is niche segments like multifamily.

We are still seeing growth in multifamily, especially in a state like Texas. Again, this is a non-cat-exposed REIT segments of Texas, or Arizona, and even to a degree in California. The multifamily market remains pretty robust.

We do look at the economic impact or potential economic impacts on that line of business, probably as close as anyone that we have. But it's performing pretty well, as you can see by the growth.

Andrew Anderson

Maybe one last quick one. It sounded like the reinsurance announcement you made in December, risk-adjusted pricing was up 35%. I just want to make sure I heard that right, and that's the same expectation in the mid-year, but it sounds like if you use the E&S carrier a bit more, you will be able to push some rate through and get inflation adjustments on that as well to offset.

Mac Armstrong

It was 30%, just to clarify, but that informs us.

I think there is cautious optimism that 6/1 might not be as draconian as 1/1, but we are not going to hang our hats on that right now. But you are absolutely right. We do have levers, the E&S company, clearly on the commercial quake side, but also on the homeowner's side, the residential side, we can use the E&S company, and we are in an increasing fashion.

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Just as an aside, in first part of this year, about 20% of our new business on residential earthquake is E&S. That lever is being used in an increasing fashion.

Operator

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

Meyer Shields

First, Mac, can you talk about the distribution force that you have for agriculture?

Mac Armstrong

Sure. The crop deal, we are working with Advanced AgProtection, which is run by two long-standing crop executives, and they are acting as the MGA. They are handling the claims as well.

Ben Latham, who is the President there, he has been in this market for 30-plus years. He has distribution touch points throughout the Dakotas, Illinois, Iowa, Tennessee, and Ohio. Focusing on farmers and introducing brokers and farmers that write crop insurance like soybeans and some wheat, but more the beans and corn. It's going to be through an MGA with regional producers in those local markets.

Meyer Shields

Okay. If I am interpreting it correctly, we can expect a fairly rapid ramp-up in premiums because of their existing relationships.

Mac Armstrong

They should have existing relationships. We have not forecasted a ton of growth in 2023. We think it has great promise, 2023, 2024, and beyond.

They just got approval from the RMA and the USDA, and right now is when there is the majority of the business written up until about March 15, so they are bringing business on. I think it's really going to be a meaningful contributor in 2024.

I think it's important to point out that this is a fronted deal. We are going to get smarter in the market. Jon Christianson, our President, and Jon Knutzen, our Chief Risk Officer, have long-standing history in the market. They were both crop reinsurance brokers prior to their time with Palomar. But this is going to be purely fee generative, certainly in 2023.

Meyer Shields

Second question. When you talk about the PMLs coming down, does that have any impact on your need or desire to renew the aggregate cover?

Mac Armstrong

To me, it makes the aggregate all at more appealing to our existing reinsurance partners there. The aggregate fundamentally is designed around protection from a frequency of severe property catastrophe events, and then obviously providing an ROE floor.

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By reducing the wind PML, you are reducing the continental wind exposure that's in that aggregate and really making it look more like a third or fourth event cover for Hawaiian hurricane or earthquake. The reinsurers that have made money to date in it, I think they find it more attractive by the underwriting changes and the change in the book of business.

We are in the market on that and underway with discussions. I think we believe that we can get it done at economically compelling levels. If that's not the case, there are alternative structures that we could put in place that serve the purpose of protection from multiple severe events and where we would put that ROE floor on. It may not be in aggregate, though.

But we will let our investors in the market know as we get closer to 4/1.

Meyer Shields

Then final question. I don't know how this works from a rating agency perspective, but does the changing reinsurance market have any impact on your targeted net written premium to equity, or net written premium to surplus goals?

Chris Uchida

No, it does not. Our view is still the same. Obviously, we use a heavy amount of excess of loss. Really, I feel that that ratio is more pertinent to quota share even though we do use it for the catastrophe business.

But we still feel comfortable with the net written ratios targets for catastrophe being 1:1 and then for the newer lines of business that are subject to more attritional and less catastrophe exposed, such as the casualty line and the inland marines, builder's risk type lines, getting that ratio up to like a 1.5:1-type ratio.

We still feel very good about those ratios and there has not been any, call it, pressure or view change from our standpoint on how those are viewed.

Mac Armstrong

Yes. Just to add on and echo what Chris is saying. If you look at just our BCAR scores from past, they are well above our A- level. They are closer to an A+ level. More excess of loss actually helps the BCAR too.

Ultimately, we are going to manage the ratio as what we feel best and others are comfortable with. From a long-term perspective, if there is some deviation in the short-term is frankly going to be additive to how much premium we could write.

Operator

Our next question is from Pablo Singzon with JPMorgan. Please proceed.

Pablo Singzon

Mac, you had touched on this already, but I just wanted to get more color on your line of sight and comfort on the reinsurance costs you are embedding in the guidance. Given that you didn't renew your main programs for the mid-year, but it seems like you are in discussions in the market. You obviously did the quota share early this year.

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Your confidence and comfort level in getting the reinsurance costs that you are embedding in your expectations.

Mac Armstrong

Pablo, you are absolutely right. We are focused on it right now.

We were in London a couple of weeks ago. I am heading to Europe next week to meet with the host of our Continental European reinsurers. Jon Knutzen, and Chris Cebula, and John Christianson and I are spending a lot of time on it. We feel very good about the reinsurance assumptions that are in the guidance that we provided. Like I said, and like you've just touched upon, it is informed by what we procured and paid at 1/1.

Again, we feel that we have a lot of different ways to play the reinsurance market and manage the cost. But we are not going to deviate from the guideposts of the 250-year PML, retentions inside of 5% of surplus and less than a quarter or half a quarter of pretax earnings or some that are in that level.

But we feel very good that the capacity is there and the assumptions set in the guidance are achievable.

Pablo Singzon

Then second one for Chris. The 22% to 24% guidance on the loss ratio. I just wanted to confirm that that includes, first, the higher reinsurance costs you are going to pay the tier, so half of your higher reinsurance costs through the ceding. Then I think in the past, you have also talked about some books you are trying to run off that might produce elevated claims.

But I just want to confirm that the 22% to 24% is an all-in view incorporating in those two items.

Chris Uchida

That’s a very good view on the loss ratio.

Obviously, there is pressure on the loss ratio, because of the excess of loss costs and the quota share. Obviously, that impacted the denominator in that calculation. But yes, our target of 22% to 24% does contemplate that type of change and that type of pressure. As the excess loss changes, it does push up the loss ratio with actually not changing any of the net dollars.

No, that is a very astute view on that, but we do contemplate that and especially in the second half of the year.

Pablo Singzon

To follow-up on that comment, you provided your view for 2023, but if you think about 2024 and 2025, 2024 will essentially have a full year of higher reinsurance costs. It seems like, at least based on the numbers you gave, you think you can hold the line in 2023. But in 2024, do you see yourself holding line or is that gap going to increase, and obviously, you have to think about reinsurance versus what you are doing on the primary side.

But just any thoughts on how one full year of higher reinsurance pricing might compare against what you are doing on the primary side when thinking about 2024?

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Mac Armstrong

Yes. Pablo, thinking out to 2024, I actually think, you are going to have only five months of the 2023 costs. My expectation is 2024 will start to rationalize a little bit.

I am not going to make a call that the hard market will end, but I don't think the rate increases will be as pronounced. We are seeing some snippets of some capital coming in or more retro support than what was initially expected and that's a positive, certainly for the primary industry. I think it's a positive for the industry broadly.

I think as it relates to 2024, we feel there is no need for us to deviate from what we are doing in 2023 and 2024 would look a lot similar from a complexion and mix of excess of loss versus non-excess of loss business. Hold aside that there might be a little more rapid growth from some of the casualty lines or fronting lines.

Pablo Singzon

Then last for me, the AAL that you offer the $4 million, that doesn't include $2.5 million flood losses in California, right? That's more a Southeast exposure type number.

Chris Uchida

That's right.

Operator

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

Mark Hughes

Mac, when you look at the profit on your new quake business, is it as profitable say as it was last year before the reinsurance costs went up?

Obviously, with the business you had written on older pricing as you pay higher reinsurance costs, that's going to have some impact on your bottom line. But is the new business with updated pricing, with using the E&S company more frequently? Is it as profitable as what you were writing last year?

Mac Armstrong

Mark, it won't be as profitable as what we are writing last year.

Some of that is, frankly, driven by the fact that the good portion of our residential book in the standard market is written on admitted paper. We are getting a 10% renewal or automatic increase due to the inflation guard. But we can only use the E&S company for a portion of that where you can recoup those rising loss costs, and in the commercial, you can recoup a good portion of those rising loss costs.

But new business that we write this year will not have the same margin as a new business that we wrote in 2023. I think though it's important for us to reiterate, we want to maintain a market leadership position in an earthquake. It's still a very profitable line of business. Market cycles change, and so there could be

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a point where reinsurance pricing could conceivably decline, and then you are going to see some pretty elegance in the margins.

But on the whole, we are taking a long-term view. We think that for 2023, we are projecting 23.5% net income growth at the midpoint of the guidance with a very hard reinsurance market will still generate a 20-plus ROE and have a combined ratio that's in the low 70s. We want to maintain the leadership position in the quake market because it's still going to contribute to those numbers that I just gave you.

Mark Hughes

Chris, what's a good tax rate for 2023?

Chris Uchida

Obviously, tax rate is higher this quarter and higher for the year than we have talked about at 21%. The big driver of that, we do add back executive compensation that exceeds the maximums provided by the IRS. Then in Q4, it was driven by the fact that not many stock options were exercised, so it drove a little bit higher.

I think if that trend continues and I expect the tax rate to trend a little bit higher as well. I think if we go at that trend, it's probably going to be in the 22% to potentially 23% range. But if stock price does what we want it to do, then I think options come back in the table, and they can push it back down to 21%.

But I would probably say, today, 22% is probably a good target for 2023.

Operator

We have reached the end of our question-and-answer session. I would like to turn the conference back over to Mac for closing comments.

Mac Armstrong

Thank you very much, Operator, and thank you to all who are able to join us this morning. We appreciate your questions and your continued support. As always, I want to thank the team at Palomar who remain instrumental into our short and long-term success and their productivity is industry leading.

To conclude, we had a great year in 2022. We produced record written premium, record earnings, and an adjusted ROE of 18.3%. The results demonstrate the durability of the business model. I think the durability of the business model is even further evidenced in the guidance that we are giving for 2023.

We are confident that we will navigate this hard reinsurance market, and we will be able to generate strong net income growth and adjusted return on equity of 21%. More importantly, execute on Palomar 2X and deliver predictable earnings growth for the long-term.

Thank you very much and enjoy the rest of your day. Take care.

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