Second Quarter 2023 Earnings Call Transcript

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CONFERENCE CALL PARTICIPANTS

Tracy Benguigui, *Barclays*

Mark Hughes, *Truist Securities*

David Motemaden, *Evercore ISI*

Andrew Anderson, *Jefferies*

Pablo Singzon, *J.P. Morgan*

PRESENTATION

Operator

Good morning, and welcome to the Palomar Holdings, Inc. Second Quarter 2023 Earnings Conference Call.

During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference line will be opened for questions with instructions to follow at that time. As a reminder, this conference call is being recorded.

I would now like to turn the conference call over to Mr. Chris Uchida, Chief Financial Officer. Chris, please go ahead, sir.

Chris Uchida

Thank you, Operator, and good morning, everyone. We appreciate your participation in our second quarter 2023 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 p.m. Eastern Time on August 10, 2023.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about Management's future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties and other factors that could cause actual results to differ materially from those indicated or implied by such statements. Such risks and other factors

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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 the most comparable GAAP measure can be found in our earnings release.

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

Mac Armstrong

Thank you, Chris, and good morning, everyone. I'm very pleased with the strong results of Palomar's second quarter. Our team successfully executed our Palomar 2x strategy of profitable growth, even in the teeth of elevated catastrophe activity and a historically hard reinsurance market that significantly impacted the insurance industry.

In the quarter, we focused our capital and resources towards targeted segments of our book of business, like Earthquake, Inland Marine and Casualty to maximize our risk-adjusted returns, while we continue to reduce exposure to segments of our book that add volatility to our results. This prudent approach resulted in gross written premium growth of 25%. When excluding the drag from runoff and deemphasized products, this growth rate was an even more impressive 44%. Importantly, we delivered an adjusted return on equity of 21.3% in the second quarter.

Beyond the strong financial results, the quarter featured several noteworthy accomplishments that position us well for near and long-term success. Namely, we've successfully placed our 6/1 reinsurance program in line with our expectations and subsequently raised our adjusted net income guidance for the full year. We hired a team of professional liability underwriters to extend our Casualty franchise in attractive niches like real estate E&O.

And lastly, in July, we received a revised positive outlook of our rating from A.M. Best. Over the course of the second quarter, we made incremental progress in 2023's identified strategic objectives: sustaining profitable growth, managing the dislocation in the global insurance market, enhancing earnings predictability and scaling the organization. Looking forward, we will continue to execute these imperatives, but look to convey their progress through 5 key lines of business that will drive the value of Palomar over the medium term. Those lines of business are Earthquake, Inland Marine and Other Property, Casualty, Fronting and Crop, our newest product.

So with that, I'd like to walk through each business, beginning with our earthquake franchise, which I expect to remain our largest line of business. Our core earthquake franchise grew 24% in the second quarter as our Residential Earthquake book grew 20%, in line with the first quarter, and our Commercial Earthquake book grew 29%. The dislocation in the earthquake market, whether it be a function of rising reinsurance costs, reductions in claims paying capacity and coverage at the CEA or the exodus of homeowners markets from California is becoming more pronounced, which continues to afford Palomar the opportunity to both grow and optimize its book of business.

During the quarter, we saw commercial accounts renewed at a risk-adjusted increase of 24%, which was a 25% sequential increase from the prior quarter. Additionally, our E&S Residential Earthquake business grew 75% year-over-year. At the end of the second quarter, E&S policies constituted a total of 8.8% of in-force California Residential Earthquake premium. We expect this environment to remain a tailwind for our business through the second half of this year and into next year. Lastly, in the quarter, we entered into a

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partnership with USAA, who will now offer our Residential Earthquake products in California. This new arrangement not only expands our reach, but also validates our Residential Earthquake franchise.

Turning to Inland Marine and Other Property products, Inland Marine experienced growth of 54% year-over-year through a combination of rate increases and new underwriters allowing us to expand our regional and distribution footprint. Builders Risk, our largest Inland Marine product saw 7% to 10% rate increases and expanded its quota share support, allowing us to write larger limits without taking on disproportionate risks as well as add incremental ceding commission. Our Excess Property line saw 10% rate increases and over 600% year-over-year growth as it builds a niche of non-cat exposed property business.

Importantly, both these products are core to our strategy of maximizing our margins and using prudent risk management to achieve favorable loss ratios. As it pertains to other property products such as Commercial All Risk, Hawaii Hurricane and Flood, we're hyper-focused on exposure management and contracting the existing book where necessary. In the case of Commercial All Risk, we made significant progress reducing our continental hurricane PML to $100 million, led to a 45% reduction in premium year-over-year. However, Commercial All Risk policies that remain on our books renewed at an average increase of 60%, allowing us to recoup the rising cost of reinsurance.

Turning to our Casualty business. We grew this segment 92% year-over-year, highlighted by strong premium growth in professional liability. During the quarter, we integrated our tuck-in acquisition, XEO Insurance Services and hired a group of experienced underwriters and claim professionals to help extend the real estate E&O and miscellaneous professional liability franchises. Taking a surgical approach to the build out of the Casualty business that involves hiring underwriting talent with long-standing history and expertise in targeted niches and geographies.

From an underwriting standpoint, the Casualty book's loss performance continues to remain stable. Our focus on limit management and avoiding severity exposed risk has enabled this performance. Our thoughtful underwriting approach was validated with improved terms and conditions at the renewal of our 4/1 Casualty quota share treaty.

Turning to Palomar front. We grew this business at a strong pace, delivering 82% growth over the prior year. During the second quarter, two of our fronting programs renewed their reinsurance with incremental capacity support, a demonstration of their quality and sound underwriting performance. While our growth from fronting is favorable, we want to reiterate our strategic approach to fronting detailed last quarter. The goal of our fronting effort is to provide services to select group of MGAs, carriers and reinsurers, while we can gain experience on the lines of business to further our diversification into specialty markets. We closely manage the compliance oversight, reinsurance and collateral of our 7 fronting partners. This is a focus and strategic approach. We maintain a risk participation on selected partners with the current maximum participation of 5%.
Our approach has allowed us to quickly assess and limit our counterparty exposure to potentially fraudulent letters of credit and transactions arranged by Vesttoo. Fortunately, our exposure is limited to a single counterparty and is immaterial.

Our foray into the crop market was via a fronting arrangement with Advanced AgProtection, a leading crop MGA. As I mentioned last quarter, this is a partnership that we are particularly excited about. At this time, we are finalizing a strategic investment in Advanced AgProtection that further aligns our organizations and our prospects of building a meaningful presence in crop insurance.

Two members of our executive management team, Jon Christianson and Jon Knutzen have extensive experience in the crop market. Upon consummation of the deal, Jon Christianson will join the Board of Directors of Advanced AgProtection. Palomar is now one of only 13 approved insurance providers with access to the $20 billion insured crop marketplace. We expect to generate crop written premium in the third

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quarter and that crop insurance will be a significant contributor to our growth in 2024 as we generate a combination of both fee and underwriting income. Our goal is for crop to prove a core pillar of Palomar 2x.

Turning to our reinsurance program. As announced in June, we successfully completed our 6/1 core reinsurance program renewal. Pricing was in line with our expectations, and we were able to preserve event retentions and exhaustion points at historic levels that we view as sacrosanct. Our retention of $17.5 million remains less than one quarter's earnings and less than 5% of the Company's surplus. Coverage now exhausts at $2.68 billion for earthquake events, $900 million for Hawaii hurricane events and $100 million for all continental United States hurricane events. The $550 million of incremental reinsurance limit procured over the course of 2023 provides ample capacity for our growth in the subject business line as well as coverage to a level exceeding Palomar's 1:250-year peak zone probable maximum loss.

Importantly, our XOL program is in place until June 1, 2024. The reinsurance placement, combined with our strong first half results led to the recent upgrade at Palomar and our subsidiaries to a positive outlook by A.M. Best.

Lastly, we are updating our 2023 adjusted net income guidance to $89 million to $93 million. This updated guidance reflects catastrophe losses incurred in the first quarter and second quarter of approximately $4 million.

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

Chris Uchida

Thank you, Mac. Please note that during my portion, when referring to any per share figure, I'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 incur a net loss. As a reminder, beginning in the fourth quarter of 2022, we have modified our definition 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 second quarter of 2023, our net income was $17.6 million or $0.69 per share compared to net income of $14.6 million or $0.57 per share for the same quarter last year. Our adjusted net income was $21.8 million or $0.86 per share compared to adjusted net income of $22.4 million or $0.87 per share for the same quarter of 2022. Our second quarter adjusted underwriting income was $23.1 million compared to $24.8 million last year. Our adjusted combined ratio was 72.2% for the second quarter compared to 69.1% in the second quarter of 2022. For the second quarter of 2023, our annualized adjusted return on equity was 21.3% compared to 23.7% for the same period last year. The second quarter adjusted return on equity is further validation of our ability to maintain top line growth with a predictable rate of return above our Palomar 2x target of 20%, even during a quarter with very active severe convective storms and in a historically hard reinsurance market.

Gross written premiums for the second quarter were $274.3 million, an increase of 25.4% compared to the prior year second quarter. Excluding deemphasized and current runoff products, our written premium growth rate was 44% for the quarter. Net earned premiums for the second quarter were $83.1 million, an increase of 3.5% compared to the prior year second quarter. For the second quarter of 2023, our ratio of net earned premiums as a percentage of gross earned premiums was 34.3% compared to 50.8% in the second quarter of 2022 and compares sequentially to 37% in the first quarter of 2023. These results reflect the expected decrease due to our growth of lines of business that use quota share reinsurance, including fronting and the increased cost of our excess of loss reinsurance.

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Losses and loss adjustment expenses for the second quarter were $17.9 million, including $2.2 million of catastrophe losses from severe convective storms during the quarter, slightly offset by favorable prior year catastrophe development. The loss ratio for the quarter was 21.5%, comprised of an attritional loss ratio of 18.9% and a catastrophe loss ratio of 2.6%. Based on our year-to-date loss ratio of 23.2%, we expect a loss ratio of 21% to 24% for the year, including the catastrophe loss from the first half of the year. The expected range excludes large catastrophe events in the second half of the year but includes mini catastrophes and aligns with how we provide our adjusted net income guidance.

Our acquisition expense as a percentage of gross earned premium for the second quarter was 10.8% compared to 18.1% in the second quarter last year and compared sequentially to 11.4% in the first quarter of 2023. Additional ceding commission and fronting fees continue to drive the improvement. The ratio of other underwriting expenses, including adjustments to gross earned premiums for the second quarter was 6.9% compared to 8.5% in the second quarter last year and compared sequentially to 6.8% in the first quarter of 2023.

Continued improvement compared to last year and in line with our go-forward sequential expectations as we invest in underwriting through people and operations. We continue to expect long-term scale in this ratio. Our net investment income for the second quarter was $5.5 million, an increase of 76.5% compared to the prior year's second quarter. The year-over-year increase was primarily due to higher average balance of investments held during the three months ended June 30, 2023, due to cash generated from operations and a mix shift of invested assets from lower-yielding investment assets into higher-yielding investment assets with a similar credit quality.

Our yield in the second quarter was 3.61% compared to 2.61% in the second quarter last year. The average yield on our investments made in the second quarter remains above 5%. Our commercial real estate exposure in our investment portfolio is minimal at less than 3% of our portfolio and does not include any direct loans. We continue to conservatively allocate our positions to asset classes that generate attractive risk-adjusted returns.

During the quarter, we repurchased 166,482 shares of our stock for a total of $8.7 million under our 2-year $100 million share repurchase program. As of the end of the quarter, we had $50 million of our authorized share repurchase remaining that we will continue to use opportunistically as we view our share price is undervalued. At the end of the quarter, our net written premium to equity ratio was 0.88x to 1x. We are well capitalized and have ample capital to support our Palomar 2X organic growth objectives and opportunistically buy back shares. As Mac mentioned, we are updating our 2023 adjusted net income guidance range to $89 million to $93 million, an increase from $88 million to $92 million. This range includes approximately $4 million of net catastrophe losses incurred during the first half of the year, but does not include additional catastrophe losses for the remainder of the year.

On a gross earned premium basis, we expect our net earned premium ratio and acquisition expense ratio to continue to decrease in the second half of 2023 from the levels reflected in our second quarter results. After our recent successful reinsurance placement, our net earned premium ratio should be at its lowest point in the third quarter, the first full quarter under the new reinsurance placement. Additionally, based on the current market, our effective tax rate for the year may remain elevated between 22% to 24%.

Before opening the call for questions, I would like to note that Jon Christianson, President of Palomar will be joining the question-and-answer session of this call.

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

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Operator

Thank you.

Our first question is coming from Tracy Benguigui from Barclays.

Tracy Benguigui

Thank you. Your attritional loss ratio of 18.9% was below your guide of 22% to 24% for '23. Could you unpack that a little bit?

Chris Uchida

Yes. Thanks, Tracy. That's a good question. When we look at our loss ratio for the quarter, obviously, we're happy with the results. The overall loss ratio was 21.5%. If you put back in the prior period development, that loss ratio moves up a little bit to 22.3% for the quarter, which I would say is in the low range of the guidepost we gave out of 22% to 24%. Mini-cats for us were elevated this quarter, the severity and magnitude of those events caused us to put some of those losses into catastrophes. As you saw that loss ratio for the quarter being about 2.6%. Overall, we feel good about those results.

The loss ratio was a little bit better. I think mini-cats were a little bit higher, causing the loss ratio probably to be about 1.6 points higher than we would have expected. Still better than expected. But overall, everything is in line with how we feel about the year.

I think the one thing you'll notice on the prepared remarks, we did, call it, decrease the bottom of the range for the full year. We went from 21% to 24% reflecting what we've seen in the first half of the year, but still expecting those loss ratios to improve in the latter half of the year and then into Q1 next year.

Tracy Benguigui

Is that a function of pricing?

Mac Armstrong

I think—this is Mac. I think pricing is contributing to that. I think it's also part of our concerted efforts to run off certain segments of the book. I know one of the things that you were focused on was the growth. We grew 44% in the areas that we are investing in, and we're thrilled with that. One of the benefits of running off some of these lines or deemphasizing some of these lines like All Risk is, is it does improve the loss ratio. Even in the second quarter, All Risk, which declined close to 40% year-over-year, it still had $1 million of cat loss, and it has a higher attritional loss and certainly the 21% that we blend out to.

So, one of the positives and one of the reasons why we are running off some of these books that have higher volatility is that they also have higher loss ratios. That's also a meaningful contributor to why the loss ratio was what it was this quarter and why we think—and Chris has always said, we expect it to continue to go down somewhat over the course of this year and certainly into '24.

Tracy Benguigui

Okay. My next question, I'd like to talk about the durability of your fronting program in light of higher reinsurance costs and increased market concern about reinsurance counterparty risk, particularly on collateral?

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Mac Armstrong

Yes. I'm happy to do so, Tracy, and it's a timely and smart question. We're seeing strong growth from targeted fronting partners. As I mentioned in my remarks, we have seven of them. We take a rifle-shot approach, which allows us to manage these partners closely and frankly collaboratively. It's more like an underwriting relationship. So, it's a pillar and segment where we're seeing nice considerable growth, but that percentage of the premium that it can constitute is not the same from adjusted net income. It's a nice segment for us. It allows us to be disciplined and prudent with new partners and who we bring on. We can be very selective.

I think the one thing that certainly with the shakeout of what's happening in the fronting market broadly with Vesttoo, our exposure is immaterial. We were able to get in front of this really quickly, and we understand not just our exposure, but our remedies and those remedies are several. I think for us, we continue to look closely at how we manage these programs and how the industry will shake out, two of our reinsurance programs for our fronting partners renewed with increased capacity and support and consistent economics in the second quarter. We also had one successfully renewed at the first part of the third quarter, incepting in July 1. So, I think there will be consequences.

I think for us, though, it's probably a net positive for Palomar because, first and foremost, we're an underwriting organization. We're already seeing program submissions from MGAs that are looking for potentially a new fronting partner. We're also seeking potentially more stable fronting partner. We've also seen submission flow uptick in a few casualty lines from renewals coming away from MGAs that have potential collateral exposure to us just in the open market with our Casualty segment. All in all, we won't deviate from our fronting strategy. If anything, our blended strategy and our targeted strategy is affirmed here. I think it also overall validates our model as an underwriting organization.

Operator

Next question today is coming from Mark Hughes from Truist Securities.

Mark Hughes

Thank you. The earned premium, you alluded to the top line growth. You certainly were influenced this quarter by the runoff and deemphasized lines. What should the earned premium growth be given kind of your mix of fronting versus underwritten business? How should the earned premium trajectory be?

Mac Armstrong

Well, Chris can chime in, Mark, but this is Mac. What I would say is that you look at those five segments that we've talked about. We see very strong sustained growth in Earthquake. It's growing 20%. I think that's a good rule of thumb for that line. When you look at Casualty and Inland Marine, there is considerable growth. Fronting, it's hard to say that it's going to sustain a 90% growth rate, but what we like is there is embedded growth with most of our partners here. Some are kind of hitting their critical mass in steady state. But that's all right for us because there's still a nice earned premium ramp for us.

Long winded way of saying, I think the growth is going to continue to be strong. Expecting it to be 44% might be a bit ambitious, but we feel like that it's a healthy growth vector when you look at the underlying contributors like Inland Marine, Casualty and obviously, Quake.

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Chris Uchida

Yes. Mac talked about the top line growth of the written premium. Obviously, that will influence how the gross earned premium grows. I talk about this a lot that with the change in the mix of business with a lot of fronting and business that uses quota share, and with the increased excess of loss costs that we will see for the first full quarter in Q3, that the net earned premium ratio will continue to decrease. It was 34% in the second quarter. It's going to get into the low-30s for Q3 and potentially a little bit in Q4 as well.

So, I just want to make sure people think about that as they model it because the excess of loss reinsurance costs that we've talked about before was up about 30%, which is as expected as we modeled into our guidance, but I want to make sure people are thinking about that and modeling it correctly when they think about our net earned premium ratio and the results that we're going to see in the second half of the year. Q3 will be the lowest point of that, and then we'll start to scale more as we continue to grow the business, but the excess of loss cost is flat and in place until 6/1 of '24.

Mark Hughes

When you look at the renewals that are coming up, you're describing about a 20 point differential between what would have been other than the deemphasized and runoff business. What's going to be the marginal impact in Q3 and Q4, if it was 20 points in Q2? How much of these risk management adjustments going to impact the second half?

Mac Armstrong

I think it's probably in and around the difference between maybe 10 points to 14 points overhang of the growth. Most of the specialty homeowners business will be out by the third quarter. The All Risk is over the course of the year.

So, if you look at All Risk, what we're really trying to solve for is getting the PML down to $100 million, and it's basically there. At that level, we feel that it is a sustainable level where we can maintain a manageable reinsurance expense. Obviously was up meaningfully. I think it's one thing that I'd point out is if you look at the relative cost of all-peril and wind reinsurance versus earthquake, it's double. We're focusing more of our cat dollars on earthquake.

For wind, we want to get it down to $100 million continental hurricane PML. I think at that point, we can justify our retention. It's a $4 million AAL at that level, and it has minimal severe convective storm exposure. That means that there is an opportunity for us to take rate and optimize that book and get it to grow, but that's really not going to start until the first quarter of '24.

Mark Hughes

Then finally, the Commercial Quake business, better pricing, but a little bit of deceleration at the top line, —deceleration—from very strong growth to strong growth. Anything noteworthy there?

Mac Armstrong

No. That market—and Jon Christianson can chime in. But I would say, I mean, it grew 30% or 29% in the quarter. We want to be mindful of where the reinsurance costs were going to shake out, and that would inform the PML. Frankly, we want to make sure that we could procure the incremental $550 million of reinsurance support to support the growth that we're seeing. What I'll tell you right now is our metrics have never been better. The capacity in the market is dwindling. We feel very good about sustaining strong growth in Commercial Earthquake.

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But Jon, anything you'd add?

Jon Christianson

I agree with all that. I think we've seen now many quarters in a row of that strong rate appreciation in the Commercial Earthquake segment. As we look forward to the next few quarters, there's no signs that would suggest that it would decelerate.

Operator

Thank you. Next question is coming from David Motemaden from Evercore ISI.

David Motemaden

Just a question on the crop opportunity. It sounds like you think that will start coming in, in the third quarter. I guess how big do you think that has the potential to be as another growth lever that we haven't really seen here in the first half? And then how should we think about the profitability profile of that business versus your existing business?

Mac Armstrong

Dave, yes, this is Mac. Again, I'll let Jon speak to this. I think there are a few things that I would want to get across to you. For this year, it's really a start-up. We will generate some premium in the third quarter and in the second half of the year but it's more fronted, so it's really going to be a fee generation product.

For 2024, we think it can be a meaningful premium. It's a $20 billion market. We're 1 of 13 approved insurance providers. We have terrific in-house expertise and a terrific distribution partner in Advanced AgProtection. We are optimistic that it can become a large contributor to premium in due time. But in 2024, it has a chance to be high double-digit millions of premium.

Jon Christianson

Yes. With regard to the profitability aspect of the question, it is a historically profitable line. Importantly, it's not correlated with our existing core lines, and it has a short tail and a combined exposure period with strong reinsurance support backing it. From a profitability standpoint, we feel it folds in nicely with the other lines of business that we have.

Mac Armstrong

I think the one thing that I would add to that, Dave, and I should have brought this up, next year, we expect we'll take risk on it, but you're talking about, just call it, conservatively a 10% participation. It's still going to be a nice balance of fee and underwriting income like we've done with all of our new products. We're not going to deviate from that strategy. Nice fee income stream as well as a nice underwriting income component to it. It may end up being an 8% to 10% margin in that year.

David Motemaden

Got it. Understood. That's helpful. Then just on the Vesttoo, the one counterparty where you have exposure, it sounds like it's immaterial in size. Was that something where you just absorbed what you had reinsured or is that something where you just replaced the LOC in question?

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Mac Armstrong

So, it's for a prior—it's sort of a treaty period that has expired. So we're looking at just what's in trust and what would be our exposure if it goes beyond trust. So, if it goes beyond the trust, which we have full control of, that's where our exposure would be. Again, it's immaterial. For everything that's in place right now, Vesttoo is not an issue, they're not a reinsurer.

David Motemaden

Then maybe just finally, it sounds like capacity has definitely not been an issue for the seven existing programs, but just wondering on the growth—the future growth of adding new program partners. Is there just—have you seen a slowdown in the conversations that you've been having with capacity providers? It sounds like MGAs want to partner with you guys, but are you able to secure the capacity on the back end for newer partners?

Mac Armstrong

No. I mean I think for us, we've had successful reinsurance renewals. We're being very selective in talking to potential new fronting partners. Ultimately, we view these fronting partners as people that we're going to take a risk on at some point in time. We hold them to a different standard than maybe other markets do. As a result, we are getting a lot of inbounds. We expect that we will add to them in time, but it's going to be a very deliberate addition. But I would say on what's been in the press the last few weeks, we're seeing a lot more inbounds, but selectivity has not changed, if not increased.

Operator

Our next question is coming from Andrew Andersen from Jefferies.

Andrew Andersen

Hey, good afternoon. Just with regards to the fronting program, Mac, I'm not sure if I heard you mention Cyber, but it seems from like industry pricing surveys, it's kind of softening a bit. Can you talk about the appetite there for the fronting program with regards to Cyber?

Mac Armstrong

Sure, Andrew. Yes. Cyber is one of our large partners in the fronting arena. That was the renewal that I referred to that was early third quarter. It's a 7/1. That was successfully placed with great capacity support. We had taken modest risk participation there we have for the last two years. Yes, we're watching the pricing. I think for that product in that fronting relationship; we really do view that like we are the underwriter here. While it's only a low mid-single-digits participation, we manage it like something that we're taking 30%, 40%, 50% of.

So, on the whole, rates are certainly down from where they were two, three years ago, but we feel good about the performance. We feel great about the reinsurance support. They got the ability to grow from a revenue perspective or from a premium perspective, so the premium capital has increased. On the whole, I think it's a line of business that is performing well. It certainly requires increasing diligence because of the market conditions, but it's a great partnership.

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Andrew Andersen

Okay. On the Casualty business, you mentioned an uptick in submissions there. Should we really just think of that as some of the real estate E&O, or is it perhaps some different lines? And can you remind us if that's going to largely be on the E&S entity, which looked like the growth was a little bit slower in this quarter?

Mac Armstrong

Yes, Andrew. Good question on the Casualty side. We're pleased with the growth there. It's 92%, and it's now approaching—it's 4-plus percent of the book. We're being deliberate here, though, too. We are using the E&S Company for the predominance of it. We do have a handful of GL business that's on the admitted company. That tends to be focusing on kind of small to mid-market commercial contractors, call it $5 million to $20 million in annual predominantly low and moderate hazard stuff.

So, think about like trade contractors or general contractors that are building schools. We really are trying to avoid classes that have severity on the admitted side or high severity exposure. What I will say is on the professional lines where that's mostly E&S; it's growing really nicely, but also deliberately. It's targeted niches that we're going into, real estate E&O is the one you highlighted. But when we brought on some underwriters in the quarter, a lot of them, they spent the quarter ramping up. Now we're starting to see them leverage their expertise, leverage their distribution relationships.

Gerrit VandeKemp, who oversees our professional lines, and I were talking recently about a collection agency program that he's already starting to write with one of his underwriters that is just coming on and has nice potential to be a great supplement to the E&O franchise, but very targeted and niche. That's what we're looking to do. I think if we can take that deliberate approach from a reach and distribution and appetite perspective, the book not only will grow, but it will be profitable and predictable.

Operator

Thank you. Next question today is coming from Pablo Singzon from J.P. Morgan.

Pablo Singzon

Hi, thank you. So my first question is on guidance. You increased it twice over the past several months. I was hoping you could unpack those changes a bit here. To what extent was the updated guidance based on your first half performance? To what extent is the reflection of what you think will happen in the second half of the year?

Mac Armstrong

Pablo, I think it's a combination of the two. It's a good question and thanks for asking it. What I would say is the first guidance raise was potentially—it was a little bit of a delay off of Q1, but we wanted to see where reinsurance pricing shook out. That informed the raise that we did in June. This quarter on the heels of Q2, we raised guidance again to reflect the results in the first quarter, but also what we expect to see in the second half of the year.

Chris pointed out; he's taken down the loss ratio range. That's informing it. Again, the business that we're running off has—you could argue that certainly some of it was unprofitable and certainly with the reinsurance load that we're seeing on wind business, it would have been unprofitable on a prospective

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basis if we had stayed on. Long-winded way of saying it's a combination of the two, but we feel like there's great momentum in the business. Our goal is to beat and raise; that's our operative focus.

Pablo Singzon

Then the second question is maybe for Chris. I heard what you said about expense ratios going down on a gross basis, right? But if you look at the expense ratio against net earned premiums, I think this is the first quarter over the past four or five where it actually went up year-over-year, and that's probably more a function of net earned going down.

Do you see that trend persisting through the second half because of what you described, essentially the reinsurance costs kicking in? Will that essentially inflate the expense ratio on a net earned basis as well for the second half of the year?

Chris Uchida

Yes. You pointed it out well, Pablo, right? When you think about the expense ratio, even the loss ratio on a net earned basis, it is severely impacted by the excess of loss, right? I don't think that we—my view is that combined ratio doesn't do a good job of measuring those ratios when you have an excess of loss load like we do and seeing the excess of loss load going up by close to 30%, like we've talked about, is going to impact that with really no overall change in potentially the expense ratio or the loss ratio. It's kind of why we take it out, especially on the expenses. We think about it on a gross basis.

You can model a little bit easier. You can look at it. When I look at the acquisition expense ratio, I see that continuing to tick down because of the mix change, whether it be fronting things of that nature, but then the same with the expenses, right? It's a little bit flatter, which we talked about. It feels like everything is heading in the right direction. When I look at it on a gross basis, it takes out the noise of the excess of loss. That's why when we talk about the gross earned premium ratio and think about that, we talk about that separately, so that you guys can think about how the excess of loss is going to impact it, and that's going to go from 34% down to the low-30s in the second half of the year. That's how we think about it. But you're absolutely right. The modeling impact of those ratios and call it being a little bit higher this quarter is impacted by the excess of loss cost. Like I said, that cost is going to be higher in Q3, which is going to be the first full quarter with that loaded in.

Mac Armstrong

I think the other thing to add, Pablo, and Chris described it well. Just a reminder, we brought on a lot of underwriters in the second quarter. Great talent and claims professionals alike that will generate a return, whether it be top line or improving the bottom line through cost containment and loss management, but that will take a little bit of time. There was a decent amount of some cost—not some cost, but cost that should generate a return, certainly in '24.

Pablo Singzon

Okay. Then last question for you, Mac. I heard your comments about disruption in the California market potentially being an opportunity for you to grow Earthquake. The question is, just given what's happening and the amount of disruption, is there a risk that the market gets overly disrupted where, for whatever reason, the uptick of earthquake insurance goes down? I'm thinking of massive withdrawals capacity, for example. If the disruption reaches that level, is that still good for your Earthquake business?

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Mac Armstrong

Yes, Pablo. I'll let Jon Christianson offer this, too. The disruption in the homeowners market, I think remains good for our business. Whether it be the non-renewing policies that may have had an Earthquake endorsement or stand-alone companion policy attached to it. We get to compete on that, whether it be the CEA taking their deductibles up to 15% on anything over $1 million of Coverage A or reducing the amount of Coverage C, which is your personal property, those are all good dynamics for us.

I don't think we've reached a point where there's a precipice that we've gone beyond. I think this is just a bit of kind of a slow burn change in the California market that we are going to be benefiting from.

Jon Christianson

Yes. I'd add with the disruption that we've seen to date in that homeowners market in California, it has not translated into anything unusual with our Residential Earthquake book. Our book has been very predictable, and our partnerships remain very strong in the state of California. We have not seen anything that would indicate a disruption to a very predictable and profitable line of business for us.

Pablo Singzon

Okay. Even with the homeowners pricing going up double-digits, it seems like from what you're saying there's still appetite for earthquake insurance as a rider to the basic homeowners product. Is that fair?

Mac Armstrong

That's fair. Yes. I mean, again, our buyers tend to be mass affluent that have a lot of equity value in their home, so they're protecting an asset. We have not seen people reduce coverage. We offer multiple deductible options that hasn't deviated where they move their deductible up to manage the expense. We look at that. But if you look at just, a, the continued growth, 20% in Residential Quake, but also the increasing take-up in E&S, which frankly, E&S, on E&S, where an EQ policy cost more on a per dollar basis or per dollar reinsurance basis than in the admitted side, I think that's a reflection of the appetite.

Operator

Thank you. We've reached the end of our question-and-answer session. I'd like to turn the floor back over to Mac Armstrong for any further or closing comments.

Mac Armstrong

Thank you very much, Operator, and thanks to all who joined this morning. We appreciate your participation, certainly, your questions and as well, most of all your continued support. As always, I want to thank the great team here at Palomar for their diligent work, all that we accomplished this quarter and all the work that was done to further expand the franchise in the new specialty segments and further extend the Palomar 2X strategic initiative.

We are growing where we want to. We are hitting our ROE targets, our earnings targets, and we're raising guidance. We'll look to continue to do this. I think what we have in front of us is really exciting, and we are going to continue to build an industry-leading franchise. Thanks very much and speak to you next quarter.

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