Third Quarter 2023 Earnings Call Transcript

November 2, 2023

CORPORATE PARTICIPANTS

Christopher Uchida, *Chief Financial Officer*

Mac Armstrong, *Chairman and Chief Executive Officer*

Jon Christianson, *President*

CONFERENCE CALL PARTICIPANTS

Mark Hughes, *Truist Securities*

Andrew Lambert, *Piper Sandler*

David Motemaden, *Evercore ISI*

Meyer Shields, *KBW*

Andrew Andersen, *Jefferies*

Pablo Singzon, *JPMorgan*

PRESENTATION

Operator

Good morning and welcome to the Palomar Holdings Third Quarter 2023 Earnings Conference Call.

As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Mr. Chris Uchida, Chief Financial Officer. Please go ahead.

Christopher Uchida

Thank you, Operator, and good morning, everyone. We appreciate your participation in our third quarter 2023 earnings call.

With me here today is Mac Armstrong, our Chairman and Chief Executive Officer. Additionally, Jon Christianson, our President, is here to answer questions during the Q&A portion of the call.

As a reminder, a telephonic replay of this call will be available on the Investor Relations section on our website until 11:59 p.m. Eastern Time, on November 9, 2023.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about Management's future expectations, beliefs, estimates, plans, and prospects. Such statements are subject to a variety of risks, uncertainties, and other factors that could cause actual results to differ materially from those indicated or implied by such statements. Such risks and other factors are set forth in our quarterly report on Form 10-Q 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 to all.

I am pleased with our strong third quarter. These results included record quarterly gross written premium, adjusted net income growth of 153%, and an adjusted return on equity of 22.3%. Our concerted efforts over the last several years to reduce the volatility in our book of business and earnings base was also on full display in the third quarter as we incurred negligible loss from catastrophes despite elevated activity across the industry. The execution of our Palomar 2X strategic plan during the quarter instills a high level of confidence that Palomar will produce consistent profitable growth in the quarters and years ahead and certainly as we enter 2024.

In addition to the quarter’s strong underwriting results, we also continued to invest in growth across the organization. During the third quarter, we saw 24% growth in gross written premium, excluding the impact of de-emphasized products, our growth rate was an even more stellar at approximately 31%.

As discussed last quarter, we are channeling our capital and resources towards targeted lines of business that we believe will generate optimal risk-adjusted returns. This quarter, we continue the strategic focus and key lines of business such as Commercial Earthquake, Flood, Casualty, and Crop. We are adhering to our grow where we want approach, concentrating on existing and new growth vectors that will enable the success of Palomar 2X.

This simple mantra has helped build Palomar to an attractive specialty insurance company with a diverse book capable of delivering a return on equity exceeding 20%, 22.3% this quarter and 21.7% year-to-date to be exact.

At this point, I'd like to review our five key business lines starting with our earthquake franchise. Our core earthquake franchise grew 23% in the third quarter, as our Residential Earthquake grew through 16% and our Commercial Earthquake grew through 35%, a nice acceleration from the second quarter's growth of 29%.

Favorable market conditions such as the ongoing California homeowner's market dislocation, reduced coverage offerings from the California Earthquake Authority, compelling excess and surplus lines market conditions, as well as new and existing partnerships continue to drive a Residential Earthquake portfolio. Quarter-end, we saw excess and surplus premium increase to 10% of total in-force California Residential Earthquake premium as compared to 9% in the prior quarter.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

During the quarter, Commercial Earthquake rates increased approximately 26% on a risk-adjusted basis. We are pleased to see our Commercial Earthquake book grow from a rate and an exposure standpoint as we utilize the portion of the incremental capacity procured on June 1 of this year.

Commercial Earthquake metrics, like average annual loss and 250-year problem maximum loss premium, are at the best level since our formation in 2014. We remain bullish on the growth and profitability prospects of both the Residential and Commercial Earthquake lines as we approach 2024.

Turning to Inland Marine and other property, this category is the prime example of grow where we want as we are investing in certain lines of business such as Builder's Risk, Excess Property and Flood, while deemphasizing or transitioning lines of business like All Risk or Hawaiian Hurricane.

Builder's Risk, our largest Inland Marine product, grew 37% year-over-year, saw 5% to 10% rate increases, and brought on new underwriting talent to expand our geographic reach and distribution footprint for the quarter.

Our Excess Property line saw approximately 7% rate increases and 185% year-over-year growth as it built a portfolio of non-cat exposed property business. Flood rate and premium grew 36% year-over-year. Importantly, we saw minimal losses from the catastrophe activity in the quarter, including Tropical Storm Hillary in Southern California.

As mentioned last quarter, we expected to reduce our Condo and Hurricane 250-year probable maximum loss to $100 million by September 30. One derivation of this accomplished goal was the contraction of our Commercial All Risk premium base by 28% year-over-year. Importantly, the remaining Commercial All Risk book is attractive with policies renewing at an average increase of more than 55% in the third quarter.

It's also worth highlighting that the Commercial All Risk book performed well from a loss standpoint as it incurred minimal losses from catastrophes in the quarter, including Tropical Storm Hillary, Hurricane Idalia, and the severe convective storm activity experienced throughout the country.

With respect to Hawaiian Hurricane, I'd like to reiterate that we incurred no losses from the Lahaina wildfires and that our thoughts are with our clients and partners impacted by the event. During the quarter, Hawaiian Hurricane premium grew 17% with all the growth coming from rain increases and our inflation guard.

On an exciting note, during the quarter we formed Laulima Exchange, a fully licensed reciprocal insurer for which we will serve as the attorney in fact manager. This new vehicle allows us to transition our business model for the Hawaiian Hurricane product from one that is risk-bearing to one that is fee generative. It will also reduce our corporate excess of loss reinsurance costs and also eliminate balance sheet exposure to wind losses from hurricanes hitting Hawaii. We are also pleased to note, Laulima allows Palomar to remain a meaningful player in the Hawaiian market, albeit with a different long-term profile.

As I mentioned earlier, we incurred negligible cat losses in the quarter, and we firmly believe that the underwriting exercises commenced in 2020, including exiting admitted All Risk and Specialty Homeowners, reducing gross and net line sizes, shifted layered and shared limits, and implementing geographic concentration caps, not only bore sound results in the third quarter, but also limited catastrophe losses year-to-date. This work, in addition to Laulima, should help perpetuate this trend into 2024.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Casualty business grew 57% year-over-year, highlighted by strong premium growth from our professional liability products. As previously discussed, we're taking a surgical approach to the build-out of the Casualty business that involves hiring underwriting talent with longstanding history and expertise in targeted niches and geography.

Our foray into the environmental arena is another strategic imperative to bolster our Casualty franchise. In September, we hired a 15-year industry veteran, Brian Pushic, to spearhead this venture.

The deliberate building of our Casualty business permits us to be mindful of social inflation as well as areas of the business where there have been meaningful adverse court decisions. We employ prudent risk management to minimize loss potential in the classes we write and believe we are minimally exposed to social inflation.

The book is seeing blended rate increases of approximately 5% year-over-year with rates doing a bit higher in excess liability. Casualty books loss ratios is performing in line with our conservative loss fix as we build up a sizable loss reserve base that we expect to favorably develop over time.

Turning to Palomar Fund, we delivered 30% year-over-year growth in the third quarter, having remained selective and highly engaged with our strong fronting partners. Our goal at fronting is to provide fee-generative services to a select group of MGAs, carriers, and reinsurers riding specialty lines of business and industry segments where we have a developed investment thesis and some measure of domain expertise. We actively manage the compliance, oversight, reinsurance, and collateral of our fronting partners and maintain their risk participation in certain instances with the current maximum participation of 8%.

In October, we finalized two new fronting arrangements that are fully collateralized and reinsured. These new partnerships are in lines of business that leverage in-house expertise and are 100% fee-generative when they commence writing business in the fourth quarter.

In the third quarter, we are excited to write our first crop premium. Our crop insurance business is comprised of multiple payroll crop insurance, or MPCI, which we expect to be approximately 90% of our premium, and livestock and private product insurance. The premium in the third quarter was from MPCI tied to the 2023 growing season.

Our MPCI program, offered in conjunction with the U.S. Department of Agriculture's Risk Management Agency, RMA, is a federally subsidized insurance program that covers revenue shortfalls or production losses due to natural causes like drought, hail, and wind.

As previously stated, we expect that crop insurance will be a significant contributor to our growth in 2024 as we generate a combination of fee and underwriting. We are encouraged with the opportunities identified for the 2024 growing season and believe we will generate high double-digit millions of premium next year.

Our strategic partner in crop, Advanced Ag Protection, has extensive sector experience and distinct technology that allows us to target risk at the producer and regional level and more importantly, compete effectively even without immediate scale. We are targeting business throughout the Midwest on a variety of crops with the goal of minimizing exposure to a single event or heavy accumulation losses in a single region. We expect crops to be the core pillar of Palomar 2X over time and are pleased with the progress to date.

As it pertains to our reinsurance program, the third quarter is light on activity as we have just completed successful renewal of our core excessive loss tower in June. During the quarter, we renewed cyber and

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

real estate errors and omissions quarter share facilities at expiring terms with incremental reinsurer support.

Additionally, it is worth noting that going forward our core excessive loss tower will be increasingly single-peril earthquake as we transition our Hawaiian hurricane exposure to Laulima. This should bode well for pricing and overall expense in next year's renewal. Overarchingly, we feel particularly good about the quality of our portfolio and the results that we have delivered to our broad reinsurance panel.

Lastly, regarding reinsurance, we are pleased to announce that Matt Grunewald has joined Palomar to oversee our Assumed Reinsurance efforts. With a proven record of accomplishment in navigating complex reinsurance landscape, Matt will play a pivotal role in enhancing our specialty market franchise and further help diversify our book of business. His expertise and insights will not only bolster our reinsurance capabilities, but also contribute significantly to our overall growth and profitability in the long term.

We update our 2023 adjusted annual income guidance of $90 million to $93 million. Tightening of the guidance range marks our third beaten raise this year and importantly includes catastrophe losses incurred of approximately $3.4 million, year-to-date. As a reminder, our original guidance range of $86 million to $90 million excluded catastrophe losses.

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

Christopher 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 when we incur a net loss.

As a reminder, beginning in the fourth quarter of 2022, we have modified our definitions for adjusted net income, diluted adjusted earnings per share, and adjusted return on equity to adjust for net realized and unrealized gains and losses. We have modified the current and prior period figures accordingly.

For the third quarter of 2023, our adjusted net income was $23.3 million or $0.92 per share compared to adjusted net income of $9.2 million or $0.36 per share for the same quarter of 2022. Our third quarter adjusted underwriting income was $25 million compared to $7.5 million last year. Our adjusted combined ratio was 70.9% for the third quarter compared to 90.3% for the third quarter of 2022.

For the third quarter of 2023, our annualized adjusted return on equity was 22.3% compared to 9.9% for the same period last year. The third quarter adjusted return on equity continues to validate our ability to maintain top line growth with a predictable rate of return above our Palomar 2X target of 20%.

Gross written premiums for the third quarter were $314 million, an increase of 24% compared to the prior year's third quarter. Excluding de-emphasized products, our written premium growth rate was 30.6% for the quarter.

Additionally, our fronting results include $11.6 million of crop premium. It is important to remember the seasonality of the crop premium. We expect some crop premium in the fourth quarter with sequentially more in the first quarter. But based on the nature of that business, the third quarter will represent the

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

majority of written premium on an annual basis. Next year, we will likely separate crop written premium into its own category.

Net earned premiums for the third quarter were $85.8 million, an increase of 10.1% compared to the prior year's third quarter. For the third quarter of 2023, our ratio of net earned premiums as a percentage of gross earned premiums was 31.6%, compared to 41.7% in the third quarter of 2022, and compared sequentially to 34.3% in the second quarter of 2021, reflecting the expected decrease to our growth of funding and lines of business that use quota share reinsurance, and the first full quarter with our renewed Excess of Loss Reinsurance Program. With the mix of business maturing and our excess of loss reinsurance program in place, our net earned premium ratio should be at its lowest point in the third quarter and we expect this ratio to increase in future quarters.

Losses and loss adjustment expense for the third quarter were $16.1 million, including $0.5 million of favorable prior period catastrophe loss development. While there was elevated catastrophic activity during the quarter, the Company exposure and losses from these events did not rise to the magnitude to warrant breaking out those losses as catastrophe loss. Said differently, these losses equate to what we describe as mini-catastrophe, and something we budgeted in our loss ratio assumption. The loss ratio for the quarter was 18.8%. Excluding the favorable catastrophe loss development, the attritional loss ratio was 19.4%.

Based on a year-to-date loss ratio of 21.7%, we now expect a 20% to 23% loss ratio for the year, including catastrophe losses to date. This range excludes future large catastrophe events 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 third quarter was 9.9% compared to 14.6% in the third quarter last year and compared sequentially to 10.8% in the second quarter of 2023. Additional seating commission and fronting fees continue to drive that improvement. Similar to our net earned premium ratio, the acquisition expense ratio may be flat to modestly up in future quarters as our business mix matures.

The ratio of other underwriting expenses, including adjustments, the gross earned premiums for the third quarter was 6.7% compared to 7.3% in the third quarter last year and compared sequentially to 6.9% in the second quarter of 2023. Continued improvement compared to last year and in line with our go-forward sequential expectations as we invest in our organization as we continue to grow. We expect long-term scale in this ratio while we may see periods of sequential flatness as we continue to invest in scaling the organization.

Our net investment income for the third quarter was $6 million, an increase of 61% compared to the prior year's third quarter. The year-over-year increase was primarily driven by a higher average balance of investments held to the three-month-ended September 30, 2023, and a mixed shift of invested assets from lower-yielding investment assets into higher-yielding investment assets with a similar credit quality.

Our yield in the third quarter was 3.9% compared to 2.8% in the third quarter last year. The yield on investments made in the third quarter was 6.3%. We continue to conservatively allocate our position to asset classes that generate an attractive risk-adjusted return.

During the quarter, we repurchased 117,739 shares of our stock for a total of $6.6 million under our two-year $100 million share repurchase program. As of the end of the quarter, we have $43.5 million of our authorized share repurchase remaining.

As Mac mentioned, we are increasing our 2023 adjusted net income guidance range to $90 million to $93 million. This range includes catastrophe losses incurred to date. On a gross earned premium basis, we

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

expect our net earned premium ratio to increase and acquisition expense ratio to be flat to modestly up in the fourth quarter of 2023 and beyond from the levels reflected in our third quarter results.

Additionally, based on the current market, our effective tax rate for the year may remain elevated between 22% and 24%.

Lastly, Mac mentioned the formation of Laulima Exchange, a licensed reciprocal insurer. While Laulima Exchange is owned by its members and not Palomar, we have provided the funding for the initial surplus note. As such, Laulima Exchange will be consolidated as part of our operating results. In the future, after it has sufficient operating history, we expect to separate Laulima Exchange from our consolidation.

With that, I would like to ask the Operator to open the line for any questions. Operator?

Operator

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

Mark Hughes

Good afternoon or good morning. The change in Hawaii, did you say whether that was going to be accretive, neutral, or dilutive to earnings?

Mac Armstrong

Hey, Mark, this is Mac. Simply put, with Laulima in 2024, we expect it to be net neutral to earnings. I think there is a potential upside if we can drive more business on to Laulima than what we're willing to write right now on Palomar paper. The real strategic rationale for that new endeavor is to allow us to transition the line of business that has potential for material losses to something that's more fee generative. It will help reduce and manage reinsurance costs on a prospective basis. Furthermore, it allows us to stay in the Hawaiian market. Lastly, it will reduce material cat exposure on Palomar specialty. We're very excited about it. I think on the whole, it's net neutral in '24. In '25, it has the potential to drive—be accretive.

Mark Hughes

Understood. What kind of behavior are you seeing out of the California Earthquake Authority? I think you might have said in earlier quarters that it didn't appear to be having real material impact in your ability to grow. Is that changed?

Mac Armstrong

Yes. Mark, I would say the CEA certainly is having no impact on our ability to grow on the Residential Earthquake side. We grew 16% in the quarter, which frankly is our hardest from a comparable perspective. It just so happens it's our largest quarter. The stable levels of new business that we're writing has a disproportionately lower impact in this quarter versus others. But on the whole, the CEA continues to call back its coverages. It continues to encourage its participating insurers to explore alternative arrangements. We remain a very collegial competitor with the CEA and try to collaborate with them. But we have not seen some type of a step function increase in production because a participating insurer has decided to leave the CEA, but rather the business is coming over in a more organic policy by policy fashion as it pulls back—as I said, pulls back its coverages and tries to manage or reduce its exposure.

Mark Hughes

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Understood. Last question, Chris, the ratio of earned to gross, any thoughts on how that will trend in coming quarters? Is that expected to continue to taper off, go down, or will that stabilize? How do you see that?

Christopher Uchida

Yes. Based on the results of the third quarter, the gross to earned ratio was 31.6%. Based on the excess of loss reinsurance renewal at 6/1, you only had one month of that in the Q2 results. Q3 of this year is the first full quarter where you have the full effect of that increase in excess of loss cost. As we stated before, that was about a 30% increase, which equates to about a $13 million increase on a quarter comparison to the 6/1/22 excess of loss risk transfer period. That $13 million is fully in for Q3. That number will be stable until 6/1 of '24, at the next renewal. I expect the net earned premium ratio to improve from where it's at right now. It's 31.6% in Q3, I would expect it to tick up moderately in Q4, Q1, and then Q2. Depending on how that renewal goes, we'll let you know what we expect that ratio to go. But overall, I expect Q3 to be the low point for that ratio and to improve going forward.

Mark Hughes

Appreciate that. Thank you.

Christopher Uchida

You're welcome.

Mac Armstrong

Thanks, Mark.

Operator

Our next question comes from Andrew Lambert with Piper Sandler. Please proceed with your question.

Andrew Lambert

Hey, guys. Andrew on here for Paul. Congratulations on the quarter.

Christopher Uchida

Thanks, Andrew.

Andrew Lambert

Yes. I was just looking at your results and some of your press releases, and there was some expansion in the casualty space in the quarter. I'm just wondering if you could give some insight into how you look at the balance of property versus casualty as part of your Palomar 2X plan.

Mac Armstrong

Yes, Andrew, thanks for that question. Yes, we were pleased with the continued traction in the casualty market, and we were also excited to make incremental investments in that franchise, most notably with the launch of the environmental practice. Premium for the environmental practice, we hope to generate

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

some in the fourth quarter, but it's really going to drive growth in '24 and, frankly, '25 for that matter. Long term, we think we have segments in the casualty arena that can be meaningful from a scale perspective. I don't know right now if we're in a position to say that we think casualty will be 40% of the book. I don't think it will be to that level, but we do think that we have segments, whether it's in professional lines, or contractors' liability, or environmental, that can get to scale and replicate the scale that we have achieved in a segment like Builders' Risk.

Long-term, it's going to be a meaningful contributor. It's going to continue to be a nice diversifier, and it's also going to be one that we take a very tactical approach and a conservative approach to as we build up a nice book of reserves or base of reserves and use a considerable amount of reinsurance to avoid disproportionate impact of a shock loss.

Andrew Lambert

Great, thanks. Following up on that, you guys commented earlier in the call about the acquisition expense ratio going up. I was just hoping you could provide some color on how you guys are thinking about M&A, perspectively.

Mac Armstrong

Yes, sure. I'll let Chris speak to our acquisition expense in terms of customer acquisition and really commissions and the like. I think M&A for us, we've not been a serial acquirer by any stretch of the imagination. We are very much more focused on organic growth. We will opportunistically look at deals, but I think if you look at what we have in our product suite, we have ample room for growth, we have multiple growth vectors. We will remain an organic growth story for the indefinite future.

Christopher Uchida

Speaking about the acquisition expense specifically, it was 9.9% for the quarter, an improvement sequentially from last quarter. We do see that ratio starting to flatten out to potentially moving up modestly. As we look at the growth rates and the mixes of the business, fronting is starting to come in line with some of our other lines of business from a growth rate standpoint. Overall, we feel that the acquisition expense will now start to potentially tick up or be flatter as all of our lines start to grow at a little more similar rate, whether it be casualty, whether it be fronting. But overall, we feel very good about it. Just a reminder, we usually look at those on a gross basis just because of the impact that the increased excess of loss can have on combined ratio type ratios.

Andrew Lambert

Great. Thanks for the help. Congrats again on the quarter.

Mac Armstrong

Thank you very much.

Operator

Our next question comes from David Motemaden, with Evercore ISI. Please proceed with your question.

David Motemaden

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Hi. I just had a question just how you're—I know you guys renew most of your reinsurance at 6/1, but I'm just wondering how your view has changed, if at all, as we head into the 1/1 renewal. I'm focused both on property cat and on the casualty side. I'm wondering if something has happened that has caused you guys to move more wind risk off balance sheet through the exchange for the Hawaiian hurricane business.

Mac Armstrong

Hey Dave, this is Mac, and I'm happy to address all of that. They're good questions and things that we're frankly encouraged about. Let me start with just casualty. We did have two casualty treaties renew in the quarter. As I mentioned, they renewed at expiring terms, and we did have incremental reinsurer support, whether it's supporting us from a capacity standpoint or new re-insurers coming on to the panel. Those were both, again, quota shares, and they were for professional lines and one of our fronted casualty arrangements. Business as usual there and encouraging, and I would say that both of those treaties continue to perform very well from a loss perspective and are building up a nice base of reserves.

As you're looking at the Laulima exchange, I think our decision there is, in this current market environment from a reinsurance and excessive loss pricing, we believe we can generate equivalent returns as an attorney in fact manager as opposed to a risk bearer. All things being equal, if we can generate a similar level of return and not put that pressure on our balance sheet, we would prefer to do that. The transition from Palomar Specialty to Laulima for a good portion of our book will help reduce reinsurance expense. It will help also make our program, frankly, more single peril, which I think will result in not just lower expense as we remove expense out from exposure reduction, but also just more attractive to reinsurers as—once you get above $100 million of all peril exposure, it's going to really be all earthquake from an excessive loss standpoint. I think Laulima was just sound capital management and the ability to generate an equivalent risk adjusted return—not an equivalent risk adjusted return—generate an equivalent return with a very different risk profile.

Lastly, we do not have anything from an excess of loss renewing at 1/1. We do have a quota share for a Commercial Earthquake and we feel very good about the success in placing that at equivalent, if not superior, economics. As I mentioned, the underlying metrics in our Commercial Earthquake book are at all time bests so that makes this very appealing to quota share reinsurers. Looking forward, we are very confident that our book is going to stand out to our reinsurance panel from a performance perspective, which leads us to believe that at 6/1, and I think it's what we're hearing at 1/1, too, is if it's flat to modestly up, that is very digestible for us. There's certainly some leading indicators that make us very confident that to flat it modestly up is achievable and attainable. I think that there are also some unique factors to Palomar that make us more confident that that's attainable.

David Motemaden

Got it. Understood that. That makes sense on the reciprocal. Understood there. With all the changes, Chris, so heard you on the lowering the attritional loss ratio outlook for this year, how should we think about it going forward into 2024 and 2025? Would you still expect continued improvement off of the full year '23 levels?

Christopher Uchida

Yes, Dave. No, that's a great question. Obviously, we've talked about it previously that we did expect the loss ratio to improve. Maybe it's improving a little earlier than we expected, but obviously, we're happy with the results. All of our lines are performing—all of our, I guess I should say, continuing lines are performing as expected. You will notice that in the earnings release, we did have some unfavorable prior period development that was really driven by lines that we were running off. It helps validate the decision

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

to run off those lines. The favorable catastrophe development that you saw was actually from this year. It was the Q1 events were the primary driver of that. The California flooding that happened earlier this year, we did have favorable development there.

Overall, we're happy with where the loss ratio is this quarter. We do expect some potential improvement from that, maybe in Q4 and Q1, but overall, we're starting to get to what I would say is the bottom of that loss ratio improvement. We are still growing a lot of lines that are very, one, profitable, but do have attritional losses with them. That can be casualty, that could be in the marine. As those lines continue to grow and as we get those runoff lines out of our portfolio, I do expect to see the loss ratio tick up over time. Maybe, let's call it Q2-ish of next year, maybe Q3 of next year, I wouldn't be surprised to see the loss ratio start incrementally moving back up. But it's really going to be driven by the overall mix of those business and the growth in those lines of business. It's going to happen I think as expected, but no surprises. It's not going to, as I've said before, jump to 30% overnight, but it's going to incrementally tick up and still anchored by that strong earthquake business that has a 0% loss ratio.

Mac Armstrong

Dave, I think, a couple points to add on to, and I completely agree with Chris is saying, it may modestly tick up the second half of 2024, but that will be on the heels of higher earned premium from those lines of business that are contributing a higher attritional loss ratio. The combined, which on an adjusted basis was 70.8%, will stay relatively in line. Furthermore, the ROE will continue to trend above 20%. Furthermore, earthquake is now indexing the growth rate, and we feel very good about earthquake growth in to '24, too. They're not going to be wide vacillations. We're very pleased with the loss ratio and we think it's kind of in a nice steady state right now.

David Motemaden

Got it. Understood. Thank you.

Mac Armstrong

Thanks, Dave.

Operator

Our next question comes from Meyer Shields, with KBW. Please proceed with your question.

Meyer Shields

Great. Thanks so much. I was hoping you could outline maybe the specific asset you have for assumed reinsurance and the time frame for getting that started, is that going to be running 1/1?

Mac Armstrong

Hey, Meyer. Yes, thanks for asking the question. As you know, we have written assumed reinsurance throughout our history and a lot of our earthquake partnerships actually are assumed reinsurance arrangements, especially in geographies that the average premium is pretty modest. It’s more effective from a cost and administrative standpoint to structure as an assumed re-deal.

Bringing on Matt is really helping us institutionalize what we already have in place, what we did at 1/1 of '23, for instance, where we set up a lot of, for lack of a better term, kind of swaps where we were taking some uncorrelated property exposure in exchange for getting excess of loss support on our core

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

earthquake program. Matt joining us will allow us to see more deals. He has a long-standing track record in the space. What we'll look to write will be, again, uncorrelated specialty in some property business. We will write some at 1/1 in addition to what we already have, renewing at 1/1. I think it will kind of really extend our specialty, insure, strategy, and franchise. Hopefully some premium at 1/1, definitely at 6/1 and 4/1 of next year. It's going to look similar to what we've done historically, with probably a little bit more specialty business folded in.

Meyer Shields

Okay, perfect. That's very helpful. Unrelated question, but we've been hearing some homeowners' insurers, and this is really on the standard line side, talk about maybe slowing inflation guard related increases. I'm wondering whether there's any reason to expect that on your book.

Mac Armstrong

Yes, Meyer, thanks for the question. We have not seen that, but I'm going to let Jon Christianson speak to that.

Jon Christianson

Yes, Meyer. We continue to push through strong inflation guard increases each year, and we monitor the premium retention, as you know, and watch how that renewal book performs as we push through those inflationary factors. To date, we have no reason to change our current direction with regard to continuing to push strong inflation guard, regardless of what some of our homeowner carrier partners decide to do independent of our renewal activity. No reason for us to change at the moment.

Mac Armstrong

Yes, and the thing that I would add, Meyer, I'd add two things. One, first and foremost, we want to underwrite our companion products alongside the homeowners, but we come up with what the requisite insurance to value would be. If a homeowner carrier has one sense of it, we may have a different one. But it's premised on what our underwriting and what our analytics are determining is the appropriate replacement cost for the structure. Then secondly, we are writing—our inflation guard is probably most pronounced in a state like Hawaii or California where inflation maybe has not moderated quite as rapidly as maybe other parts of the country. I think that's going to inform it too.

Meyer Shields

Okay. Excellent. Thank you so much.

Operator

Our next question comes from Andrew Andersen, with Jefferies. Please proceed with your question.

Andrew Andersen

Hey, good afternoon. Just thinking about the Hawaii reciprocal, do you view this as kind of a proof of concept for other opportunities perhaps? I'm thinking of specialty homeowners, and I think there's some reciprocal exchanges there, or is this kind of a one-off opportunity?

Mac Armstrong

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Andrew, yes, that's a good question. I think having a reciprocal certainly gives us the ability to export that strategy to other lines, but for now, we are acutely focused on it in Hawaii. This is, again, a very sound strategic rationale to putting Laulima in place in Hawaii. We have a 12-to-18-month exercise to transition our exposure off of Palomar Specialty onto Laulima. Maybe at that point, we'll pick up our heads and see where we can export it elsewhere, because the model does work. But for now, it is a one trick pony.

Andrew Andersen

Got it. On a Residential Flood, can you maybe just give us an update of what that business is, maybe the size the market and loss ratio that you're underwriting to in this line?

Mac Armstrong

Sure, yes. Our inland flood strategy, and I'll let Jon come over the top on me, is exactly what I described. It’s an inland flood. We are not writing outside of the state of Hawaii really coastal exposure. We are trying to avoid stacking limits. If we have some continental hurricane exposure, we're not going to write the flood. It tends to be more inland flood in western and midwestern states and then in the northeast, most notably Pennsylvania. It's all primary limits that's competing with the NFIP. What we're looking to do is really underwrite risk at a much more granular level. We write a 30-by-30 meter geocode and that factors in elevation as well as proximity to floodplains and flood zone location. We've been deliberate in how we've grown from a geographic perspective, and I think we'll continue to do so. We are charting to use the ENS company in an increasing fashion as well. But this is one where we don't want to stack limit, stack exposure from a loss perspective. But Jon, you want to talk to us about that?

Jon Christianson

Yeah. We're targeting from a loss perspective, predictable expected losses. As Mac mentioned, we do not currently write in the Southeastern United States and coastal areas to avoid the volatility of loss. We're able to price the product to a profitable level, pull in exposure from lower hazard zones. We will write some higher hazard zones, but really targeting those risks that fit a predictable, profitable loss ratio. The business is priced on a granular level to ensure consistency in delivering results. I think even in a heightened loss year of 2023, from a Flood perspective, the product performed as we'd expect.

Mac Armstrong

I think our loss tick on that's going to be around a 40 typically.

Christopher Uchida

Yes, and I'd say one good example of that to add on is this quarter we did have exposure to Hilary. We performed; our book performed very well in that. We will have some losses from that, but based on the performance of our book, it did not rise to the magnitude that it needed to be separated as a catastrophe. Overall, we're very happy with the performance of the book broadly and during the quarter.

Andrew Andersen

Great. Thank you.

Mac Armstrong

Thanks, Andrew.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Operator

Our next question comes from Pablo Singzon, with JPMorgan. Please proceed with your question.

Mac Armstrong

Hey, Pablo, are you there?

Operator

Are you muted, Pablo? Pablo, is your line muted?

Pablo Singzon

Yes, sorry about that. It was muted. Sorry about that.

Operator

It's okay.

Mac Armstrong

No problem.

Pablo Singzon

Yes. The first question is for Chris. You described a lot of things that are happening in the Company, improving the loss ratio and maybe the first half of next year and uptick in the second half, a flattening of the acquisition cost ratio, there's a reciprocal exchange. If you were to sort of simplify it and put everything together, what would the combined ratio look like directionally as we go into '24 and '25? I think in the past, you had talked about a gradual uptick every year, maybe half a point, a point. Is that still the trajectory you're thinking about given everything that you guys are doing at this point?

Christopher Uchida

Yes. No, I think directionally, that's still accurate. One thing I want to think about and talk about is the impact that the excess of loss cost does have on our ratios and one of the reasons we try and talk about acquisition expense ratio, other underwriting expense ratio on more of a gross basis. When you looked at it this year, I talked about the $13 million of additional costs earlier. That $13 million of additional costs is in the denominator of the expense ratio. This quarter, that does add to the overall ratio that you're going to get. When you look at it, the ratios this quarter would have been probably about 13% lower than they were if that additional expense was not in there. The expense ratio would have probably been around 45% to 46%, and the loss ratio even would have been about 16% to 17%.

We try not to give too much specific combined ratio guidance, but to your point, I do expect it to tick up modestly as things improve. But overall, we try and think about those expense ratios on a growth standpoint. That 9.9%, I do—for acquisition expense, I do expect that to be flatter to potentially up. That's going to be driven by mix. The growth rates for a lot of our lines of business are starting to come more in line. Fronting is a big piece of that, we're not going to get 150% fronting growth like we did previously and so that seeding commission will not outpace the acquisition expense. I expect the acquisition expense ratio to be a little bit flatter. When you look at the other underwriting expense, it was about 6.7% this quarter versus 6.9% in Q2. It did go down, but we're not going to stop investing.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.
1-888-562-0262 1-604-929-1352 www.viavid.com

Mac talked about that we have some new team members on the underwriting side to help drive environmental and some of the assumed rebusiness. We will invest in those teams. We will invest in their systems. While that ratio might be flatter to potentially up on a sequential quarter basis, over the long term, we do expect to see some scale in the other underwriting expenses. Overall, everything is performing as we'd expect. But I do want to make sure I pointed out that the excess of loss cost in the denominator for those ratios does impact it and can push those ratios a little higher than if you were looking at it with flat excess of loss costs.

Pablo Singzon

Yes, that's a fair point. The second question I had, this one on premiums. If you look at net earned premiums, they're on track to grow about 9% this year, which is down from 35% last year, because of various reasons you've covered in the past, like reinsurance and the runoffs here in lines. I think before Mac had offered 20% as a rule of thumb for growth in earthquake, and my guess is you can probably grow faster in the newer attritional lines. If you assume a manageable, stable attritional interest environment here, would it be reasonable to think that your net earn growth will certainly improve from here, but maybe track closer to the growth stream and growth of these lines as they grow? Thank you.

Mac Armstrong

Yes, Pablo, that's a great point you raised. Yes, the answer is yes. If reinsurance pricing doesn't go up 30%, gross and net should follow each other pretty closely. Especially now as fronting won't be disproportionately—growing at a disproportionately faster rate. Yes, we think there is great promise for operating leverage in our model, especially as reinsurance pricing stabilizes, which I think it will this year, and has the potential to decrease in future years. Your point is a good one and one worth noting. Net earned premium has the chance to scale nicely.

Christopher Uchida

Yes. I think just from a modeling standpoint, I think the best way to think about it is a little more sequentially, on a quarter-over-quarter basis, especially off of Q3, and that the dollar amount, like you said, should be going up. It's a little harder to compare to prior years because of that excess of loss cost that you talked about. But I like to try and model that a little more sequentially and seeing how those things over dollars will move on a quarter over quarter basis, especially, let's call it using Q3 as a good base now that all the excess of loss is fully baked in and those dollars should not change until 6/1 of '24, based on the next reinsurance renewal.

Pablo Singzon

Yes, that's clear. Thank you.

Mac Armstrong

Thanks, Pablo.

Operator

We have reached the end of the question-and-answer session. I'd now like to turn the call back over to Mac Armstrong for closing comments.

Mac Armstrong

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com

Yes, thank you, Operator, and thank you all who joined us this morning. We appreciate your participation, your questions, and your support.

To conclude, I want to reiterate how pleased I am with our third quarter results and how proud I am of our team who allowed us to achieve them. We are focused on profitable growth and predictable earnings and believe that we are well positioned to accomplish these objectives for the remainder of this year, 2024 and beyond.

Before closing, I just want to take a moment to thank Bob Dowdell, a member of our board of directors who recently passed away. Bob has been involved as an advisor and member of our board since we formed the Company some 10 years ago. He was a mentor, coach, and friend to all on our leadership team. He was also Palomar's greatest cheerleader. We'll miss him dearly.

Thank you again, enjoy the rest of your day. Take care.

Operator

This concludes today's conference. You may disconnect your lines at this time, and we thank you for your participation.

ViaVid has made considerable efforts to provide an accurate transcription. There may be material errors, omissions, or inaccuracies in the reporting of the substance of the conference call. This transcript is being made available for information purposes only.

1-888-562-0262 1-604-929-1352 www.viavid.com