

Heritage Insurance Holdings, Inc.  
Form 10-Q  
May 09, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number

001-36462

Heritage Insurance Holdings, Inc.

(Exact name of Registrant as specified in its charter)

Delaware 45-5338504  
(State of Incorporation) (IRS Employer

Identification No.)

2600 McCormick Drive, Suite 300

Clearwater, Florida 33759

(Address, including zip code, of principal executive offices)

(727) 362-7200

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer  
Non-accelerated filer Smaller reporting company  
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate number of shares of the Registrant's Common Stock, \$0.0001 par value, outstanding on May 7, 2018 was 26,569,804

HERITAGE INSURANCE HOLDINGS, INC.

Table of Contents

	Page
<u>PART I – FINANCIAL INFORMATION</u>	
<u>Item 1 Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets: March 31, 2018 (unaudited) and December 31, 2017</u>	2
<u>Condensed Consolidated Statements of Operations and Other Comprehensive Income: Three months ended March 31, 2018 and 2017 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Stockholders' Equity: Three months ended March 31, 2018 and 2017 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows: Three months ended March 31, 2018 and 2017 (unaudited)</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	28
<u>Item 3 Quantitative and Qualitative Disclosures about Market Risk</u>	34
<u>Item 4 Controls and Procedures</u>	36
<u>PART II – OTHER INFORMATION</u>	
<u>Item 1 Legal Proceedings</u>	36
<u>Item 1A Risk Factors</u>	36
<u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	36
<u>Item 4 Mine Safety Disclosures</u>	36
<u>Item 6 Exhibits</u>	37
<u>Signatures</u>	38

---

## FORWARD-LOOKING STATEMENTS

Statements in this Quarterly Report on Form 10-Q (“Form 10-Q”) or in documents incorporated by reference that are not historical facts are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include statements about anticipated growth in revenue, earnings per share, estimated unpaid losses on insurance policies, investment returns and expectations about our liquidity, and our ability to meet our investment objectives and to manage and mitigate market risk with respect to our investments. These statements are based on current expectations, estimates and projections about the industry and market in which we operate, and management’s beliefs and assumptions. Without limiting the generality of the foregoing, words such as “may”, “will”, “expect”, “believe”, “anticipate”, “intend”, “could”, “would”, “estimate”, or “continue” or the negative variations and comparable terminology are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance and involve certain known and unknown risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements. The risks and uncertainties include, without limitation:

- the possibility that actual losses may exceed reserves;
- the concentration of our business in coastal states, which could be impacted by hurricane losses or other significant weather-related events such as northeastern winter storms;
- our exposure to catastrophic weather events;
- the fluctuation in our results of operations;
- increased costs of reinsurance, non-availability of reinsurance, and non-collectability of reinsurance;
- our failure to effectively manage our growth and integrate acquired companies;
- increased competition, competitive pressures, and market conditions;
- our failure to accurately price the risks we underwrite;
- inherent uncertainty of our models and our reliance on such model as a tool to evaluate risk;
- the failure of our claims department to effectively manage or remediate claims;
- low renewal rates and failure of such renewals to meet our expectations;
- our failure to execute our diversification strategy;
- failure of our information technology systems and unsuccessful development and implementation of new technologies;
- a lack of redundancy in our operations;
- our failure to attract and retain qualified employees and independent agents or our loss of key personnel;
- our inability to generate investment income;
- our inability to maintain our financial stability rating;
- effects of emerging claim and coverage issues relating to legal, judicial, environmental and social conditions;
- the failure of our risk mitigation strategies or loss limitation methods; and
- changes in regulations and our failure to meet increased regulatory requirements.

Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or operating results.

These forward-looking statements are subject to numerous risks, uncertainties and assumptions about us described in our filings with the Securities and Exchange Commission (the “SEC”). The forward-looking statements we make in our Form 10-Q are valid only as of the date of our Form 10-Q and may not occur in light of the risks, uncertainties and assumptions that we describe from time to time in our filings with the SEC. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from our forward-looking statements is included in the section entitled “Risk Factors” in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2017. Except as required by applicable law, we undertake no obligation and disclaim any obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.



## PART I – FINANCIAL INFORMATION

## Item 1 – Financial Statements

## HERITAGE INSURANCE HOLDINGS, INC.

## Condensed Consolidated Balance Sheets

(Amounts in thousands, except per share and share amounts)

	March 31, 2018	December 31, 2017
<b>ASSETS</b>	(unaudited)	
Fixed maturity securities, available for sale, at fair value (amortized cost of \$496,812 and \$552,458 in 2018 and 2017, respectively)	\$486,678	\$549,796
Equity securities, available for sale, at fair value (cost of \$17,395 and \$17,548 in 2018 and 2017, respectively)	16,235	17,217
Total investments	502,913	567,013
Cash and cash equivalents	193,641	153,697
Restricted cash	20,836	20,833
Accrued investment income	4,241	5,057
Premiums receivable, net	66,734	67,757
Reinsurance recoverable on paid and unpaid claims	553,823	357,357
Prepaid reinsurance premiums	164,061	227,764
Income taxes receivable	17,523	37,338
Deferred policy acquisition costs, net	53,862	41,678
Property and equipment, net	18,417	18,748
Intangibles, net	94,999	101,626
Goodwill	152,459	152,459
Other assets	22,902	19,883
<b>Total Assets</b>	<b>\$1,866,411</b>	<b>\$1,771,210</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Unpaid losses and loss adjustment expenses	\$547,735	\$470,083
Unearned premiums	452,537	475,334
Reinsurance payable	56,008	17,577
Long-term debt, net	185,138	184,405
Deferred income tax	18,280	34,333
Advance premiums	37,738	23,648
Accrued compensation	7,328	16,477
Accounts payable and other liabilities	172,754	169,537
<b>Total Liabilities</b>	<b>\$1,477,518</b>	<b>\$1,391,394</b>

## Commitments and contingencies (Note 16)

## Stockholders' Equity:

Common stock, \$0.0001 par value, 50,000,000 shares authorized, 26,569,806 shares issued and 25,769,806 outstanding at March 31, 2018 and 26,560,004 shares issued and 25,885,004 outstanding at December 31, 2017	3	3
Additional paid-in capital	297,112	294,836
Accumulated other comprehensive loss	(7,649 )	(3,064 )
Treasury stock, at cost, 7,214,797 shares at March 31, 2018 and 7,099,597 shares at December 31, 2017	(89,184 )	(87,185 )
Retained earnings	188,611	175,226
Total Stockholders' Equity	388,893	379,816
Total Liabilities and Stockholders' Equity	\$1,866,411	\$1,771,210

See accompanying notes to unaudited condensed consolidated financial statements.

## HERITAGE INSURANCE HOLDINGS, INC.

## Condensed Consolidated Statements of Operations and Other Comprehensive Income

(Unaudited)

(Amounts in thousands, except per share and share amounts)

	For the Three Months Ended March 31,	
	2018	2017
<b>REVENUES:</b>		
Gross premiums written	\$204,366	\$142,235
Change in gross unearned premiums	22,797	12,373
Gross premiums earned	227,163	154,608
Ceded premiums	(121,055 )	(62,432 )
Net premiums earned	106,108	92,176
Net investment income	3,302	2,502
Net realized (losses) gains	(227 )	771
Other revenue	2,843	3,844
Total revenues	112,026	99,293
<b>EXPENSES:</b>		
Losses and loss adjustment expenses	53,091	46,647
Policy acquisition costs, net of ceding commission income of \$14.3 million and \$0, respectively	12,187	23,442
General and administrative expenses, net of ceding commission income of \$4.7 million and \$0, respectively	21,931	17,314
Total expenses	87,209	87,403
Operating income	24,817	11,890
Interest expense, net	4,820	2,181
Income before income taxes	19,997	9,709
Provision for income taxes	5,168	3,726
Net income	\$14,829	\$5,983
<b>OTHER COMPREHENSIVE INCOME</b>		
Change in net unrealized (losses) gains on investments	(6,478 )	3,981
Reclassification adjustment for net realized investment losses (gains)	227	(771 )
Income tax benefit (expense) related to items of other comprehensive income	1,823	(1,236 )
Total comprehensive income	\$10,401	\$7,957
Weighted average shares outstanding		
Basic	25,727,553	28,806,709
Diluted	26,732,019	28,806,709
Earnings per share		
Basic	\$0.58	\$0.21
Diluted	\$0.55	\$0.21



See accompanying notes to unaudited condensed consolidated financial statements.

3

---

## HERITAGE INSURANCE HOLDINGS, INC.

## Condensed Consolidated Statements of Stockholders' Equity

Three Months Ended March 31, 2018 and 2017

(Unaudited)

(Amounts in thousands, except share amounts)

	Common Shares	Par Value	Additional Paid-In Capital	Retained Earnings (Deficit)	Treasury Shares	Accumulated Other Comprehensive (Loss) Income	Total Stockholders' Equity
Balance at December 31, 2017, as previously reported	25,885,006	\$ 3	\$ 294,836	\$ 175,226	\$(87,185)	\$(3,064)	\$ 379,816
Cumulative effect of change in accounting principle (ASU 2016-01), net of tax	—	—	—	(267)	—	267	—
Balance at December 31, 2017, as adjusted	25,885,006	3	294,836	174,959	(87,185)	(2,797)	379,816
Stock buy-back	(115,200)	—	—	—	(1,999)	—	(1,999)
Stock-based compensation	—	—	1,306	—	—	—	1,306
Reclassification of income taxes upon early adoption of ASU 2018-02	—	—	—	424	—	(424)	—
Tax effect of warrant reclassification	—	—	970	—	—	—	970
Dividends declared on common stock	—	—	—	(1,601)	—	—	(1,601)
Net unrealized change in investments, net of tax	—	—	—	—	—	(4,428)	(4,428)
Net income	—	—	—	14,829	—	—	14,829
Balance at March 31, 2018	25,769,806	\$ 3	\$ 297,112	\$ 188,611	\$(89,184)	\$(7,649)	\$ 388,893

	Common Shares	Par Value	Additional Paid-In Capital	Retained Earnings (Deficit)	Treasury Shares	Accumulated Other Comprehensive (Loss) Income	Total Stockholders' Equity
Balance at December 31, 2016	28,840,443	\$ 3	\$ 205,727	\$ 182,809	\$(25,562)	\$(5,018)	\$ 357,959

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

Stock buy-back	(361,211 )	—	—	—	(4,506 )	—	(4,506 )
Stock-based compensation	—	—	1,204	—	—	—	1,204
Dividends declared on common stock	—	—	—	(1,783 )	—	—	(1,783 )
Net unrealized change in investments,							
net of tax	—	—	—	—	—	1,974	1,974
Net income	—	—	—	5,983	—	—	5,983
Balance at March 31, 2017	28,479,232	\$ 3	\$ 206,931	\$ 187,009	\$(30,068)	\$ (3,044)	\$ 360,831

See accompanying notes to unaudited condensed consolidated financial statements.

## HERITAGE INSURANCE HOLDINGS, INC.

## Condensed Consolidated Statements of Cash Flows

(Unaudited)

(Amounts in thousands)

	For the Three Months Ended March 31,	
	2018	2017
<b>OPERATING ACTIVITIES</b>		
Net income	\$14,829	\$5,983
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
activities:		
Stock-based compensation	1,306	1,204
Bond amortization and accretion	1,792	2,225
Amortization of original issuance discount on debt	871	—
Depreciation and amortization	7,041	2,841
Net realized gains	227	(771 )
Deferred income taxes	(13,260 )	(421 )
Changes in operating assets and liabilities:		
Accrued investment income	816	(245 )
Premiums receivable, net	1,023	8,140
Prepaid reinsurance premiums	63,703	60,551
Reinsurance premiums receivable and recoverable	(196,466)	—
Income taxes receivable	19,815	4,289
Deferred policy acquisition costs, net	(12,184 )	1,564
Other assets	(3,019 )	152
Unpaid losses and loss adjustment expenses	77,652	(8,565 )
Unearned premiums	(22,797 )	(12,373 )
Reinsurance payable	38,431	(55,743 )
Accrued interest	3,217	(1,931 )
Accrued compensation	(9,219 )	(834 )
Advance premiums	14,090	3,516
Other liabilities	—	(5,596 )
Net cash (used in) provided by operating activities	(12,132 )	3,986
<b>INVESTING ACTIVITIES</b>		
Proceeds from sales and maturities of investments available for sale	127,328	46,608
Purchases of investments available for sale	(71,498 )	(47,709 )
Cost of property and equipment acquired	(83 )	(148 )
Net cash provided by (used in) investing activities	55,747	(1,249 )
<b>FINANCING ACTIVITIES</b>		
Mortgage loan payments	(68 )	—
Purchase of treasury stock	(1,999 )	(4,506 )

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

Cash dividends paid	(1,601 )	(1,783 )
Net cash used in financing activities	(3,668 )	(6,289 )
Increase (decrease) in cash, cash equivalents, and restricted cash	39,947	(3,552 )
Cash, cash equivalents and restricted cash, beginning of period	174,530	126,727
Cash, cash equivalents and restricted cash, end of period	\$214,477	\$123,175
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Interest paid	\$5,406	\$1,931

Reconciliation of cash, cash equivalents, and restricted cash to the condensed consolidated balance sheets

	March 31, 2018	December 31, 2017
	(in thousands)	
Cash and cash equivalents	\$193,641	\$153,697
Restricted cash	20,836	\$20,833
Total cash, cash equivalents and restricted cash shown in the condensed consolidated statements of cash flows	\$214,477	\$174,530

See accompanying notes to unaudited condensed consolidated financial statements.

HERITAGE INSURANCE HOLDINGS, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The condensed consolidated financial statements as of and for the three months ended March 31, 2018 and 2017 include Heritage Insurance Holdings, Inc. (“Parent Company”); its property and casualty insurance subsidiaries: Heritage Property & Casualty Insurance Company (“Heritage P&C”), Narragansett Bay Insurance Company (“NBIC”) and Zephyr Insurance Company, Inc. (“Zephyr”); Heritage MGA, LLC, the managing general agent that manages substantially all aspects of our Florida insurance subsidiary’s business; Contractors’ Alliance Network, LLC (“CAN”), our vendor network manager for Florida claims which includes BRC Restoration Specialists (“BRC”), our provider of restoration, emergency and recovery services; Skye Lane Properties, LLC, our property management subsidiary; First Access Insurance Group, LLC, our retail agency; Osprey Re Ltd. (“Osprey”), our reinsurance subsidiary that may provide a portion of the reinsurance protection purchased by our insurance subsidiaries; and Heritage Insurance Claims, LLC, an inactive subsidiary reserved for future development.

Through our insurance subsidiaries, Heritage P&C, Zephyr and NBIC, we write personal residential insurance for single-family homeowners and condominium owners, and rental property insurance in the states of Alabama, Connecticut, Florida, Georgia, Hawaii, Massachusetts, New Jersey, New York, North Carolina, Rhode Island and South Carolina. We also provide commercial residential insurance for Florida properties and are also licensed in the states of Mississippi and Pennsylvania. We are vertically integrated and control or manage substantially all aspects of insurance underwriting, customer service, actuarial analysis, distribution and claims processing and adjusting.

The condensed consolidated financial information included herein as of and for the three months ended March 31, 2018 and 2017 does not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. However, such information reflects all adjustments consisting of normal recurring accruals which are, in the opinion of management, necessary for a fair statement of the financial condition and results of operations for the interim periods. The results for the three months ended March 31, 2018 and 2017 are not indicative of annual results. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The December 31, 2017 consolidated balance sheet was derived from the Company’s audited consolidated financial statements as of and for the year ended December 31, 2017.

For further information, refer to the consolidated financial statements and footnotes thereto included in Heritage Insurance Holdings, Inc.’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (the “2017 Form 10-K”). References to “we”, “us”, “our”, or the “Company” refer to Heritage Insurance Holdings, Inc. and its consolidated subsidiaries.

Changes to significant accounting policies

We have made no material changes to our significant accounting policies as reported in our Annual Report on Form 10-K for the year ended December 31, 2017.

## Reclassification

We have reclassified certain amounts in the 2017 statement of operations to conform to our 2018 presentation. Additionally, we reclassified certain amounts in the 2017 consolidated statement of cash flows to conform to the 2018 presentation, relating to the presentation of restricted cash and cash equivalents. This reclassification is a result of our adoption of Accounting Standards Update (ASU) 2016-18, Restricted Cash effective January 1, 2018.

## Recently Adopted Accounting Pronouncements

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): The amendment allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (“Tax Act”). In addition, under ASU 2018-02, an entity will be required to provide certain disclosures regarding stranded tax effects. The new guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. The Company early adopted the updated guidance effective January 1, 2018 and elected to

reclassify the stranded income tax effects relating to the reduction in the federal corporate income tax rate from accumulated other comprehensive income (“AOCI”) to Retained earnings at the beginning of the period of adoption. The net impact of the accounting change resulted in a \$0.4 million decrease in AOCI comprised of income taxes associated with net unrealized losses on investments and a corresponding increase in retained earnings.

In May 2017, the FASB issued ASU No. 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting, clarifying when a change to the terms or conditions of a share-based payment award must be accounted for as a modification. The new guidance requires modification accounting if the fair value, vesting condition or the classification of the award is not the same immediately before and after a change to the terms and conditions of the award. The new guidance is effective for the Company on a prospective basis beginning on January 1, 2018, with early adoption permitted. This new guidance does not have an impact on the Company’s condensed consolidated financial statements as it is not the Company’s practice to change either the terms or conditions of share-based payment awards once they are granted.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805). Clarifying the Definition of a Business, which provides additional guidance on evaluating whether transactions should be accounted for as acquisitions of assets or businesses. The guidance requires an entity to evaluate if substantially all the fair value of the assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If this threshold is met, the new guidance would define this as an asset acquisition; otherwise, the entity then evaluates whether the asset meets the requirement that a business include, at a minimum, an input and substantive process that together significantly contribute to the ability to create outputs. The guidance is effective for the Company on a prospective basis beginning on January 1, 2018, with early adoption permitted. The impact of this guidance will be determined by the terms of any future acquisitions.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 is a new accounting standard that will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. This updated guidance is effective on January 1, 2018, and will require adoption on a retrospective basis with early adoption permitted. The Company has not experienced any transactions that are within the scope of this guidance and accordingly will evaluate the effect of this guidance further if and when any such transactions occur.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows, which requires entities to include in their cash and cash-equivalent balances in the statement of cash flows those amounts that are deemed to be restricted cash and restricted cash equivalents. The ASU does not define the terms “restricted cash” and “restricted cash equivalents.” To conform to the new guidance, the Company reclassified \$20.9 million of restricted cash to the beginning period balance for cash, cash equivalents and restricted cash for the three months ended March 31, 2017.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities. The ASU, will significantly change the income statement impact of equity investments held by an entity and the recognition of changes in fair value of financial liabilities when the fair value option is elected. The guidance requires equity investments to be measured at fair value with changes in fair value recognized through net income. In February 2018, the FASB issued ASU 2018-03, “Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10)” to clarify certain aspects of ASU No. 2016-01. The updated guidance was effective for the quarter ended March 31, 2018. The adoption of this guidance resulted in the recognition of \$0.4 million of net pre-tax unrealized loss on equity investments as a cumulative effect adjustment that decreased retained earnings as of January 1, 2018 and increased AOCI by the same amount. The Company elected to report changes in the fair value of equity investments in Other revenue.



In May 2014, the FASB issued ASU Topic 2014-09, Revenue from Contracts with Customers. The ASU 2014-09 creates a new topic, Topic 606, to provide guidance on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The updated guidance requires an entity to recognize revenue as performance obligations are met, in order to reflect the transfer of promised goods or services to customers in an amount that reflects the consideration the entity is entitled to receive for those goods or services. The standard is effective for the Company in the first quarter of 2018. The Company has determined that this pronouncement is not applicable to its insurance contracts and is not material to the Company's condensed consolidated financial statements.

#### Accounting Pronouncements

The Company describes below recent pronouncements that may have a significant effect on its consolidated financial statements or on its disclosures upon future adoption. The Company does not discuss recent pronouncements that are not anticipated to have an impact on, or are unrelated to, its financial condition, results of operations, or related disclosures.

7

---

In March 2018, the FASB issued ASU 2018-04, Investments-Debt Securities (Topic 320) and Regulated Operations (Topic 980). Pursuant to SEC Staff Accounting Bulletin No. 177 and SEC Release No 33-9273, the amendment of ASU 2018-04 adds, amends and supersedes various paragraphs that contain SEC guidance in ASC 320, Investments-Debt Securities and ASC 980, Regulated Operations. The Company does not anticipate the adoption of ASU 2018-04 will have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles-Goodwill and Other. The amendments in ASU 2017-04 intend to simplify the subsequent measurement of goodwill, eliminating Step 2 from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in ASU 2017-04, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. The standard is effective for the Company in the first quarter of 2020 on a prospective basis with early adoption permitted. The Company does not expect the adoption of this standard will have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses Measurement of Credit Losses on Financial Instruments. The estimate of expected credit losses should consider historical information, current information, as well as reasonable and supportable forecasts, including estimates of prepayments. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset in order to present the net carrying value at the amount expected to be collected on the financial asset on the consolidated balance sheet. The guidance also amends the current accounting for other-than-temporary impairment model by requiring an estimate of the expected credit loss only when the fair value is below the amortized cost of the asset. The length of time the fair value of an available-for-sale debt security has been below the amortized cost will no longer impact the determination of whether a potential credit loss exists. The available-for-sale debt security model will also require the use of a valuation allowance as compared to the current practice of writing down the asset. The standard is effective for the Company in the first quarter of 2020 with early adoption permitted in the first quarter of 2019. The Company does not expect the adoption of this standard will have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Lease Accounting, which amends the accounting treatment for leases. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Lessees (for capital and operating leases) and lessors (for sales-type leases, direct financing leases, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. Early adoption is permitted. The Company is currently evaluating the impact that the adoption of ASU 2016-02 may have on its consolidated financial statements.

There are no other recently issued accounting standards that apply to the Company or that are expected to have a material impact on the Company's results of operations, financial condition, or cash flows.

## NOTE 2. ACQUISITION

### Acquisition of NBIC

On November 30, 2017, the Company completed the acquisition of all the outstanding capital stock of NBIC Holdings, Inc., the parent company of Narragansett Bay Insurance Company, a leading specialty underwriter of personal residential insurance products and services in several states in the northeastern United States for \$250.0 million, including \$210.0 million in cash, plus 2,222,215 shares of the Company's common stock with an aggregate fair value of \$40.0 million. The completion of the NBIC acquisition represents a significant advancement in executing the Company's geographic diversification strategy by leveraging the Company's combined platform to accelerate growth along the Eastern region. The Company recognized goodwill of \$106 million, attributable to expected growth and profitability, none of which is expected to be deductible for income tax purposes. Refer to the 2017 Form 10-K for additional information on this acquisition.

8

---

## Unaudited Pro Forma Financial Information

The following unaudited pro forma results of operations assume that the NBIC acquisition occurred at the beginning of the periods presented. The pro forma amounts include certain adjustments, including depreciation and amortization expense and income taxes. The unaudited pro forma information assumes the acquisition had taken place January 1, 2017.

The unaudited pro forma effects for the three months ended March 31, 2017 is as follows:

For the Three Months Ended March 31, 2017	
(in thousands, except per share)	
Revenue	\$ 113,686
Net income	\$ 7,441
Basic, earnings per share	\$ 0.26
Diluted, earnings per share	\$ 0.26

## NOTE 3. INVESTMENTS

The following table details the difference between cost or adjusted/amortized cost and estimated fair value, by major investment category, at March 31, 2018 and December 31, 2017:

	Cost or Adjusted/Unrealized		Gross Unrealized	
	Amortized Costs (In thousands)	Gains	Losses	Fair Value
<b>March 31, 2018</b>				
U.S. government and agency securities	\$41,298	\$ 4	\$ 924	\$40,378
States, municipalities and political subdivisions	60,825	8	1,360	59,473
Special revenue	244,984	109	5,253	239,840
Industrial and miscellaneous	147,197	130	2,788	144,539
Redeemable preferred stocks	2,508	2	62	2,448
Total fixed maturities	496,812	253	10,387	486,678
Nonredeemable preferred stocks	14,297	21	443	13,875
Equity securities	3,098	5	743	2,360
Total equity securities	17,395	26	1,186	16,235
Total investments	\$514,207	\$ 279	\$ 11,573	\$ 502,913

	Cost or Adjusted/Unrealized		Gross Unrealized	
	Amortized Costs	Gains	Losses	Fair Value

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

(In thousands)

December 31, 2017				
U.S. government and agency securities	\$39,445	\$ 7	\$ 572	\$ 38,880
States, municipalities and political subdivisions	76,876	104	569	76,411
Special revenue	269,277	524	2,124	267,677
Industrial and miscellaneous	162,093	668	633	162,128
Redeemable preferred stocks	4,767	4	71	4,700
Total fixed maturities	552,458	1,307	3,969	549,796
Nonredeemable preferred stocks	14,450	69	195	14,324
Equity securities	3,098	64	269	2,893
Total equity securities	17,548	133	464	17,217
Total investments	\$570,006	\$ 1,440	\$ 4,433	\$ 567,013

9

The Company calculates the gain or loss realized on the sale of investments by comparing the sales price (fair value) to the cost or adjusted/amortized cost of the security sold. The Company determines the cost or adjusted/amortized cost of the security sold using the specific-identification method. The following tables detail the Company's net realized (losses) gains by major investment category for the three months ended March 31, 2018 and 2017.

	2018		2017	
	Gains		Gains	
	(Losses)	Fair Value at Sale	(Losses)	Fair Value at Sale
	(In thousands)			
For the Three Months Ended March 31,				
Fixed maturities	\$87	\$ 50,067	\$22	\$ 3,078
Equity securities	2	74	793	4,408
Total	89	50,141	815	7,486
Fixed maturities	(218)	48,143	(7 )	5,141
Equity securities	(98 )	2,167	(37 )	3,052
Total	(316)	50,310	(44 )	8,193
Net realized (losses) gains	\$(227)	\$ 100,451	\$771	\$ 15,679

The table below summarizes the Company's fixed maturities at March 31, 2018 by contractual maturity periods. Actual results may differ as issuers may have the right to call or prepay obligations, with or without penalties, prior to the contractual maturity of those obligations.

	March 31, 2018		Fair Value	Percent of Total	
	Cost or Amortized Cost	Total	(In thousands)		
	(In thousands)				
Due in one year or less	\$59,427	12	% \$ 59,325	12	%
Due after one year through five years	155,018	31	% 152,898	31	%
Due after five years through ten years	139,852	28	% 135,752	28	%
Due after ten years	142,515	29	% 138,703	29	%
Total	\$496,812	100	% \$ 486,678	100	%

The following table summarizes the Company's net investment income by major investment category for the three months ended March 31, 2018 and 2017, respectively:

For the Three  
Months Ended  
March 31,  
2018 2017  
(In thousands)

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

Fixed maturities	\$2,945	\$2,511
Equity securities	307	497
Cash, cash equivalents and short-term investments	157	69
Other investments	259	—
Net investment income	3,668	3,077
Investment expenses	366	575
Net investment income, less investment expenses	\$3,302	\$2,502

The Company does not intend to sell investments that are in an unrealized loss position and it is not likely that the Company will be required to sell any investments before recovery of their amortized cost basis. As such, the Company does not consider those investments with an unrealized loss to be other-than-temporarily impaired at March 31, 2018 or December 31, 2017. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in the three months ended March 31, 2018 and 2017.

10

---

The following tables present an aging of our unrealized investment losses by investment class as of March 31, 2018 and December 31, 2017:

	Less Than Twelve Months			Twelve Months or More		
	Number of Securities	Gross Unrealized Losses	Fair Value	Number of Securities	Gross Unrealized Losses	Fair Value
	(In thousands)					
<b>March 31, 2018</b>						
U.S. government and agency securities	52	\$ 521	\$18,674	30	\$ 404	\$9,317
States, municipalities and political subdivisions	59	1,043	47,179	9	317	10,611
Industrial and miscellaneous	432	2,330	121,512	45	458	11,598
Special revenue	322	2,823	159,473	177	2,429	65,134
Redeemable preferred stocks	9	62	2,135	18	9	179
Total fixed maturities	874	6,779	348,973	279	3,617	96,839
Nonredeemable preferred stocks	186	434	12,354	—	—	—
Equity securities	19	252	1,288	15	491	1,024
Total equity securities	205	\$ 686	\$13,642	15	\$ 491	\$1,024
Total	1,079	\$ 7,465	\$362,615	294	\$ 4,108	\$97,863

	Less Than Twelve Months			Twelve Months or More		
	Number of Securities	Gross Unrealized Losses	Fair Value	Number of Securities	Gross Unrealized Losses	Fair Value
	(In thousands)					
<b>December 31, 2017</b>						
U.S. government and agency securities	53	\$ 284	\$ 20,053	24	\$ 289	\$9,294
States, municipalities and political subdivisions	51	359	49,803	8	210	10,503
Industrial and miscellaneous	284	376	87,898	38	256	11,788
Special revenue	295	777	133,580	183	1,347	69,359
Redeemable preferred stocks	41	66	3,987	17	5	61
Total fixed maturities	724	1,862	295,321	270	2,107	101,005
Nonredeemable preferred stocks	127	188	10,047	6	7	159
Equity securities	11	46	677	12	223	1,095
Total equity securities	138	\$ 234	\$ 10,724	18	\$ 230	\$ 1,254
Total	862	\$ 2,096	\$ 306,045	288	\$ 2,337	\$ 102,259

#### NOTE 4. FAIR VALUE OF FINANCIAL INSTRUMENTS

For the Company's investments in U.S. government securities that do not have prices in active markets, agency securities, state and municipal governments, and corporate bonds, the Company obtains the fair values from its third-party valuation service and we evaluate the relevant inputs, assumptions, methodologies and conclusions associated with such valuations. The valuation service calculates prices for the Company's investments in the aforementioned security types on a month-end basis by using several matrix-pricing methodologies that incorporate inputs from various sources. The model the valuation service uses to price U.S. government securities and securities



of states and municipalities incorporates inputs from active market makers and inter-dealer brokers. To price corporate bonds and agency securities, the valuation service calculates non-call yield spreads on all issuers, uses option-adjusted yield spreads to account for any early redemption features, then adds final spreads to the U.S. Treasury curve as of quarter end. The inputs the valuation service uses in their calculations are not quoted prices in active markets, but are observable inputs, and therefore represent Level 2 inputs.

11

---

The following table presents information about the Company's assets measured at fair value on a recurring basis. The Company assesses the levels for the investments at each measurement date, and transfers between levels are recognized on the actual date of the event or change in circumstances that caused the transfer in accordance with the Company's accounting policy regarding the recognitions of transfers between levels of the fair value hierarchy. At March 31, 2018 and December 31, 2017, there were no transfers in or out of Level 1, 2, and 3.

March 31, 2018	Total	Level 1	Level 2	Level 3
	(in thousands)			
<b>Fixed maturities investments:</b>				
U.S. government and agency securities	\$40,378	\$353	\$40,025	\$ —
States, municipalities and political subdivisions	59,473	—	59,473	—
Special revenue	239,840	—	239,840	—
Industrial and miscellaneous	144,539	—	144,539	—
Redeemable preferred stocks	2,448	2,448	—	—
<b>Total fixed maturities investments</b>	<b>\$486,678</b>	<b>\$2,801</b>	<b>\$483,877</b>	<b>\$ —</b>
Nonredeemable preferred stocks	13,875	13,875	—	—
Equity securities	2,360	2,360	—	—
<b>Total equity securities</b>	<b>\$16,235</b>	<b>\$16,235</b>	<b>\$—</b>	<b>\$ —</b>
<b>Total investments</b>	<b>\$502,913</b>	<b>\$19,036</b>	<b>\$483,877</b>	<b>\$ —</b>

December 31, 2017	Total	Level 1	Level 2	Level 3
	(in thousands)			
<b>Fixed maturities investments:</b>				
U.S. government and agency securities	\$38,880	\$359	\$38,521	\$ —
States, municipalities and political subdivisions	76,411	—	76,411	—
Special revenue	267,677	—	267,677	—
Industrial and miscellaneous	162,128	—	162,128	—
Redeemable preferred stocks	4,700	—	4,700	—
<b>Total fixed maturities investments</b>	<b>\$549,796</b>	<b>\$359</b>	<b>\$549,437</b>	<b>\$ —</b>
Nonredeemable preferred stocks	14,324	14,324	—	—
Equity securities	2,893	2,893	—	—
<b>Total equity securities</b>	<b>\$17,217</b>	<b>\$17,217</b>	<b>\$—</b>	<b>\$ —</b>
<b>Total investments</b>	<b>\$567,013</b>	<b>\$17,576</b>	<b>\$549,437</b>	<b>\$ —</b>

#### NOTE 5. OTHER COMPREHENSIVE INCOME

Other comprehensive income was \$(4.4) million and \$2.0 million for the three months ended March 31, 2018 and 2017, respectively. The difference between net income as reported and comprehensive income was due to the changes in unrealized gains and losses, net of tax on available-for-sale debt securities.

For the Three Months Ended March 31,

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

	2018		2017			
	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
	(in thousands)					
<b>Other comprehensive income</b>						
Change in unrealized losses on investments, net	\$(6,478)	\$1,871	\$(4,607 )	\$3,981	\$(1,529)	\$ 2,452
Reclassification adjustment of realized losses (gains) included in net income	227	(48 )	179	(771 )	293	(478 )
Effect on other comprehensive income	\$(6,251)	\$1,823	\$(4,428 )	\$3,210	\$(1,236)	\$ 1,974

12

---

## NOTE 6. PROPERTY AND EQUIPMENT, NET

Property and equipment, net consisted of the following at March 31, 2018 and December 31, 2017:

	March 31, 2018		December 31, 2017
	(In thousands)		
Land	\$2,582	\$ 2,582	
Building	12,132	12,148	
Computer hardware and software	3,957	4,093	
Office furniture and equipment	766	759	
Tenant and leasehold improvements	3,846	3,660	
Vehicle fleet	857	815	
Total, at cost	24,140	24,057	
Less: accumulated depreciation and amortization	5,723	5,309	
Property and equipment, net	\$18,417	\$ 18,748	

Depreciation and amortization expense for property and equipment was \$414 thousand and \$383 thousand for the three months ended March 31, 2018 and 2017, respectively. The Company's real estate consists of 15 acres of land and five buildings with a gross area of 229 thousand square feet and a parking garage.

## NOTE 7. GOODWILL AND OTHER INTANGIBLE ASSETS

## Goodwill and Intangible Assets

At March 31, 2018 and December 31, 2017 goodwill (see Note 2) was \$152.5 million and intangible assets were \$95.0 million and \$101.6 million, respectively. The Company has determined the useful life of the value of the business acquired to be one year. The Company has determined the useful life of the other intangible assets to range between 2.5-15 years. The Company has recorded \$1.3 million relating to insurance licenses and classified as an indefinite lived intangible which is subject to annual impairment testing concurrent with goodwill.

	Goodwill (in thousands)
Balance as of December 31, 2017	\$ 152,459
Goodwill acquired	—
Impairment	—

Balance as of March 31, 2018	\$ 152,459
------------------------------	------------

#### Other Intangible Assets

Our intangible assets resulted primarily from the acquisitions of ZAC and NBIC Holdings, Inc. and consist of brand, agent relationships, renewal rights, customer relations, trade names, non-competes and insurance licenses.

Amortization expense of our intangible assets was \$6.6 million and \$3.6 million for the three months ended March 31, 2018 and March 31, 2017, respectively. No impairment in the value of amortizing or non-amortizing intangible assets was recognized during the three months ended March 31, 2018 or 2017.

13

---

Estimated annual pretax amortization of intangible assets for each of the next five years and thereafter is as follows (in thousands):

Year	Amount
2018 remaining	\$18,149
2019	\$8,208
2020	\$6,365
2021	\$6,351
2022	\$6,351
2023	\$6,351
Thereafter	\$41,909
	\$93,684

(1) Excludes insurance licenses valued at \$1.3 million and classified as an indefinite lived intangible which is subject to annual impairment testing and not amortized.

#### NOTE 8. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (“EPS”) for the periods indicated.

	For the Three Months Ended March 31,	
	2018	2017
Basic earnings per share:		
Net income attributable to common stockholders (000's)	\$14,829	\$5,983
Weighted average shares outstanding	25,727,553	28,806,709
Basic earnings per share:	\$0.58	\$0.21
Diluted earnings per share:		
Net income attributable to common stockholders (000's)	\$14,829	\$5,983
Weighted average shares outstanding	25,727,553	28,806,709
Weighted average dilutive shares	1,004,466	—
Total weighted average dilutive shares	26,732,019	28,806,709
Diluted earnings per share:	\$0.55	\$0.21

#### NOTE 9. DEFERRED POLICY ACQUISITION COSTS

The Company defers certain costs in connection with written policies, called deferred policy acquisition Costs (“DPAC”), net of corresponding amounts of ceded reinsurance commissions, called deferred reinsurance ceding commissions (“DRCC”). Net DPAC is amortized over the effective period of the related insurance policies. The Company earns ceding commission on its quota share reinsurance contracts. Ceding commission income reduces policy acquisition costs and other general underwriting expenses included in general and administration expense on the income statement. Ceding commission income is deferred and recognized over the quota share contract period. For the three months ended March 31, 2018, the Company recorded in aggregate \$19.0 million in ceding commission income.

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

The Company anticipates that its DPAC costs will be fully recoverable in the near term. The table below depicts the activity with regard to DPAC during the three-month periods ended March 31, 2018 and 2017:

	For the Three Months Ended March 31,	
	2018	2017
	(In thousands)	
Beginning Balance	\$41,678	\$42,779
Policy acquisition costs deferred	24,371	21,878
Amortization <sup>(1)</sup>	(12,187)	(23,442)
Ending Balance	\$53,862	\$41,215

1. Includes ceding commission income of approximately \$14.3 million.

14

---

## NOTE 10. INCOME TAXES

During the three months ended March 31, 2018 and 2017, the Company recorded \$5.2 million and \$3.7 million, respectively, of income tax expense which corresponds to an estimated annual effective tax rate of 25.8% and 38.3%, respectively. Effective tax rates are dependent upon components of pre-tax earnings and the related tax effects. Pre-tax earnings were higher for the first quarter of 2018, although they were impacted by the adoption of ASU 2016-01 which included \$869 thousand of unrealized losses on equity securities within pre-tax earnings. Higher pre-tax earnings caused tax favored adjustments to be lower on a percentage basis in 2018 compared to the prior year. Additionally, the Tax Cuts and Jobs Act of 2017 (“TCJA”) lowered the federal corporate tax rate from 35% to 21% effective January 1, 2018 causing a decrease in the overall effective tax rate when compared to the prior year.

The table below summarizes the significant components of our net deferred tax assets (liabilities):

	March 31, 2018	December 31, 2017
Deferred tax assets:	(In thousands)	
Unearned premiums	\$13,210	\$12,488
Unearned commission	10,742	11,987
Net operating loss	2,389	4,727
Tax-related discount on loss reserve	1,158	1,250
Unrealized loss	2,424	—
Investments	293	—
Stock-based compensation	987	—
Prepaid expenses	1,205	1,950
Other	375	331
Total deferred tax asset	32,783	32,733
Deferred tax liabilities:		
Deferred acquisition costs	15,626	9,775
Prepaid expenses	10,334	27,568
Unrealized gains	—	30
Property and equipment	527	—
Note discount	2,920	3,818
Basis in purchased investments	265	335
Basis in purchased intangibles	20,625	24,250
Other	766	1,290
Total deferred tax liabilities	51,063	67,066
Net deferred tax liability	\$(18,280)	\$(34,333 )

On December 22, 2017, the U.S. government enacted the Tax Act, which makes broad and complex changes to the U.S. Tax code. One of the provisions of the Tax Act reduced the corporate federal income tax rate from 35% to 21% effective January 1, 2018. Pursuant to current accounting guidance, all deferred tax assets and liabilities were re-measured in 2017 to recognize the tax rate that is expected to apply when the tax effects are ultimately recognized in future periods upon the date of enactment.



Certain income tax effects of the Tax Act are reflected in the Company's financial results in accordance with Staff Accounting Bulletin No. 118 ("SAB 118"), which provides SEC staff guidance regarding the application of ASC 740. Our 2017 Form 10-K discusses enactment of the Tax Act on December 22, 2017, and its impact on our financial results for that period. Interpretive guidance of the Tax Act will be received throughout 2018, and we expect to update our estimates and our disclosure on a quarterly basis as interpretative guidance is received within each quarter that it is received. During the period ended March 31, 2018, the U.S. Treasury Department and the Internal Revenue Service have not issued further clarification or guidance for the items for which our accounting for the Tax Act is incomplete.

In assessing the net carrying amount of deferred tax assets, we consider whether it is more likely than not that we will not realize some portion or all of the deferred tax assets. The ultimate realization of deferred tax assets depends upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

15

---

The statute of limitations related to our federal and state income tax returns remains open from our filings for 2014 through 2016. For the 2014 tax year, the federal income tax return was examined by the tax authority resulting in no material adjustment. Currently, no taxing authorities are examining any of our federal or state income tax returns.

At March 31, 2018 and December 31, 2017, we had no significant uncertain tax positions.

#### NOTE 11. REINSURANCE

The Company's reinsurance program is designed, utilizing the Company's risk management methodology, to address its exposure to catastrophes or large non-catastrophic losses. The Company's program provides reinsurance protection for catastrophes including hurricanes, tropical storms, tornadoes and winter storms. The Company's reinsurance agreements are part of its catastrophe management strategy, which is intended to provide its stockholders an acceptable return on the risks assumed in its property business, and to reduce variability of earnings, while providing protection to the Company's policyholders.

##### 2017 – 2018 Reinsurance Program

##### Heritage P&C and Zephyr Program

The Company placed its reinsurance program for the period from June 1, 2017 through May 31, 2018 during the second quarter of 2017. This reinsurance program incorporates the catastrophe risk of our two insurance subsidiaries, Heritage P&C, a Florida based insurer writing property insurance in multiple states, and Zephyr, a Hawaii based insurer. The programs are allocated amongst traditional reinsurers, catastrophe bonds issued by Citrus Re Ltd., a Bermuda special purpose insurer formed in 2014 ("Citrus Re"), and the Florida Hurricane Catastrophe Fund ("FHCF"). Coverage is specific to each insurer unless otherwise noted. The 2017-2018 reinsurance program provides, including retention, first event coverage up to \$1.75 billion in Florida, first event coverage up to \$731 million in Hawaii, and multiple event coverage up to \$2.6 billion. This coverage exceeds the requirements established by the Company's rating agency, Demotech, Inc., the Florida Office of Insurance Regulation, and the Hawaii Insurance Division. For the twelve months ending May 31, 2018, no single uncollateralized private reinsurer represented more than 10% of the overall limit purchased from our total reinsurance coverage.

The reinsurance program, which is segmented into layers of coverage, protects the Company for excess property catastrophe losses and loss adjustment expenses. The Company's 2017-2018 reinsurance program incorporates the mandatory coverage required by law to be placed with FHCF, which is available only for Florida catastrophe risk. For the 2017 hurricane season, the Company maintained the prior year selected participation percentage in the FHCF at 45%. The Company also purchased private reinsurance below and alongside the FHCF layer, as well as aggregate reinsurance coverage. The Company is not utilizing its captive, Osprey, for any catastrophe risk for the 2017 hurricane season. The Company has a primary retention of the first \$20 million of losses and loss adjustment expenses. Additionally, the December 1, 2016 treaty between Heritage P&C and Osprey was commuted effective June 1, 2017.

Heritage P&C provides property insurance coverage for states other than Hawaii. The following describes the various layers of its June 1, 2017 to May 31, 2018 reinsurance program:

**Heritage P&C's Retention.** If a first catastrophic event strikes a Heritage P&C risk, its primary retention is the first \$20 million (\$15 million plus \$5 million co-participation on the Top and Aggregate layer described below) of losses and loss adjustment expenses. If a second catastrophic event strikes a Heritage P&C risk, its primary retention decreases to \$16 million and the remainder of the losses are ceded to third parties. In a first event exceeding approximately \$878 million, there is an additional co-participation of 20% subject to a maximum co-participation of \$727,000. Assuming a 1-100yr first event, a second event exceeding approximately \$420 million, results in an

additional Company co-participation of 11.5% subject to a maximum co-participation of \$36 million. Heritage P&C has a \$16 million (including 20% co-participation) primary retention after a 1-100 yr. first event for events beyond the second catastrophic event.

**Shared Layers.** Immediately above the retention, the Company has purchased \$372 million of reinsurance from third party reinsurers. This coverage includes the following layers: Top and Aggregate layer, Underlying layer, Layer 1, Layer 2 and a private sliver alongside those layers. Through the payment of a reinstatement premium, Heritage P&C and Zephyr are able to reinstate \$352 million of this reinsurance one time. There is \$20 million of shared coverage subject to a seasonal aggregate of \$68 million.

**FHCF Layer.** Heritage P&C's FHCF program provides coverage for Florida events only and includes an estimated maximum provisional limit of 45% of \$1.3 billion, in excess of its retention of \$414 million. The limit and retention of the FHCF coverage is subject to upward or downward adjustment based on, among other things, submitted exposures to FHCF by all participants. Heritage P&C has purchased coverage alongside from third party reinsurers and through

16

---

reinsurance agreements with Citrus Re. To the extent the FHCF coverage is adjusted, this private reinsurance with third party reinsurers and Citrus Re will adjust to fill in any gaps in coverage up to the reinsurers' aggregate limits for this layer. The FHCF coverage cannot be reinstated once exhausted, but it does provide coverage for multiple events. Layers alongside the FHCF. The Heritage P&C reinsurance program includes third party layers alongside the FHCF. These include 2015 B and 2015 C series catastrophe bonds, 2016 D and 2016 E catastrophe bonds and 2017-2 catastrophe bonds issued by Citrus Re, which total \$412.5 million of coverage, as discussed below, as well as a traditional reinsurance layer providing \$5 million of coverage.

**2017-2 Notes:** During May 2017, Heritage P&C entered into a catastrophe reinsurance agreement with Citrus Re. The agreements provide for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2017. Heritage P&C pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued an aggregate of \$35 million of principal-at-risk variable notes due March 2020 to fund the reinsurance trust account and its obligations to Heritage P&C for \$35 million of coverage under the reinsurance agreements. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements. We anticipate this layer will be exhausted due to Hurricane Irma losses. This coverage does not reinstate and any gap in coverage for the 2018 hurricane season will be addressed in our 2018-2019 catastrophe reinsurance program.

**2016 Class D and E Notes:** During February 2016, Heritage P&C and Zephyr entered into two catastrophe reinsurance agreements with Citrus Re. The agreements provide for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2016. For the 2017 hurricane seasons these notes provide coverage only to Heritage P&C who pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued an aggregate of \$250 million of principal-at-risk variable notes due February 2019 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class D notes provide \$150 million of coverage and the Class E notes provide \$100 million of coverage. The Class D and Class E notes provide reinsurance coverage for a sliver of the catastrophe coverage that had previously been provided by the FHCF. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements. We anticipate that a portion of the 2016 Class E notes layer will be exhausted due to Hurricane Irma losses. This coverage does not reinstate and any gap in coverage for the 2018 hurricane season will be addressed in our 2018-2019 catastrophe reinsurance program.

**2015 Class B and C Notes:** During April 2015, Heritage P&C entered into catastrophe reinsurance agreements with Citrus Re. The agreements provide for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2015. Heritage P&C pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued principal-at-risk variable notes due April 2018 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class B notes provide \$97.5 million of coverage, and the Class C notes provide \$30 million of coverage. The Class B and Class C notes provide reinsurance coverage for a sliver of the catastrophe coverage that had previously been provided by the FHCF. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements. We anticipate that a portion of the 2015 Class B and C notes layer will be exhausted due to Hurricane Irma losses. We have directed the Trustee to hold the collateral beyond the contract period to provide reimbursements for Hurricane Irma claims. This layer of reinsurance coverage will expire in advance of the 2018 hurricane season and any gap in coverage for the 2018 hurricane season will be addressed in our 2018-2019 catastrophe reinsurance program

Layers above the FHCF - Florida program

2017-1 Notes: During March 2017, Heritage P&C entered into catastrophe reinsurance agreements with Citrus Re. The agreements provide for three-years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2017. Heritage P&C pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued principal-at-risk variable notes due March 2020 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The notes provide \$125 million of coverage for a layer above the FHCF. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

2015 Class A Notes: During April 2015, Heritage P&C entered into catastrophe reinsurance agreements with Citrus Re. The agreements provide for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2015. Heritage P&C pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued principal-at-risk variable notes due April 2018 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class A notes provide \$150 million of coverage for a layer above the FHCF. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

Multi-Zonal Layers. The Company purchased additional layers which provide coverage for Heritage P&C for a second event and both first and second event coverage for Hawaii. The first event coverage for Hawaii is a counterpart to the multi-state catastrophe bond layers and FHCF layer. There is a total of \$254 million of reinsurance coverage purchased on this basis, which the Company is able to reinstate one time through the payment of a reinsurance reinstatement premium.

Aggregate Coverage. In addition to what is described above, much of the reinsurance is structured in a way to provide aggregate coverage. \$984 million of limit is structured on this basis (Top and Aggregate, Underlying, Layer 1, Layer 2, Private layers, Multi-Zonal, 2017-1 Notes, 2017-2 Notes, and 2015 Class A Notes). To the extent that this coverage is not fully exhausted in the first catastrophic event, it provides coverage commencing at its reduced retention for second and subsequent events where underlying coverage has been previously exhausted. The Company paid a reinsurance reinstatement premium for \$606 million of this coverage, which can be a reinstated one time. Layers (with exception to FHCF, 2016 Class D & E Notes, and 2015 Class B & C Notes) are “net” of a \$40 million attachment point. Layers inure to the subsequent layers if the aggregate limit of the preceding layer(s) is exhausted, and the subsequent layer cascades down in its place.

Zephyr provides property insurance coverage for Hawaii. The various layers of its 2017-2018 reinsurance program area as follows:

Zephyr’s Retention. If a first catastrophic event strikes Hawaii, Zephyr has a primary retention of the first \$20 million (\$15 million plus \$5 million co-participation on the Top and Aggregate layer) of losses and loss adjustment expenses. If a second event strikes Hawaii, Zephyr’s primary retention decreases to \$16 million and the remainder of losses are ceded to third parties. In a first event exceeding approximately \$386 million, there is an additional co-participation of 3.8% subject to a maximum co-participation of \$12 million. Assuming a 1-100-year event, a second event exceeding approximately \$386 million results in an additional co-participation of 117.7%, subject to a maximum co-participation of \$56 million. Zephyr has a \$16 million primary retention for events beyond the second catastrophic event.

Shared Layers above retention. Immediately above the retention, the Company has purchased \$372 million of reinsurance from third party reinsurers. This coverage includes the following layers: Top and Aggregate layer, Underlying layer, Layer 1, Layer 2 and a private sliver alongside those layers. Through the payment of a reinsurance reinstatement premium, Heritage P&C and Zephyr are able to reinstate \$352 million of this reinsurance one time. There is \$20 million of shared coverage subject to a seasonal aggregate of \$68 million.

•

Multi-Zonal Layers. The Company purchased additional layers which provide coverage for Florida for a second event and both first and second event coverage for Hawaii. The first event coverage for Hawaii is a counterpart to the multi-state catastrophe bond layers and FHCF layer. There is a total of \$302 million of reinsurance coverage purchased on this basis, of which \$254 million can be reinstated through the payment of reinsurance restatement premium. The multi-zonal occurrence layer provides first and second event coverage of \$254 million for Hawaii and second event coverage of \$254 million for Florida. A Top and Aggregate multi-zonal layer provides first event coverage of \$48 million for Hawaii and second or subsequent event coverage of \$48 million for Florida.

18

---

•**Top Hawaii only layer.** Zephyr has an additional layer purchased from third party reinsurers which provides \$26 million of coverage for Hawaii only losses. This layer has one free reinstatement.

•**Aggregate Coverage.** In addition to what is described above, much of the reinsurance is structured in a way to provide aggregate coverage. An aggregate of \$700 million of limit is structured on this basis (Top and Aggregate, Underlying, Layer 1, Layer 2, Private Layers, Multi-Zonal, Hawaii Only). To the extent that this coverage is not fully exhausted in the first catastrophic event, it provides coverage commencing at its reduced retention for second and subsequent events where underlying coverage has been previously exhausted. \$632 million can be reinstated through the payment of a reinsurance premium.

For a first catastrophic event striking Florida, our reinsurance program provides coverage up to \$1.75 billion of losses and loss adjustment expenses, including our retention, and we are responsible for all losses and loss adjustment expenses in excess of such amount. For a first catastrophic event striking Hawaii, our reinsurance program provides coverage up to \$731 million of losses and loss adjustment expenses, including our retention, and we are responsible for all losses and loss adjustment expenses in excess of such amount. For subsequent catastrophic events, our total available coverage depends on the magnitude of the first event, as we may have coverage remaining from layers that were not previously fully exhausted. An aggregate of \$632 million of limit purchased in 2017 includes reinstatement through the purchase of reinsurance reinstated premium. In total, we have purchased \$2.6 billion of potential reinsurance coverage, including our retention, for multiple catastrophic events. Our ability to access this coverage, however, will be subject to the severity and frequency of such events. Hurricane losses in states other than Hawaii would be covered under the Heritage P&C program with the exception of the FHCF coverage and the series 2015, 2016 and 2017 catastrophe bonds. Management deemed this reinsurance protection to be sufficient given the level of catastrophe exposure in 2017 for Alabama, Georgia, North Carolina and South Carolina.

In placing our 2017-2018 reinsurance program, we sought to capitalize on favorable reinsurance pricing and mitigate uncertainty surrounding the future cost of our reinsurance by negotiating multi-year arrangements. The \$687.5 million of aggregate coverage we have purchased from Citrus Re Ltd, which includes the 2015 Class A, B, and C notes, the 2016 Class D & E notes, and the 2017 Series notes extends \$277.5 million of coverage until May 2018, \$250 million of coverage for two-year period and \$160 million of coverage for a three-year period. To the extent coverage is all or partially exhausted before the end of three years, it cannot be reinstated. In the aggregate, multi-year coverage from Citrus Re Ltd accounts for approximately 26% of our purchases of private reinsurance for the 2017 hurricane season. The terms of each of the multi-year coverage arrangements described above are subject to adjustment depending on, among other things, the size and composition of our portfolio of insured risks in future periods.

**Per Risk Coverage:** The Company also purchased property per risk coverage for losses and loss adjustment expenses in excess of \$1 million per claim. The limit recovered for an individual loss is \$9 million and total limit for all losses is \$27 million. There are two reinstatements available with additional premium due based on the amount of the layer exhausted. In addition, the Company purchased facultative reinsurance in excess of \$10 million for any commercial properties it insured where the total insured value exceeded \$10 million.

#### NBIC Program

NBIC, our insurance subsidiary located in Rhode Island, provides property insurance coverage in the states of Connecticut, Massachusetts, New Jersey, New York and Rhode Island. NBIC's catastrophe reinsurance program provides coverage for loss occurrences up to \$1 billion (1:100-year event) on the first event and includes automatic reinstatement protection. The program includes coverage for catastrophic events such as severe winter storms, hurricanes and tornadoes. During 2017, NBIC's net retention for a catastrophic event of up to \$1.0 billion is \$1.3 million. NBIC's reinsurance program also covers non-catastrophic losses. A summary of NBIC's combined reinsurance protection follows. The reinsurance program is placed with strong participation from leading reinsurers across global markets with no one reinsurer exceeding 10%. The reinsurance partners are all rated A- to A+ by Standard and Poor's.

Property Catastrophe Excess of Loss

NBIC's property catastrophe program protects NBIC from the aggregation of losses in a single occurrence. Reinstatement provisions (one reinstatement at 100% of premium) on the first three layers and a portion of the fourth layer provides protection for NBIC from a second catastrophic event. The program is 81.25% placed, with the remaining 18.75% of catastrophe protection coming from NBIC's gross quota share contract. NBIC's net retention of \$20 million is further reduced with a net quota share reinsurance contract described below.

19

---



#### Reinstatement Premium Protection

NBIC's Reinstatement Premium Protection locks in the cost of a potential reinstatement premium charge that would occur should an event trigger catastrophe reinsurance. NBIC buys reinstatement premium protection for the first three layers and a portion of the fourth catastrophe excess of loss layers.

#### Aggregate Contract

For the year ended December 31, 2017, NBIC had 25% of an Aggregate contract, in two sections:

Section 1: \$20 million excess \$21.5 million in the aggregate for all catastrophe losses excluding named tropical storms.

Section 2: \$12 million excess \$8 million for named tropical storm losses.

NBIC placed 25% of an aggregate contract on December 31, 2017, expiring May 31, 2018. The limit on the contract is \$13.5 million, retention of \$18.5 million and franchise deductible of \$1.0 million.

#### Gross Quota Share

NBIC purchased an 18.75% gross account quota share reinsurance treaty which provides ground up loss recoveries of up to \$1 billion.

#### Net Lines Quota Share

NBIC's net lines quota share is proportional reinsurance for which certain of our other reinsurance inures to the quota share (property catastrophe excess of loss and reinstatement premium protection and the second layer of the general excess of loss.) An occurrence limit of \$20 million for catastrophe losses is in effect on the quota share, subject to certain aggregate loss limits that vary by reinsurer. The amount and rate of reinsurance commissions slide, within a prescribed minimum and maximum, depending on loss performance. NBIC ceded 60% of net premiums and losses during 2017 to the Net Quota Share. The net quota share program was renewed on December 31, 2017 ceding 49.5% of the net premiums and losses and 8% of the prior year quota share will runoff.

#### General Excess of Loss

NBIC's general excess of loss reinsurance protects NBIC from single risk losses, both property and casualty. The casualty coverage provided by this contract also responds on a "Clash" basis, meaning that multiple policies involved in a single loss occurrence can be aggregated into one loss and applied to the reinsurance contract. The coverage is in two layers in excess of NBIC's retention of the first \$300,000 of loss. The first layer is \$450,000 excess \$300,000 and the second layer is \$2.75 million excess \$750,000 (Casualty second layer is \$1.25 million excess \$750,000). Both layers are 81.25% placed with the gross quota share providing the additional 18.75% coverage.

#### Semi-Automatic Facultative Excess of Loss

NBIC's automatic property facultative reinsurance protects NBIC from single risk losses, for property risks with a total insured value excess of \$3.5 million subject to a limit of \$2.5 million.

#### Product specific reinsurance for Umbrella and Home Systems Protection

NBIC's umbrella facultative program protects NBIC's Umbrella Liability business through the quota share reinsurance contract. NBIC has limits of liability of up to \$1 million with 90% quota share, subject to an additional limit of

liability of up to \$4 million with 100% quota share. The home system protection (HSP) product is designed to protect customers from sudden and accidental mechanical breakdowns to furnaces, boilers, HVAC systems, home entertainment systems, pool heating and filtering equipment, and other mechanical systems that are not covered by standard homeowners' insurance policies. The coverage is included in NBIC's base policy and is 100% reinsured through Hartford Steam Boiler.

#### 2016 - 2017 Reinsurance Program

The Company placed its reinsurance program for the period from June 1, 2016 through May 31, 2017 during the second quarter of 2016. This reinsurance program incorporated the catastrophe risk of our two insurance subsidiaries, Heritage P&C, a Florida based

20

---

insurer and Zephyr, a Hawaii based insurer, into one reinsurance structure. The programs are incorporated into one reinsurance structure and are allocated amongst traditional reinsurers, catastrophe bonds issued by Citrus Re Ltd., a Bermuda special purpose insurer formed in 2014 (“Citrus Re”), and the Florida Hurricane Catastrophe Fund (“FHCF”). Coverage is shared by both insurers unless otherwise noted. The 2016-2017 reinsurance program provided, including retention, first event coverage up to \$1.9 billion in Florida, first event coverage up to \$1.1 billion in Hawaii, and multiple event coverage up to \$3.1 billion.

The reinsurance program, which was segmented into layers of coverage, protects the Company for excess property catastrophe losses and loss adjustment expenses. The Company’s 2016-2017 reinsurance program incorporated the mandatory coverage required by law to be placed with FHCF, which was available only for Florida catastrophe risk. For the 2016 hurricane season, the Company reduced its selected participation percentage in the FHCF from 75% to 45%. The Company also purchased private reinsurance below, alongside and above the FHCF layer, as well as aggregate reinsurance coverage. The following describes the various layers of the Company’s June 1, 2016 to May 31, 2017 reinsurance program.

• **The Company’s Retention.** If a first catastrophic event strikes Florida, the Company had a primary retention of the first \$40 million of losses and loss adjustment expenses, of which Osprey was responsible for \$20 million. If a first catastrophic event strikes Hawaii, the Company had a primary retention of the first \$30 million of losses and loss adjustment expenses, of which Osprey was responsible for \$15 million. If a second event strikes Florida, Heritage P&C’s primary retention decreased to \$15 million and the remainder of the losses are ceded to third parties. If a second event strikes Hawaii, Zephyr’s primary retention decreased to \$5 million. In the second event only for a loss exceeding \$190 million, there was an additional Company co-participation of 5.4% subject to a maximum co-participation of \$11.6 million. Heritage P&C and Zephyr each had a \$5 million primary retention for events beyond the second catastrophic event. Osprey had no primary retention beyond the first catastrophic event in Florida or Hawaii. Additionally, Osprey was responsible for payment of up to \$5.3 million of reinstatement premium, depending on the amount of losses incurred.

• **Shared Layers above retention and below FHCF.** Immediately above the retention, the Company had purchased \$374 million of reinsurance from third party reinsurers. Through the payment of a reinstatement premium, the Company was able to reinstate the full amount of this reinsurance one time. To the extent that \$374 million or a portion thereof was exhausted in a first catastrophic event, the Company had purchased reinstatement premium protection insurance to pay the required premium necessary for the reinstatement of this coverage.

• **FHCF Layer.** The Company’s FHCF program provided coverage for Florida events only and included an estimated maximum provisional limit of 45% of \$1.5 billion, in excess of its retention of \$460 million. The limit and retention of the FHCF coverage was subject to upward or downward adjustment based on, among other things, submitted exposures to FHCF by all participants. The Company had purchased coverage alongside from third party reinsurers and through reinsurance agreements with Citrus Re. To the extent the FHCF coverage is adjusted, this private reinsurance with third party reinsurers and Citrus Re would be adjusted to fill in any gaps in coverage up to the reinsurers’ aggregate limits for this layer. The FHCF coverage cannot be reinstated once exhausted, but it would have provided coverage for multiple events.

• **Layers alongside the FHCF.** The Florida reinsurance program included third party layers alongside the FHCF. These included 2015 C and 2015 B series catastrophe bonds, which cover Florida only for the 2016 season, and 2016 D and 2016 E catastrophe bond series issued by Citrus Re, which total \$377.5 million of coverage, as discussed below, as well as a traditional reinsurance layer providing \$200 million of coverage. Through a reinstatement, the Company would be able to reinstate the full \$200 million of reinsurance one time. These 2016 catastrophe bonds and the traditional reinsurance layer provided coverage for both Florida and Hawaii catastrophe losses.

• **2016 Class D and E Notes:** During February 2016, Heritage P&C and Zephyr entered into two catastrophe reinsurance agreements with Citrus Re. The agreements provided for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2016. Heritage P&C and Zephyr paid a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued an aggregate of \$250 million of

principal-at-risk variable notes due February 2019 to fund the reinsurance trust account and its obligations to Heritage P&C and Zephyr under the reinsurance agreements. The Class D notes provided \$150 million of coverage and the Class E notes provide \$100 million of coverage. The Class D and Class E notes provided reinsurance coverage for a sliver of the catastrophe coverage that had previously been provided by the FHCF. The limit of coverage is fully collateralized by a reinsurance trust account for the benefit of Heritage P&C and Zephyr. The maturity date of the notes may be extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

2015 Class B and C Notes: During April 2015, Heritage P&C entered into catastrophe reinsurance agreement with Citrus Re. The 2015 notes did not provide coverage for Zephyr for the 2016 hurricane season. The agreements

21

---

provided for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2015. Heritage P&C paid a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued principal-at-risk variable notes due April 2018 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class B notes provided \$97.5 million of coverage, and the Class C notes provide \$30 million of coverage. The Class B and Class C notes provided reinsurance coverage for a sliver of the catastrophe coverage that had previously been provided by the FHCF. The limit of coverage was fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes may have been extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

Layers above the FHCF - Florida program

• **2015 Class A Notes:** During April 2015, Heritage P&C entered into catastrophe reinsurance agreement with Citrus Re. The 2015 notes did not provide coverage for Zephyr for the 2016 hurricane season. The agreements provided for three years of coverage from catastrophic losses caused by named storms, including hurricanes, beginning on June 1, 2015. Heritage P&C paid a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued principal-at-risk variable notes due April 2018 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The Class A notes provided \$150 million of coverage for a layer above the FHCF. The limit of coverage was fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. The maturity date of the notes could have been extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

• **2014 Class A Notes:** Coverage immediately below and above the 2015 Class A notes is provided by the 2014 reinsurance agreements entered into with Citrus Re. The first contract with Citrus Re provided \$150 million of coverage immediately below 2015 Class A, and the second contract provided an additional \$50 million of coverage which sits immediately above 2015 Class A. During April 2014, Heritage P&C entered into two catastrophe reinsurance agreements with Citrus Re. The 2014 notes did not provide coverage for Zephyr for the 2016 hurricane season. The agreements provided for three years of coverage from catastrophic losses caused by certain named storms, including hurricanes, beginning on June 1, 2014. The limit of coverage of \$200 million was fully collateralized by a reinsurance trust account for the benefit of Heritage P&C. Heritage P&C pays a periodic premium to Citrus Re during this three-year risk period. Citrus Re issued \$200 million of principal-at-risk variable notes due April 2017 to fund the reinsurance trust account and its obligations to Heritage P&C under the reinsurance agreements. The maturity date of the notes could have been extended up to two additional years to satisfy claims for catastrophic events occurring during the three-year term of the reinsurance agreements.

• **Multi-Zonal Layers –** The Company purchased additional layers which provided coverage for Florida for a second event and both first and second event coverage for Hawaii. The first event coverage for Hawaii is a counterpart to the Florida-only catastrophe bond layers and FHCF layer. There was a total of \$282 million of reinsurance coverage purchased on this basis, with \$260 million having a prepaid reinstatement. The multi-zonal occurrence layer provided first and second event coverage of \$260 million for Hawaii and second event coverage of \$260 million for Florida. A top and drop multi-zonal layer provided first and subsequent event coverage of \$22 million for Hawaii and second or subsequent event coverage of \$22 million for Florida.

• **Aggregate Coverage.** In addition to what is described above, much of the reinsurance is structured in a way to provide aggregate coverage. \$682 million of limit is structured on this basis. To the extent that this coverage is not fully exhausted in the first catastrophic event, it provides coverage commencing at its reduced retention for second and subsequent events where underlying coverage has been previously exhausted. \$460 million of coverage has a reinstatement, which is prepaid.

For a first catastrophic event striking Florida, our reinsurance program provides coverage for \$1.9 billion of losses and loss adjustment expenses, including our retention, and we are responsible for all losses and loss adjustment expenses in excess of such amount. For a first catastrophic event striking Hawaii, our reinsurance program provides coverage

for \$1.1 billion of losses and loss adjustment expenses, including our retention, and we are responsible for all losses and loss adjustment expenses in excess of such amount. For subsequent catastrophic events, our total available coverage depends on the magnitude of the first event, as we may have coverage remaining from layers that were not previously fully exhausted. \$860 million of limit purchased in 2016 includes a reinstatement, with \$825 million being prepaid. In total, we have purchased \$3 billion of potential reinsurance coverage, including our retention, for multiple catastrophic events. Our ability to access this coverage, however, will be subject to the severity and frequency of such events.

## Property Per Risk Coverage

The Company also purchased property per risk coverage for losses and loss adjustment expenses in excess of \$1 million per claim. The limit recovered for an individual loss is \$9 million and total limit for all losses is \$27 million. There are two reinstatements available with additional premium due based on the amount of the layer exhausted. In addition, the Company purchased facultative reinsurance in excess of \$10 million for any commercial properties it insured for which the total insured value exceeded \$10 million.

## NOTE 12. RESERVE FOR UNPAID LOSSES

The Company determines the reserve for unpaid losses on an individual-case basis for all incidents reported. The liability also includes amounts which are commonly referred to as incurred but not reported, or “IBNR”, claims as of the balance sheet date.

The table below summarizes the activity related to the Company’s reserve for unpaid losses:

	For the Three Months Ended March 31,	
	2018	2017
	(in thousands)	
Balance, beginning of period	\$470,083	\$140,137
Less: reinsurance recoverable on unpaid losses	315,353	586
Net balance, beginning of period	154,730	139,551
Incurred related to:		
Current year	51,361	47,876
Prior years	1,730	(1,229 )
Total incurred	53,091	46,647
Paid related to:		
Current year	(1,252 )	11,236
Prior years	46,737	44,708
Total paid	45,485	55,944
Net balance, end of period	162,336	130,251
Plus: reinsurance recoverable on unpaid losses	385,399	1,321
Balance, end of period	\$547,735	\$131,572

As of March 31, 2018, we reported \$162 million in unpaid losses and loss adjustment expenses, net of reinsurance which included \$98.8 million attributable to IBNR net of reinsurance recoverables, or 60.9% of net reserves for unpaid losses and loss adjustment expenses.

The Company’s losses incurred for the three months ended March 31, 2018 and 2017 reflect prior year development of \$1.7 million and a redundancy of \$1.2 million, respectively, associated with management’s best estimate of the actuarial loss and LAE reserves with consideration given to Company specific historical loss experience. The unfavorable development for the three months ended March 31, 2018 resulted from \$3.0 million of unfavorable

development from catastrophe losses related to Hurricane Matthew, partially offset by favorable development from non-catastrophe losses on a consolidated basis. NBIC incurred during the three months ended March 31, 2018 from seven different winter storms in the northeast, three of which were named storms. Gross losses for winter storms during the quarter were approximately \$56.0 million on a gross basis and approximately \$9.0 million net of reinsurance.

NOTE 13. LONG-TERM DEBT

In December 2016, the Company issued \$79.5 million of Senior Secured Notes (“Secured Notes”) bearing 8.75% per annum plus the three-month average of LIBOR. Interest is accrued monthly and paid quarterly. At March 31, 2018, we recognized \$74 million on the Secured Notes, net of issuance costs which totaled approximately \$5.5 million. During the three months ended March 31, 2018 and 2017, the Company made interest payments of approximately \$2.1 million and \$1.9 million, respectively. Quarterly principal payments will commence on December 15, 2018.

In August 2017 and September 2017, the Company issued in aggregate \$136.8 million of 5.875% Convertible Senior Notes (“Convertible Notes”) maturing on August 1, 2037, unless earlier repurchased, redeemed or converted. Interest accrues from August 16, 2017 and is payable semi-annually in arrears, on February 1 and August 1 of each year, beginning in 2018. As of March 31, 2018, we recognized \$98.6 million on the Convertible Notes, net of issuance and debt discount costs which totaled approximately, \$17.0 million. During the three months ended March 31, 2018, the Company made interest payments of approximately \$3.7 million.



In April 2018, the Company reacquired \$10.6 million of its outstanding Convertible Notes in the open market at a cost of \$13.4 million.

In November 2017, the Company, through its subsidiary Heritage P&C, reacquired \$21.1 million of its outstanding Convertible Notes in the open market at a cost of \$25.2 million. Based on the reacquisition of the Convertible Notes, the Company derecognized the related debt and conversion option liability. In accordance with the purchase agreement governing the Company's offer and sale of convertible debt, the Company or its affiliates are prohibited from reselling the notes once acquired. The repurchased Convertible Notes hold no registration rights.

In October 2017, the Company and its subsidiary, Skye Lane Properties LLC, jointly obtained a commercial real estate mortgage loan in the amount of \$12.7 million, bearing interest of 4.95% per annum. The Company makes monthly principal and interest payments against the loan. During the three months ended March 31, 2018, the Company paid in principal and interest \$0.2 million.

The following table summarizes the Company's long-term debt as of March 31, 2018 and December 31, 2017:

	March 31, 2018	December 31, 2017
	(in thousands)	
Convertible debt	\$115,624	\$115,624
Mortgage loan	12,591	12,658
Senior Note payable	79,500	79,500
Total principal amount	\$207,715	\$207,782
Less: unamortized discount and issuance costs		
Debt discount and issuance cost on convertible debt	17,034	17,605
Debt issuance cost on senior note payable	5,543	5,772
Total long-term debt	\$185,138	\$184,405

#### NOTE 14. OTHER LIABILITIES

Other liabilities consist of the following as of March 31, 2018 and December 31, 2017:

Description	March 31, 2018	December 31, 2017
	(In thousands)	
Deferred ceding commission	\$47,841	\$51,109
Outstanding claim checks	97,181	79,666
Accounts payable and other payables	10,878	17,948
Accrued interest and issuance costs	1,432	3,117
Accrued dividends	1,601	—
Escrow	1,210	1,210
Premium tax	297	3,660
Other liabilities	2,045	218
Commission payables	10,269	12,609

Total other liabilities	\$172,754	\$169,537
-------------------------	-----------	-----------

#### NOTE 15. STATUTORY ACCOUNTING AND REGULATIONS

State laws and regulations, as well as national regulatory agency requirements, govern the operations of all insurers such as our insurance subsidiaries. The various laws and regulations require that insurers maintain minimum amounts of statutory surplus and risk-based capital, restrict insurers' ability to pay dividends, restrict the allowable investment types and investment mixes, and subject the Company's insurers to assessments.

The Company's insurance subsidiaries must maintain capital and surplus ratios or balances as determined by the regulatory authority of the states in which they are domiciled. Heritage P&C is required to maintain capital and surplus equal to the greater of \$15 million or 10% of their respective liabilities. Zephyr is required to maintain a deposit of \$750 thousand in a federally insured financial institution. NBIC is required to maintain capital and surplus of \$3.0 million. The statutory surplus for the three months ended

24

---

March 31, 2018 for Heritage P&C, Zephyr and NBIC was \$176.4 million, \$74.7 million and \$115.4 million, respectively. The statutory surplus for the year ended December 31, 2017 for Heritage P&C, Zephyr and NBIC was \$186.0 million, \$76.4 million and \$113.7 million, respectively. State law also requires the Company's insurance subsidiaries to adhere to prescribed premium-to-capital surplus ratios, with which the Company is in compliance. At December 31, 2017, our insurance subsidiaries met the financial and regulatory requirements of the states in which they do business.

#### NOTE 16. COMMITMENTS AND CONTINGENCIES

The Company is involved in claims-related legal actions arising in the ordinary course of business. The Company accrues amounts resulting from claims-related legal actions in unpaid losses and loss adjustment expenses during the period that it determines an unfavorable outcome becomes probable and it can estimate the amounts. Management makes revisions to its estimates based on its analysis of subsequent information that the Company receives regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) judicial decisions and legal developments in the awarding of damages; and (iv) trends in general economic conditions, including the effects of inflation. When determinable, the Company discloses the range of possible losses in excess of those accrued and for reasonably possible losses.

#### NOTE 17. RELATED PARTY TRANSACTIONS

The Company has been party to various related party transactions involving certain of its officers, directors and significant stockholders as set forth below. The Company has entered into each of these arrangements without obligation to continue its effect in the future and the associated expense was immaterial to its results of operations or financial position as of March 31, 2018 and 2017.

In January 2017, the Company entered into a consulting agreement with Mrs. Shannon Lucas, the wife of the Chairman and CEO, in which she agreed to provide consulting services related to the Company's catastrophe reinsurance and risk management program at a rate of \$400 per hour. The consulting agreement has no specific term and either party may terminate the agreement upon providing written notice. Additionally, she serves as a director of Heritage P&C with an annual compensation of \$150 thousand. For the three months ended March 31, 2018 the Company paid consulting fees to Ms. Lucas of approximately \$171 thousand.

#### NOTE 18. EMPLOYEE BENEFIT PLANS

Heritage P&C provides a 401(k) plan for substantially all of its employees. Heritage P&C contributes 100% on the first 3% of employees' contribution and 50% on the next 2% of the employees' contribution to the plan. The maximum Safe Harbor match is 4%. For the three-month periods ended March 31, 2018 and 2017, the Heritage P&C's contributions to the plan on behalf of the participating employees were \$230 thousand and \$195 thousand, respectively.

Heritage P&C provides for its employees a partially self-insured healthcare plan and benefits. For the three months ended March 31, 2018 and 2017, Heritage P&C incurred medical premium costs in the aggregate of \$853 thousand and \$571 thousand, respectively. Heritage P&C also recorded approximately \$13 thousand as unpaid claims as of March 31, 2018. A stop loss reinsurance policy caps the maximum loss that could be incurred by Heritage P&C under the self-insured plan. Heritage P&C's stop loss coverage per employee is \$60 thousand for which any excess cost would be covered by the reinsurer subject to an aggregate limit for losses in excess of \$1.5 million which would provide up to \$1.0 million of coverage. Any excess of the \$1.5 million retention and the \$1 million of aggregate coverage would be borne by Heritage P&C. The aggregate stop loss commences once our expenses exceed 125% of

the annual aggregate expected claims.

NBIC provides a 401(k) plan for its employees who elect to participate and matches the contributions up to a maximum of 4%. Employer contributions vest 20% each year until fully vested after 5 years.

#### NOTE 19. EQUITY

The total amount of authorized capital stock consists of 50,000,000 shares of common stock and 5,000,000 shares of preferred stock. As of March 31, 2018, the Company had 25,769,806 shares of common stock outstanding, 7,214,797 treasury shares of common stock and 800,000 unvested shares of restricted common stock issued reflecting total paid-in capital of \$297.1 million as of such date.

25

---

As more fully disclosed in our audited consolidated financial statements for the year ended December 31, 2017, there were, as of December 31, 2017, 25,885,004 shares of common stock outstanding, 7,099,597 treasury shares of common stock and 675,000 unvested restricted stock grants, representing \$294.8 million of additional paid-in capital.

### Common Stock

Holders of common stock are entitled to one vote for each share held on all matters subject to a vote of stockholders, subject to the rights of holders of any outstanding preferred stock. Accordingly, holders of a majority of the shares of common stock entitled to vote in any election of directors may elect all of the directors standing for election, subject to the rights of holders of any outstanding preferred stock. Holders of common stock will be entitled to receive ratably any dividends that the board of directors may declare out of funds legally available therefor, subject to any preferential dividend rights of outstanding preferred stock. Upon the Company's liquidation, dissolution or winding up, the holders of common stock will be entitled to receive ratably its net assets available after the payment of all debts and other liabilities and subject to the prior rights of holders of any outstanding preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of the Company's capital stock are fully paid and nonassessable.

### Stock Repurchase Program

On May 4, 2016, the Company announced that the Company's Board of Directors, authorized a stock repurchase program authorizing the Company to repurchase up to \$70 million of the Company's common stock. The Board of Directors has extended the repurchase plan to June 30, 2018. At December 31, 2017, the Company had purchased in aggregate approximately \$47 million in Company's common stock. During the first quarter of 2018, the Company purchased 115,200 shares of its common stock for \$2.0 million. At March 31, 2018, the Company has the capacity to repurchase \$20.8 million of its common shares until June 30, 2018.

### Dividends

On February 26, 2018, the Company's Board of Directors declared a \$0.06 per share quarterly dividend payable on April 3, 2018, to shareholders of record March 15, 2018. The declaration and payment of any future dividends will be subject to the discretion of the Board of Directors and will depend on a variety of factors including the Company's financial condition and results of operations.

## NOTE 20. STOCK-BASED COMPENSATION

### Restricted Stock

The Company has adopted the Heritage Insurance Holdings, Inc., Omnibus Incentive Plan (the "Plan") effective on May 22, 2014. The Plan authorized 2,981,737 shares of common stock for issuance under the Plan for future grants. As of December 31, 2017, all unexercised shares have been forfeited.

At March 31, 2018 there were 1,231,699 shares available for grant under the Plan. The Company recognizes compensation expense under ASC 718 for its stock-based payments based on the fair value of the awards.

During the first quarter of 2018, the Company granted 125,000 shares of restricted stock with a fair value of \$16.35. The restricted stock vests in equal annual installments over a five-year period.

The Company grants stock options at exercise prices equal to the fair market value of the Company's stock on the dates the options are granted. The options have a maximum term of ten years from the date of grant and vest primarily in equal annual installments over a range of one to five-year periods following the date of grant for employee options. If a participant's employment relationship ends, the participant's vested awards will remain exercisable for the shorter of a period of 30 days or the period ending on the latest date on which such award could have been exercisable. The fair value of each option grant is separately estimated for each grant date. The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the award and each vesting date. The Company estimates the fair value of all stock option awards as of the date of the grant by applying the Black-Scholes-Merton multiple-option pricing valuation model. The application of this valuation model involves assumptions that are judgmental and highly sensitive in the determination of compensation expense.

The Company has also granted shares of its common stock subject to certain restrictions under the Plan. Restricted stock awards granted to employees vest in equal installments generally over a five-year period from the grant date subject to the recipient's

continued employment. The fair value of restricted stock awards is estimated by the market price at the date of grant and amortized on a straight-line basis to expense over the period of vesting. Recipients of restricted stock awards have the right to receive dividends. Restricted stock activity for the quarter ended March 31, 2018 is as follows:

	Number of shares	Weighted-Average Grant-Date Fair Value per Share
Non-vested, at December 31, 2017	675,000	\$ 21.40
Granted	125,000	\$ 16.35
Vested	—	—
Canceled and surrendered	—	—
Non-vested, at March 31, 2018	800,000	\$ 20.61

Awards are being amortized to expense over the five-year vesting period. The Company recognized \$1.3 million and \$1.2 million of compensation expense for the three months ended March 31, 2018 and 2017, respectively. There was approximately \$14.4 million of unrecognized compensation expense related to the un-vested restricted stock at March 31, 2018. The Company expects to recognize the remaining compensation expense over a weighted average period of 2.9 years.

#### NOTE 21. SUBSEQUENT EVENTS

The Company performed an evaluation of subsequent events through the date the financial statements were issued and determined there were no recognized or unrecognized subsequent events that would require an adjustment or additional disclosure in the financial statements as of March 31, 2018.

On May 7, 2018, the Company announced that its Board of Directors declared a \$0.06 per share quarterly dividend payable on July 6, 2018 to stockholders of record as of June 15, 2018.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with our condensed consolidated financial statements and related notes and information included and elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2017 ("2017 Form 10-K"). Unless the context requires otherwise, as used in this Form 10-Q, the terms "we", "us", "our", "the Company", "our company", and similar references refer to Heritage Insurance Holdings, Inc., a Delaware corporation, and its subsidiaries.

### Financial Results Highlights for the Three Months Ended March 31, 2018

• Premium in force at March 31, 2018 was approximately \$923 million. There were approximately 522,000 policies in force at March 31, 2018. NBIC accounting for approximately \$331 million of in force premium and approximately 196,000 policies in-force at March 31, 2018.

• Gross premiums written of \$204.4 million and total revenue of \$112.0 million.

• Net premiums earned of \$106.1 million.

• Operating income of \$24.8 million.

• Combined ratio of 82.2% on a net basis.

• Cash, cash equivalents and investments of approximately \$697.0 million, with total assets of \$1.9 billion.

### Critical Accounting Policies and Estimates

When we prepare our consolidated financial statements and accompanying notes in conformity with U.S. generally accepted accounting principles (GAAP), we must make estimates and assumptions about future events that affect the amounts we report. Certain of these estimates result from judgments that can be subjective and complex. As a result of that subjectivity and complexity, and because we continuously evaluate these estimates and assumptions based on a variety of factors, actual results could materially differ from our estimates and assumptions if changes in one or more factors require us to make accounting adjustments. During the three months ended March 31, 2018, we reassessed our critical accounting policies and estimates as disclosed within our 2017 Form 10-K; we have made no material changes or additions with regard to such policies and estimates.



## Results of Operations

The following table reports our unaudited results of operations for the three months ended March 31, 2018 and 2017:

	For the Three Months Ended March 31,	
	2018	2017
	(in thousands)	
<b>REVENUE:</b>		
Gross premiums written	\$204,366	\$142,235
Change in gross unearned premiums	22,797	12,373
Gross premiums earned	227,163	154,608
Ceded premiums	(121,055)	(62,432)
Net premiums earned	106,108	92,176
Net investment income	3,302	2,502
Net realized (losses) gains	(227)	771
Other revenue	2,843	3,844
Total revenue	\$112,026	\$99,293
<b>OPERATING EXPENSES:</b>		
Losses and loss adjustment expenses	53,091	46,647
Policy acquisition costs, net of ceding commission income of \$14.3 million and \$0	12,187	23,442
General and administrative expenses, net of ceding commission income of \$4.7 million and \$0	21,931	17,314
Total operating expenses	87,209	87,403
Operating income	24,817	11,890
Interest expense, net	4,820	2,181
Income before income taxes	19,997	9,709
Provision for income taxes	5,168	3,726
Net income	\$14,829	\$5,983
Basic earnings per share	\$0.58	\$0.21
Diluted earnings per share	\$0.55	\$0.21
<b>Selected Other Data</b>		
Book value per share	\$15.09	\$12.67
Growth in book value per share	19.1	% 6.1
Return on average equity	15.4	% 6.7

## Comparison of the Three Months Ended March 31, 2018 and 2017

## Revenue

## Gross premiums written

Gross premiums written increased to \$204.4 million for the three months ended March 31, 2018 as compared to \$142.2 million for the three months ended March 31, 2017. The increase in gross premiums written is due to the increase in written premium of \$70.5 million associated with the acquisition of NBIC, reduced by a decline in written

premium by Heritage P&C of approximately \$8.0 million, primarily associated with exposure management. Personal residential business accounted for \$181.8 million and commercial residential accounted for \$22.6 million of the total gross premiums written for the three months ended March 31, 2018. Assumed business represented 33.4% and 59.1% of the total premium in force for the three months ended March 31, 2018 and March 31, 2017, respectively.

#### Gross premiums earned

Gross premiums earned increased to \$227.2 million for the three months ended March 31, 2018 as compared to \$154.6 million for the three months ended March 31, 2017. Approximately \$81.1 million of the increase relates to the inclusion of premium earned by NBIC, offset by a reduction in gross premium earned by Heritage P&C of approximately \$8.5 million.

#### Ceded premiums

Ceded premiums increased to \$121.1 million for the three months ended March 31, 2018 as compared to \$62.4 million for the three months ended March 31, 2017. The increase in ceded premiums relates to the inclusion of premium ceded by NBIC reduced by a \$6.5 million reduction in premium ceded by Heritage P&C and Zephyr. Premium ceded by NBIC is primarily comprised of catastrophe ceded premium as well as gross and net quota share treaties. The decrease in ceded premium by Heritage P&C and Zephyr relates to the timing of the inception of reinsurance agreements and the change in the mix of business and total insured values for the respective reinsurance contracts. Catastrophe excess of loss contracts for the 2017 hurricane season cover the period from June 1, 2017 to May 31, 2018 whereas the 2016 reinsurance contract covers the period from June 1, 2016 to May 31, 2017.

#### Net premiums earned

Net premiums earned increased to \$106.1 million for the three months ended March 31, 2018 as compared to \$92.2 million for the three months ended March 31, 2017. The increase in net premiums earned relates primarily to inclusion of net premium earned by NBIC.

#### Net investment income

Net investment income, inclusive of realized investment gains, decreased to \$3.1 million for the three months ended March 31, 2018 as compared to \$3.3 million for the three months ended March 31, 2017. The variance relates to the inclusion of net investment income earned by NBIC, offset by a decline in net investment income by Heritage P&C due to the use of funds for the payment of Hurricane Irma claims.

#### Other revenue

Other revenue decreased slightly to \$2.8 million for the three months ended March 31, 2018 as compared to \$3.8 million for the three months ended March 31, 2017.

#### Total revenue

Total revenue increased to \$112.0 million for the three months ended March 31, 2018 as compared to \$99.3 million for the three months ended March 31, 2017. The increase in total revenue relates primarily to the increase in net premiums earned described above.

#### Expenses

##### Losses and loss adjustment expenses

Losses and loss adjustment expenses ("LAE") increased to \$53.1 million for the three months ended March 31, 2018 as compared to \$46.6 million for the three months ended March 31, 2017. The increase in losses and loss adjustment expenses relates primarily to inclusion of losses and LAE associated with NBIC, reduced by a decrease associated with our consolidated Florida operations. The Company's losses incurred for the three months ended March 31, 2018 reflects prior year development of \$2.5 million, associated with management's best estimate of the actuarial loss and LAE reserves for Heritage P&C with consideration given to Company specific historical loss experience. We experienced adverse development during the quarter ended March 31, 2018 of approximately \$3 million associated with Hurricane Matthew, which was partially offset by net favorable development on a consolidated basis.

##### Policy acquisition costs

Policy acquisition costs decreased to \$12.2 million for the three months ended March 31, 2018 as compared to \$23.4 million for the three months ended March 31, 2017. The decrease is primarily attributable to ceding commission of \$14.3 million associated with NBIC quota share reinsurance treaties which significantly reduced policy acquisition costs.

General and administrative expenses

General and administrative expenses increased to \$21.9 million for the three months ended March 31, 2018 as compared to \$17.3 million for the three months ended March 31, 2017. The increase was due primarily to expenses associated with NBIC and an

increase in general and administrative expenses associated with our expansion to new states and overall infrastructure growth. The increase in expenses was reduced by \$4.7 million of NBIC ceding commission income allocable to other underwriting expenses.

#### Interest and amortization of debt issuance costs

As described in Note 13 – Long-Term Debt to our consolidated financial statements appearing elsewhere in this Form 10-Q, Heritage issued \$79.5 million in Secured Notes due 2023 on December 15, 2016 and issued \$136.8 million in Convertible Notes in the third quarter of 2017, resulting in interest expense of \$4.4 million and amortization of debt issuance costs of \$0.4 million for the quarter ended March 31, 2018.

#### Provision for income taxes

Provision for income taxes was \$5.2 million and \$3.7 million for the three months ended March 31, 2018 and 2017, respectively. Our effective tax rate for the three months ended March 31, 2018 and 2017 was 25.8% and 38.4%, respectively. The effective tax rate can fluctuate throughout the year as estimates used in the tax provision for the first quarter are updated as more information becomes available throughout the year. The decrease in the effective tax rate is associated with the enactment the Tax Act, as discussed at Note 10 of these unaudited financial statements, which decreased the enacted federal statutory tax rate from 35% to 21%.

#### Net income

Our net income for the three months ended March 31, 2018 is \$14.8 million, or \$0.55 earnings per diluted common share, compared to net income of \$6.0 million, or \$0.21 earnings per diluted common share, for the three months ended March 31, 2017. The increase relates to inclusion of NBIC net income coupled with an increase in net income associated with a reduction in losses and a lower effective tax rate associated with the Tax Act, reduced by additional interest associated with the convertible debt issued in the third quarter of 2017.

#### Ratios

Due to the impact our reinsurance costs have on net premiums earned from period to period, our management believes the ratios discussed below are more meaningful when viewed on a net basis.

	For the Three Months Ended March 31, 2018    2017	
Ratios to Gross Premiums Earned: (unaudited)		
Ceded premium ratio	53.3 %	40.3 %
Loss ratio	23.4 %	30.2 %
Operating expense ratio	15.0 %	26.4 %
Combined ratio	91.7 %	96.9 %
Ratios to Net Premiums Earned:		

Edgar Filing: Heritage Insurance Holdings, Inc. - Form 10-Q

Loss ratio	50.0%	50.6%
Operating expense ratio	32.2%	44.2%
Combined ratio	82.2%	94.8%

Ceded premium ratio

Our ceded premium ratio increased to 53.3% for the three months ended March 31, 2018 compared to 40.3% for the three months ended March 31, 2017. The increase relates primarily to NBIC, resulting from its gross and net quota share reinsurance treaties.

Gross loss ratio

Our gross loss ratio decreased to 23.4% for the three months ended March 31, 2018 compared to 30.2% for the three months ended March 31, 2017. The decrease is primarily due to inclusion of NBIC which generated a significantly lower gross loss ratio due to its quota share reinsurance program, despite the impact of losses from winter storms during the quarter ended March 31, 2018. As

31

---

described in our Annual Report on Form 10-K filing for the fiscal year ended December 31, 2017, our affiliates CAN and BRC were deployed extensively to repair properties and provide claim related services for Hurricane Irma claims. This vertical integration also had a favorable impact on our loss ratio for the quarter ended March 31, 2018.

#### Net loss ratio

Our net loss ratio decreased slightly to 50.0% for the three months ended March 31, 2018 compared to 50.6% for the three months ended March 31, 2017. While the net loss ratio was relatively consistent, we did experience higher loss ratios at Heritage P&C and NBIC, which were mitigated by profitability at CAN.

#### Gross expense ratio

Our gross expense ratio decreased to 15.0% for the three months ended March 31, 2018 compared to 26.4% for the three months ended March 31, 2017, primarily due to the benefit of ceding commission income of approximately \$19.0 million earned from NBIC's quota share reinsurance program. Our accounting policy is to allocate ceding commission between policy acquisition costs and general and administrative expenses for financial reporting purposes. Ceding commission is allocated between policy acquisition costs and general and administrative expenses based upon the proportion these costs bear to production of new business.

#### Net expense ratio

Our net expense ratio decreased to 32.2% for the three months ended March 31, 2018 compared to 44.2% for the three months ended March 31, 2017, primarily due to the benefit associated with the inclusion of NBIC ceding commission income as discussed above.

#### Combined ratio

Our combined ratio on a gross basis decreased to 91.7% for the three months ended March 31, 2018 compared to 96.9% for the three months ended March 31, 2017. Our combined ratio on a net basis decreased to 82.2% for the three months ended March 31, 2018 compared to 94.8% for the three months ended March 31, 2017. The combined ratio decreased due to the favorable impact of the NBIC acquisition on the loss and operating expense ratios as described above coupled with a lower ceded earned and gross loss ratio for the Heritage entities excluding NBIC.

#### Liquidity and Capital Resources

As of March 31, 2018, we had \$193.6 million of cash and cash equivalents, which primarily consisted of cash and money market accounts. We generally hold substantial cash balances to meet seasonal liquidity needs including amounts to pay quarterly reinsurance installments as well as meet the collateral requirements of Osprey Re Ltd. ("Osprey"), our captive reinsurance company. In addition, we have \$20.8 million in restricted cash to meet our contractual obligations related to the catastrophe bonds issued by Citrus Re Ltd.

Osprey is required to maintain a collateral trust account equal to the risk that it assumes from our insurance company affiliates. At March 31, 2018, approximately \$21 million was held in Osprey's trust account.

Although we can provide no assurances, we believe that we maintain sufficient liquidity to pay our insurance company affiliates' claims and expenses, as well as to satisfy commitments in the event of unforeseen events such as inadequate premium rates or reserve deficiencies. We maintain a comprehensive reinsurance program at levels management considers adequate to diversify risk and safeguard our financial position.

Although we can provide no assurance, we believe our current capital resources, together with cash provided from our operations, will be sufficient to meet currently anticipated working capital requirements for at least the next twelve months.

32

---



## Cash Flows

	For the Three Months Ended March 31,		
	2018	2017	Change
	(in thousands)		
Net cash provided by (used in):			
Operating activities	\$(12,132)	\$3,986	\$(16,118)
Investing activities	55,747	(1,249)	56,996
Financing activities	(3,668 )	(6,289)	2,621
Net increase (decrease) in cash and cash equivalents	\$39,947	\$(3,552)	\$43,499

## Operating Activities

Cash used by operating activities was \$12.1 million for the three months ended March 31, 2018 compared to cash provided of \$4.0 million for the three months ended March 31, 2017. The decrease in cash from operating activities was primarily due to cash used to pay Hurricane Irma claims during the first quarter of 2018 pending reinsurance recoveries. Additionally, cash was used to pay winter storm claims in the northeast.

## Investing Activities

Net cash provided by investing activities for the three months ended March 31, 2018 was \$55.7 million as compared to cash used of \$1.2 million for the comparable period in 2017. The cash provided by investing activities in the first quarter of 2018 relates to investments sold during the quarter, primarily to fund payments of Hurricane Irma claims pending reinsurance recoveries

## Financing Activities

Net cash used in financing activities for the three months ended March 31, 2018 was \$3.7 million, as compared to cash used in financing activities of \$6.3 million for the comparable period in 2017. The decrease in cash used in financing activities is due primarily to fewer shares repurchased under the stock repurchase program in the current year.

## Contractual Obligations

The following table represents our contractual obligations for which cash flows are fixed or determinable as of March 31, 2018:

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
	(in thousands)				
Convertible senior notes	\$200,535	\$3,396	\$20,379	\$20,379	\$156,381
Senior secured notes	118,426	10,312	40,655	67,459	—
Mortgage loan	22,106	826	2,678	2,679	15,923

Total Contractual Obligations \$341,067 \$14,534 \$63,712 \$90,517 \$172,304

Seasonality of our Business

Our insurance business is seasonal as hurricanes typically occur during the period from June 1 through November 30 each year and winter storms generally impact the first and fourth quarters of each year. With our catastrophe reinsurance program effective on June 1 each year, any variation in the cost of our reinsurance, whether due to changes to reinsurance rates or changes in the total insured value of our policy base, will occur and be reflected in our financial results beginning June 1 of each year, subject to certain adjustments.

JOBS Act

We qualify as an “emerging growth company” under the JOBS Act. Section 107 of the JOBS Act provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for

33

---

complying with new or revised accounting standards. In other words, an emerging growth company can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have irrevocably elected not to avail ourselves of this extended transition period and, as a result, we will adopt new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies.

We are in the process of evaluating the benefits of relying on other exemptions and reduced reporting requirements provided by the JOBS Act. Subject to certain conditions set forth in the JOBS Act, if as an emerging growth company we choose to rely on such exemptions, we may not be required to, among other things, (i) provide an auditor's attestation report on our systems of internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, (ii) provide all of the compensation disclosure that may be required of non-emerging growth public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act, (iii) comply with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements (auditor discussion and analysis), and (iv) disclose certain executive compensation-related items such as the correlation between executive compensation and performance and comparisons of the Chief Executive Officer's compensation to median employee compensation. These exemptions will apply until we no longer meet the requirements of being an emerging growth company. We will remain an emerging growth company until the earlier of (1) the last day of the fiscal year (a) following the fifth anniversary of the completion of our initial public offering, (b) in which we have total annual gross revenue of at least \$1.07 billion or (c) in which we are deemed to be a large accelerated filer, which means the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our prior second fiscal quarter, and (2) the date on which we have issued more than \$1 billion in non-convertible debt during the prior three-year period.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our investment portfolios at March 31, 2018 included fixed maturity and equity securities, the purposes of which are not for trading or speculation. Our main objective is to maximize after-tax investment income and maintain sufficient liquidity to meet policyholder obligations while minimizing market risk, which is the potential economic loss from adverse fluctuations in securities' prices. We consider many factors including credit ratings, investment concentrations, regulatory requirements, anticipated fluctuation of interest rates, durations and market conditions in developing investment strategies. Investment securities are managed by a group of nationally recognized asset managers and are overseen by the investment committee appointed by our board of directors. Our investment portfolios are primarily exposed to interest rate risk, credit risk and equity price risk. We classify our fixed maturity and equity securities as available-for-sale and report any unrealized gains or losses, net of deferred income taxes, as a component of other comprehensive income within our stockholders' equity. As such, any material temporary changes in the fair value of such securities can adversely impact the carrying value of our stockholders' equity.

#### Interest Rate Risk

Our fixed maturity securities are sensitive to potential losses resulting from unfavorable changes in interest rates. We manage the risk by analyzing anticipated movement in interest rates and considering our future capital needs.

The following table illustrates the impact of hypothetical changes in interest rates to the fair value of our fixed maturity securities at March 31, 2018 (in thousands):

Hypothetical Change in Interest rates	Change In Estimated Fair		Percentage Increase	
	Estimated Fair Value After Change	Value	(Decrease) in Estimated	Fair Value
300 basis point increase	\$ 429,352	\$ (57,326 )	(12 )	%
200 basis point increase	\$ 448,302	\$ (38,376 )	(8 )	%
100 basis point increase	\$ 467,448	\$ (19,230 )	(4 )	%
100 basis point decrease	\$ 505,534	\$ 18,856	4	%
200 basis point decrease	\$ 524,078	\$ 37,400	8	%
300 basis point decrease	\$ 536,655	\$ 49,977	10	%

34

---

## Credit Risk

Credit risk can expose us to potential losses arising principally from adverse changes in the financial condition of the issuer of our fixed maturities. We mitigate this risk by investing in fixed maturities that are generally investment grade and by diversifying our investment portfolio to avoid concentrations in any single issuer or market sector.

The following table presents the composition of our fixed maturity portfolio by rating at March 31, 2018 (in thousands):

Rating	% of Total			% of total	
	Comparable Amortized Cost	Amortized Cost	Estimated Fair Value	Estimated Fair Value	
AAA	\$ 154,873	31	% \$ 151,574	31	%
AA+	\$ 97,671	20	% \$ 95,257	20	%
AA	\$ 55,659	11	% \$ 54,539	11	%
AA-	\$ 35,784	7	% \$ 35,172	7	%
A+	\$ 41,337	8	% \$ 40,551	8	%
A	\$ 31,807	7	% \$ 31,291	7	%
A-	\$ 33,364	7	% \$ 32,757	7	%
BBB+	\$ 22,737	5	% \$ 22,390	5	%
BBB	\$ 12,943	3	% \$ 12,657	3	%
BBB-	\$ 6,116	1	% \$ 6,014	1	%
BB	\$ 701	0	% \$ 708	0	%
BB+	\$ 1,743	0	% \$ 1,708	0	%
B+	\$ 239	0	% \$ 235	0	%
B	\$ 794	0	% \$ 790	0	%
NA and NR	\$ 1,044	0	% \$ 1,035	0	%
Total	\$ 496,812	100	% \$ 486,678	100	%

## Equity Price Risk

Our equity investment portfolio at March 31, 2018 consists of common stocks and redeemable and non-redeemable preferred stocks. We may incur potential losses due to adverse changes in equity security prices. We manage this risk primarily through industry and issuer diversification and asset allocation techniques.

The following table illustrates the composition of our equity portfolio at March 31, 2018 (in thousands):

	% of Total
Estimated	Estimated

	Fair Value	Fair value	
Stocks by sector:			
Financial	\$ 2,000	12	%
Energy	2,360	15	%
Other	11,875	73	%
Subtotal	\$ 16,235	100	%
Mutual Funds and ETF By type:			
Equity	\$ —	—	
Total	\$ 16,235	100	%

#### Foreign Currency Exchange Risk

At March 31, 2018, we did not have any material exposure to foreign currency related risk.

#### Item 4. Controls and Procedures.

##### Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) that are designed to assure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

As required by Exchange Act Rule 13a-15(b), as of the end of the period covered by this Quarterly Report, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2018.

##### Changes in Internal Control over Financial Reporting

There has been no change in our internal controls over financial reporting during our most recent quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

The Company is a party to claims and legal actions arising routinely in the ordinary course of our business. Although we cannot predict with certainty the ultimate resolution of the claims and lawsuits asserted against us, we do not believe that any currently pending legal proceedings to which we are a party will have a material adverse effect on our consolidated financial position results of operations or cash flow.

#### Item 1A. Risk Factors

The risk factors disclosed in the section entitled "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, filed on March 15, 2018 set forth information relating to various risks and uncertainties that could materially adversely affect our business, financial condition and operating results. Those risk factors continue to be relevant to an understanding of our business, financial condition and operating results. No material changes have occurred with respect to those risk factors.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

##### Issuer purchases of equity securities

During the three months ended March 31, 2018, we purchased 115,200 shares of common stock for an aggregate purchase of \$2.0 million under our share repurchase program. A summary of our common stock repurchases during the three months ended March 31, 2018 under our share repurchase program is set forth in the table below (in thousands, except shares):

	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Average Price Paid Per Share <sup>(1)</sup>	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2018 through January 31, 2018	—	—	—	\$ 22,836
February 1, 2018 through February 31, 2018	—	—	—	\$ 22,836
March 1, 2018 through March 31, 2018	115,200	\$ 17.32	115,200	\$ 20,836
Total	115,200		115,200	

(1) Average price paid per share excludes cash paid for commissions.

Item 4. Mine Safety Disclosures

None

36

---



Item 6. Exhibits

The information required by this Item 6 is set forth in the Index to Exhibits accompanying this Quarterly Report on Form 10-Q.

Index to Exhibits

Exhibit

Number Description

- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH 101. SCH XBRL Taxonomy Extension Schema.
- 101.CAL 101. CAL XBRL Taxonomy Extension Calculation Linkbase.
- 101.DEF 101. DEF XBRL Taxonomy Extension Definition Linkbase.
- 101.LAB 101. LAB XBRL Taxonomy Extension Label Linkbase.
- 101.PRE 101. PRE XBRL Taxonomy Extension Presentation Linkbase.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934 as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HERITAGE INSURANCE HOLDINGS, INC.

Date: May 9, 2018 By: /s/ BRUCE LUCAS  
Bruce Lucas  
Chairman and Chief Executive Officer  
  
(Principal Executive Officer)

Date: May 9 2018 By: /s/ KIRK LUSK  
Kirk Lusk  
Chief Financial Officer  
  
(Principal Financial and Accounting Officer)