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Heritage Insurance Holdings, Inc.  
Form 10-Q  
August 08, 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 June 30, 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

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(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 August 6, 2018 was 26,569,804

HERITAGE INSURANCE HOLDINGS, INC.

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## 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 of 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)

|  | June 30,<br>2018   | December<br>31, 2017 |
|--|--------------------|----------------------|
| <b>ASSETS</b>  | (unaudited)        |                      |
| Fixed maturity securities, available for sale, at fair value (amortized<br>cost of \$519,875 and \$552,458 in 2018 and 2017, respectively) | 508,921            | \$549,796            |
| Equity securities, available for sale, at fair value (cost of \$17,070 and \$17,548<br>in 2018 and 2017, respectively)                     | 15,958             | 17,217               |
| Total investments  | 524,879            | 567,013              |
| Cash and cash equivalents  | 218,343            | 153,697              |
| Restricted cash  | 16,884             | 20,833               |
| Accrued investment income  | 4,306              | 5,057                |
| Premiums receivable, net   | 68,168             | 67,757               |
| Reinsurance recoverable on paid and unpaid claims  | 467,857            | 357,357              |
| Prepaid reinsurance premiums   | 295,924            | 227,764              |
| Income taxes receivable  | 42,492             | 37,338               |
| Deferred policy acquisition costs, net   | 69,648             | 41,678               |
| Property and equipment, net  | 18,329             | 18,748               |
| Intangibles, net   | 88,371             | 101,626              |
| Goodwill   | 152,459            | 152,459              |
| Other assets   | 23,239             | 19,883               |
| <b>Total Assets</b>  | <b>\$1,990,899</b> | <b>\$1,771,210</b>   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                    |                      |
| Unpaid losses and loss adjustment expenses   | \$488,610          | \$470,083            |
| Unearned premiums  | 485,230            | 475,334              |
| Reinsurance payable  | 276,507            | 17,577               |
| Long-term debt, net  | 177,257            | 184,405              |
| Deferred income tax  | 15,350             | 34,333               |
| Advance premiums   | 35,821             | 23,648               |
| Accrued compensation   | 6,754              | 16,477               |
| Accounts payable and other liabilities   | 119,290            | 169,537              |
| <b>Total Liabilities</b>   | <b>\$1,604,819</b> | <b>\$1,391,394</b>   |

## Commitments and contingencies (Note 16)

## Stockholders' Equity:

|   |             |             |
|---|-------------|-------------|
| Common stock, \$0.0001 par value, 50,000,000 shares authorized, 26,569,804 shares issued and 25,769,804 outstanding at June 30, 2018 and 26,560,004 shares issued and 25,885,004 outstanding at December 31, 2017 | 3           | 3           |
| Additional paid-in capital  | 294,183     | 294,836     |
| Accumulated other comprehensive loss  | (8,348 )    | (3,064 )    |
| Treasury stock, at cost, 7,214,797 shares at June 30, 2018 and 7,099,597 shares at December 31, 2017  | (89,185 )   | (87,185 )   |
| Retained earnings   | 189,427     | 175,226     |
| Total Stockholders' Equity  | 386,080     | 379,816     |
| Total Liabilities and Stockholders' Equity  | \$1,990,899 | \$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<br>Ended June 30, |            | For the Six Months Ended<br>June 30, |            |
|--|--|------------|--------------------------------------|------------|
|  | 2018                                   | 2017       | 2018                                 | 2017       |
| <b>REVENUES:</b>   |  |            |                                      |            |
| Gross premiums written   | \$263,664                              | \$159,255  | \$468,030                            | \$301,490  |
| Change in gross unearned premiums  | (32,693 )                              | (6,901 )   | (9,896 )                             | 5,472      |
| Gross premiums earned  | 230,971                                | 152,354    | 458,134                              | 306,962    |
| Ceded premiums   | (119,767 )                             | (61,902 )  | (240,822 )                           | (124,334 ) |
| Net premiums earned  | 111,204                                | 90,452     | 217,312                              | 182,628    |
| Net investment income  | 2,555                                  | 2,973      | 5,857                                | 5,475      |
| Net realized (losses) gains  | (85 )                                  | (125 )     | (312 )                               | 646        |
| Other revenue  | 4,298                                  | 3,638      | 7,141                                | 7,482      |
| Total revenues   | 117,972                                | 96,938     | 229,998                              | 196,231    |
| <b>EXPENSES:</b>   |  |            |                                      |            |
| Losses and loss adjustment expenses  | 65,989                                 | 46,046     | 119,080                              | 92,693     |
| Policy acquisition costs, net of ceding commission income for the three and six months ended June 30, 2018, of \$13,493 and \$27,738 respectively          | 19,411                                 | 21,738     | 31,598                               | 45,180     |
| General and administrative expenses, net of ceding commission income for the three and six months ended June 30, 2018, of \$4,498 and \$9,246 respectively | 24,422                                 | 16,092     | 46,352                               | 33,406     |
| Total expenses   | 109,822                                | 83,876     | 197,030                              | 171,279    |
| Operating income   | 8,150                                  | 13,062     | 32,968                               | 24,952     |
| Interest expense, net  | 5,386                                  | 2,231      | 10,206                               | 4,412      |
| Other non-operating income, net  | (542 )                                 | —          | (542 )                               | —          |
| Income before income taxes   | 3,306                                  | 10,831     | 23,304                               | 20,540     |
| Provision for income taxes   | 898                                    | 4,189      | 6,066                                | 7,915      |
| Net income   | \$2,408                                | \$6,642    | \$17,238                             | \$12,625   |
| <b>OTHER COMPREHENSIVE INCOME</b>  |  |            |                                      |            |
| Change in net unrealized (losses) gains on investments   | (545 )                                 | 3,899      | (7,023 )                             | 7,880      |
| Reclassification adjustment for net realized investment losses (gains)   | 85                                     | 125        | 312                                  | (646 )     |
| Income tax (expense) benefit related to items of other comprehensive income  | (239 )                                 | (1,549 )   | 1,584                                | (2,785 )   |
| Total comprehensive income   | \$1,709                                | \$9,117    | \$12,111                             | \$17,074   |
| <b>Weighted average shares outstanding</b>   |  |            |                                      |            |
| Basic  | 25,631,871                             | 28,283,587 | 25,679,448                           | 28,543,703 |
| Diluted  | 26,316,597                             | 28,283,587 | 26,480,707                           | 28,543,703 |
| Earnings per share   |  |            |                                      |            |



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|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | \$0.09 | \$0.23 | \$0.67 | \$0.44 |
| Diluted | \$0.09 | \$0.23 | \$0.65 | \$0.44 |

See accompanying notes to unaudited condensed consolidated financial statements.

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## HERITAGE INSURANCE HOLDINGS, INC.

## Condensed Consolidated Statements of Stockholders' Equity

Six Months Ended June 30, 2018 and 2017

(Unaudited)

(Amounts in thousands, except share amounts)

|   | Common<br>Shares | Par<br>Value | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Treasury<br>Shares | Accumulated<br>Other<br>Comprehensive<br>(Loss)<br>Income | Total<br>Stockholders'<br>Equity |
|---|------------------|--------------|----------------------------------|----------------------|--------------------|---|----------------------------------|
| Balance at December 31, 2017,<br>as previously reported                             | 25,885,004       | \$ 3         | \$ 294,836                       | \$ 175,226           | \$(87,185)         | \$(3,064)   | \$ 379,816                       |
| Cumulative effect of change in<br>accounting principle (ASU<br>2016-01), net of tax | —                | —            | —                                | (267)                | —                  | 267   | —                                |
| Balance at December 31, 2017,<br>as adjusted  | 25,885,004       | 3            | 294,836                          | 174,959              | (87,185)           | (2,797)   | 379,816                          |
| Stock buy-back  | (115,200)        | —            | —                                | —                    | (2,000)            | —   | (2,000)                          |
| Stock-based compensation  | —                | —            | 2,612                            | —                    | —                  | —   | 2,612                            |
| Convertible Option debt<br>extinguishment, net of tax                               | —                | —            | (4,235)                          | —                    | —                  | —   | (4,235)                          |
| Reclassification of income taxes<br>upon early adoption of ASU<br>2018-02           | —                | —            | —                                | 424                  | —                  | (424)   | —                                |
| Tax effect of warrant<br>reclassification   | —                | —            | 970                              | —                    | —                  | —   | 970                              |
| Dividends declared on common<br>stock   | —                | —            | —                                | (3,194)              | —                  | —   | (3,194)                          |
| Net unrealized change in<br>investments,<br><br>net of tax                          | —                | —            | —                                | —                    | —                  | (5,127)   | (5,127)                          |
| Net income  | —                | —            | —                                | 17,238               | —                  | —   | 17,238                           |
| Balance at June 30, 2018  | 25,769,804       | \$ 3         | \$ 294,183                       | \$ 189,427           | \$(89,185)         | \$(8,348)   | \$ 386,080                       |

| Common<br>Shares | Par<br>Value | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Treasury<br>Shares | Accumulated<br>Other<br>Comprehensive<br>(Loss) | Total<br>Stockholders'<br>Equity |
|------------------|--------------|----------------------------------|----------------------|--------------------|---|----------------------------------|
|------------------|--------------|----------------------------------|----------------------|--------------------|---|----------------------------------|

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|  |            |      |            |            |            | Income    |   |            |
|--|------------|------|------------|------------|------------|-----------|---|------------|
| Balance at December 31, 2016             | 28,840,443 | \$ 3 | \$ 205,727 | \$ 182,809 | \$(25,562) | \$ (5,018 | ) | \$ 357,959 |
| Stock buy-back                           | (684,022 ) | —    | —          | —          | (8,607 )   | —         |   | (8,607 )   |
| Stock-based compensation                 | —          | —    | 2,408      | —          | —          | —         |   | 2,408      |
| Dividends declared on<br>common stock    | —          | —    | —          | (3,567 )   | —          | —         |   | (3,567 )   |
| Net unrealized change in<br>investments, |            |      |            |            |            |           |   |            |
| net of tax                               | —          | —    | —          | —          | —          | 4,449     |   | 4,449      |
| Net income                               | —          | —    | —          | 12,625     | —          | —         |   | 12,625     |
| Balance at June 30, 2017                 | 28,156,421 | \$ 3 | \$ 208,135 | \$ 191,867 | \$(34,169) | \$ (569   | ) | \$ 365,267 |

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 Six Months<br>Ended June 30, |           |
|---|--------------------------------------|-----------|
|   | 2018                                 | 2017      |
| <b>OPERATING ACTIVITIES</b>   |                                      |           |
| Net income  | \$17,238                             | \$12,625  |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                                      |           |
| Stock-based compensation  | 2,612                                | 2,408     |
| Bond amortization and accretion   | 3,454                                | 4,492     |
| Amortization of original issuance discount on debt  | 2,050                                | —         |
| Depreciation and amortization   | 14,041                               | 3,798     |
| Net realized gains  | 312                                  | (646 )    |
| Net gain on repurchase of debt  | (542 )                               | —         |
| Deferred income taxes   | (15,579 )                            | (1,137 )  |
| Changes in operating assets and liabilities:  |                                      |           |
| Accrued investment income   | 751                                  | (341 )    |
| Premiums receivable, net  | (411 )                               | 3,760     |
| Prepaid reinsurance premiums  | (68,160 )                            | (106,400) |
| Reinsurance premiums receivable and recoverable   | (110,500)                            | —         |
| Income taxes receivable   | (5,154 )                             | 8,416     |
| Deferred policy acquisition costs, net  | (27,970 )                            | 987       |
| Other assets  | (3,356 )                             | (1,422 )  |
| Unpaid losses and loss adjustment expenses  | 18,527                               | (17,353 ) |
| Unearned premiums   | 9,896                                | (5,472 )  |
| Reinsurance payable   | 258,930                              | 128,140   |
| Accrued interest  | (3,148 )                             | (3,938 )  |
| Accrued compensation  | (9,723 )                             | 1,176     |
| Advance premiums  | 12,173                               | 7,320     |
| Other liabilities   | (47,109 )                            | (3,438 )  |
| Net cash provided by operating activities   | 48,332                               | 32,975    |
| <b>INVESTING ACTIVITIES</b>   |                                      |           |
| Proceeds from sales and maturities of investments available for sale                        | 163,611                              | 99,041    |
| Purchases of investments available for sale   | (132,306)                            | (93,862 ) |
| Cost of property and equipment acquired   | (367 )                               | (150 )    |
| Net cash provided by investing activities   | 30,938                               | 5,029     |
| <b>FINANCING ACTIVITIES</b>   |                                      |           |
| Mortgage loan payments  | (131 )                               | —         |

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|   |           |           |
|---|-----------|-----------|
| Repurchase of convertible note                                  | (13,248 ) | —         |
| Purchase of treasury stock                                      | (2,000 )  | (8,607 )  |
| Cash dividends paid   | (3,194 )  | (3,567 )  |
| Net cash used in financing activities                           | (18,573 ) | (12,174 ) |
| Increase in cash, cash equivalents, and restricted cash         | 60,697    | 25,830    |
| Cash, cash equivalents and restricted cash, beginning of period | 174,530   | 126,727   |
| Cash, cash equivalents and restricted cash, end of period       | \$235,227 | \$152,557 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>         |           |           |
| Income taxes paid   | \$5,406   | \$601     |
| Interest paid   | \$8,317   | \$3,900   |

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

|   | June 30,<br>2018 | December<br>31, 2017 |
|---|------------------|----------------------|
|   | (in thousands)   |                      |
| Cash and cash equivalents   | \$218,343        | \$153,697            |
| Restricted cash   | 16,884           | \$20,833             |
| Total cash, cash equivalents and restricted cash shown in the condensed consolidated statements of cash flows | \$235,227        | \$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 and six months ended June 30, 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 and six months ended June 30, 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 and six months ended June 30, 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 was effective for the Company on a prospective basis beginning on January 1, 2018. 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 was effective for the Company on a prospective basis beginning on January 1, 2018. 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 became effective on January 1, 2018 and requires adoption on a retrospective basis. 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 \$20.8 million of restricted cash to the beginning period balance for cash, cash equivalents and restricted cash for the six months ended June 30, 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 became 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 Not Yet Adopted

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.

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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.

To date, we have taken an inventory of all our operating leases, which consist primarily of auto, equipment and real estate owned and unowned by the Company, started our review of key lease agreements including contract review for embedded leases, and are currently evaluating lease terms, lease payments and appropriate discount rates to use in calculating the right-to-use asset and lease liability. In addition, we are currently evaluating the transition package of practical expedients permitted within the new standard, which among other things, allows us to use hindsight to determine the reasonably certain lease term for existing leases, and allows for the adoption of the new standard at the effective date without adjusting the comparative prior periods presented. We will be continuously assessing the impact of the new standard and the impact on our systems, processes and controls through January 1, 2019, our planned adoption date.

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.

#### 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 and six months ended June 30, 2017 is as follows:

|                             | For the<br>Three<br>Months<br>Ended<br>June 30,<br>2017 | For the<br>Six<br>Months<br>Ended<br>June 30,<br>2017 |
|-----------------------------|---|---|
|                             | (in thousands, except<br>per share)                     |   |
| Revenue                     | \$ 111,252  | \$ 224,938  |
| Net income                  | \$ 10,056   | \$ 17,394   |
| Basic, earnings per share   | \$ 0.36   | \$ 0.61   |
| Diluted, earnings per share | \$ 0.36   | \$ 0.61   |

#### NOTE 3. INVESTMENTS

The following table details the difference between cost or adjusted/amortized cost and estimated fair value, by major investment category, at June 30, 2018 and December 31, 2017:

|   | Cost or Adjusted/Unrealized       |       | Gross Unrealized |            |
|---|-----------------------------------|-------|------------------|------------|
|   | Amortized Costs<br>(In thousands) | Gains | Losses           | Fair Value |
| <b>June 30, 2018</b>                              |                                   |       |                  |            |
| U.S. government and agency securities             | \$ 30,537                         | \$ 8  | \$ 875           | \$ 29,670  |
| States, municipalities and political subdivisions | 63,340                            | 7     | 1,257            | 62,090     |
| Special revenue                                   | 274,357                           | 32    | 5,097            | 269,292    |
| Industrial and miscellaneous                      | 146,817                           | 14    | 3,628            | 143,203    |
| Redeemable preferred stocks                       | 4,824                             | 7     | 165              | 4,666      |
| Total fixed maturities                            | 519,875                           | 68    | 11,022           | 508,921    |
| Nonredeemable preferred stocks                    | 13,922                            | 30    | 517              | 13,435     |
| Equity securities                                 | 3,098                             | 42    | 617              | 2,523      |
| Total equity securities                           | 17,020                            | 72    | 1,134            | 15,958     |

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|                   |           |        |           |            |
|-------------------|-----------|--------|-----------|------------|
| Total investments | \$536,895 | \$ 140 | \$ 12,156 | \$ 524,879 |
|-------------------|-----------|--------|-----------|------------|

|   | Cost or Adjusted | Gross Unrealized | Gross Unrealized |            |
|---|------------------|------------------|------------------|------------|
|   | Costs            | Gains            | Losses           | Fair Value |
|   | (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 |

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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 and six months ended June 30, 2018 and 2017.

|                                     | 2018           |                    | 2017     |                    |
|-------------------------------------|----------------|--------------------|----------|--------------------|
|                                     | Gains          |                    | Gains    |                    |
|                                     | (Losses)       | Fair Value at Sale | (Losses) | Fair Value at Sale |
|                                     | (In thousands) |                    |          |                    |
| For the Three Months Ended June 30, |                |                    |          |                    |
| Fixed maturities                    | \$2            | \$ 70,401          | \$15     | \$ 5,706           |
| Equity securities                   | 1              | 169                | 54       | 2,352              |
| Total realized gains                | 3              | 70,570             | 69       | 8,058              |
| Fixed maturities                    | (39)           | 7,487              | (170)    | 1,686              |
| Equity securities                   | (49)           | 1,517              | (24 )    | 1,130              |
| Total realized losses               | (88)           | 9,004              | (194)    | 2,816              |
| Net realized (losses) gains         | \$(85)         | \$ 79,574          | \$(125)  | \$ 10,874          |

|                                   | 2018           |                    | 2017     |                    |
|-----------------------------------|----------------|--------------------|----------|--------------------|
|                                   | Gains          |                    | Gains    |                    |
|                                   | (Losses)       | Fair Value at Sale | (Losses) | Fair Value at Sale |
|                                   | (In thousands) |                    |          |                    |
| For the Six Months Ended June 30, |                |                    |          |                    |
| Fixed maturities                  | \$76           | \$ 233,874         | \$34     | \$ 8,635           |
| Equity securities                 | 1              | 169                | 811      | 9,565              |
| Total realized gains              | 77             | 234,043            | 845      | 18,200             |
| Fixed maturities                  | (242)          | 61,325             | (174)    | 7,244              |
| Equity securities                 | (147)          | 3,758              | (25 )    | 657                |
| Total realized losses             | (389)          | 65,083             | (199)    | 7,901              |
| Net realized (losses) gains       | \$(312)        | \$ 299,126         | \$646    | \$ 26,101          |

The table below summarizes the Company's fixed maturities at June 30, 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.

|                                       | June 30, 2018          |           |       | Fair Value | Percent of Total |   |
|---------------------------------------|------------------------|-----------|-------|------------|------------------|---|
|                                       | Cost or Amortized Cost | Number of | Total | (In        |                  |   |
|                                       | (In                    |           |       | thousands) |                  |   |
|                                       | thousands)             |           |       | (In        |                  |   |
|                                       |                        |           |       | thousands) |                  |   |
| Due in one year or less               | \$41,719               | 8         | %     | \$ 41,643  | 8                | % |
| Due after one year through five years | 163,622                | 31        | %     | 161,028    | 32               | % |

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|  |           |     |   |            |     |   |
|--|-----------|-----|---|------------|-----|---|
| Due after five years through ten years | 134,017   | 26  | % | 129,488    | 25  | % |
| Due after ten years                    | 180,517   | 35  | % | 176,762    | 35  | % |
| Total                                  | \$519,875 | 100 | % | \$ 508,921 | 100 | % |

The following table summarizes the Company's net investment income by major investment category for the three and six months ended June 30, 2018 and 2017, respectively:

|   | For the Three<br>Months Ended<br>June 30, |         | For the Six<br>Months Ended<br>June 30, |         |
|---|---|---------|---|---------|
|   | 2018                                      | 2017    | 2018                                    | 2017    |
|   | (In thousands)                            |         |   |         |
| Fixed maturities                                  | \$2,593                                   | \$2,650 | \$4,978                                 | \$5,161 |
| Equity securities                                 | 314                                       | 482     | 617                                     | 979     |
| Cash, cash equivalents and short-term investments | 204                                       | 34      | 1,243                                   | 103     |
| Other investments                                 | 114                                       | —       | 183                                     | —       |
| Net investment income                             | 3,225                                     | 3,166   | 7,021                                   | 6,243   |
| Investment expenses                               | 670                                       | 193     | 1,164                                   | 768     |
| Net investment income, less investment expenses   | \$2,555                                   | \$2,973 | \$5,857                                 | \$5,475 |

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 June 30, 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 June 30, 2018 and 2017.

The following tables present an aging of our unrealized investment losses by investment class as of June 30, 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>June 30, 2018</b>                              |                         |                         |            |                       |                         |            |
| U.S. government and agency securities             | 49                      | \$ 600                  | \$18,067   | 36                    | \$ 275                  | \$8,978    |
| States, municipalities and political subdivisions | 53                      | 868                     | 43,028     | 10                    | 388                     | 12,747     |
| Industrial and miscellaneous                      | 477                     | 3,259                   | 133,621    | 34                    | 369                     | 5,793      |
| Special revenue                                   | 324                     | 3,080                   | 159,263    | 165                   | 2,017                   | 52,697     |
| Redeemable preferred stocks                       | 6                       | 158                     | 3,548      | 7                     | 7                       | 71         |
| Total fixed maturities                            | 909                     | 7,965                   | 357,527    | 252                   | 3,056                   | 80,286     |
| Nonredeemable preferred stocks                    | 177                     | 492                     | 11,098     | 22                    | 26                      | 315        |
| Equity securities                                 | 9                       | 203                     | 801        | 8                     | 414                     | 1,101      |
| Total equity securities                           | 186                     | \$ 695                  | \$11,899   | 30                    | \$ 440                  | \$1,416    |
| Total   | 1,095                   | \$ 8,660                | \$369,426  | 282                   | \$ 3,496                | \$81,702   |
| <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

The Company measures equity securities at fair value on a recurring basis such as, redeemable preferred stock, nonredeemable preferred stock and common stock of domestic corporations which are measured using quoted prices in active markets for identical assets and as such, are represented Level 1 inputs.

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.

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 June 30, 2018 and December 31, 2017, there were no transfers in or out of Level 1, 2, and 3.

| June 30, 2018                                     | Total            | Level 1         | Level 2          | Level 3     |
|---|------------------|-----------------|------------------|-------------|
|   | (in thousands)   |                 |                  |             |
| <b>Fixed maturities investments:</b>              |                  |                 |                  |             |
| U.S. government and agency securities             | \$29,670         | \$351           | \$29,319         | \$ —        |
| States, municipalities and political subdivisions | 62,090           | —               | 62,090           | —           |
| Special revenue                                   | 269,292          | —               | 269,292          | —           |
| Industrial and miscellaneous                      | 143,203          | —               | 143,203          | —           |
| Redeemable preferred stocks                       | 4,666            | 4,666           | —                | —           |
| <b>Total fixed maturities investments</b>         | <b>\$508,921</b> | <b>\$5,017</b>  | <b>\$503,904</b> | <b>\$ —</b> |
| Nonredeemable preferred stocks                    | 13,435           | 13,435          | —                | —           |
| Equity securities                                 | 2,523            | 2,523           | —                | —           |
| <b>Total equity securities</b>                    | <b>\$15,958</b>  | <b>\$15,958</b> | <b>\$—</b>       | <b>\$ —</b> |
| <b>Total investments</b>                          | <b>\$524,879</b> | <b>\$20,975</b> | <b>\$503,904</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  | —       |

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|                                    |           |          |           |      |
|------------------------------------|-----------|----------|-----------|------|
| Industrial and miscellaneous       | 162,128   | —        | 162,128   | —    |
| Redeemable preferred stocks        | 4,700     | —        | 4,700     | —    |
| Total fixed maturities investments | \$549,796 | \$359    | \$549,437 | \$ — |
| Nonredeemable preferred stocks     | 14,324    | 14,324   | —         | —    |
| Equity securities                  | 2,893     | 2,893    | —         | —    |
| Total equity securities            | \$17,217  | \$17,217 | \$—       | \$ — |
| Total investments                  | \$567,013 | \$17,576 | \$549,437 | \$ — |

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## NOTE 5. OTHER COMPREHENSIVE INCOME

The following table is a summary of other comprehensive income and discloses the tax impact of each component of other comprehensive income for the three and six months ended June 30, 2018 and 2017:

|   | For the Three Months Ended June 30, |         |           |         |           |           |
|---|-------------------------------------|---------|-----------|---------|-----------|-----------|
|   | 2018                                |         | 2017      |         |           |           |
|   | Pre-tax                             | Tax     | After-tax | Pre-tax | Tax       | After-tax |
|   | (in thousands)                      |         |           |         |           |           |
| Other comprehensive income  |                                     |         |           |         |           |           |
| Change in unrealized losses on investments, net                               | \$(545)                             | \$(257) | \$ (802 ) | \$3,899 | \$(1,523) | \$ 2,376  |
| Reclassification adjustment of realized losses (gains) included in net income | 85                                  | 18      | 103       | 125     | (26 )     | 99        |
| Effect on other comprehensive income  | \$(460)                             | \$(239) | \$ (699 ) | \$4,024 | \$(1,549) | \$ 2,475  |

|   | For the Six Months Ended June 30, |         |             |         |           |           |
|---|-----------------------------------|---------|-------------|---------|-----------|-----------|
|   | 2018                              |         | 2017        |         |           |           |
|   | Pre-tax                           | Tax     | After-tax   | Pre-tax | Tax       | After-tax |
|   | (in thousands)                    |         |             |         |           |           |
| Other comprehensive income  |                                   |         |             |         |           |           |
| Change in unrealized losses on investments, net                               | \$(7,023)                         | \$1,518 | \$ (5,505 ) | \$7,880 | \$(2,921) | \$ 4,959  |
| Reclassification adjustment of realized losses (gains) included in net income | \$312                             | \$66    | \$ 378      | (646 )  | 136       | (510 )    |
| Effect on other comprehensive income  | \$(6,711)                         | \$1,584 | \$ (5,127 ) | \$7,234 | \$(2,785) | \$ 4,449  |

## NOTE 6. PROPERTY AND EQUIPMENT, NET

Property and equipment, net consisted of the following at June 30, 2018 and December 31, 2017:

|   | June 30,       |                   |
|---|----------------|-------------------|
|   | 2018           | December 31, 2017 |
|   | (In thousands) |                   |
| Land  | \$2,582        | \$ 2,582          |
| Building  | 12,117         | 12,148            |
| Computer hardware and software                  | 3,869          | 4,093             |
| Office furniture and equipment                  | 987            | 759               |
| Tenant and leasehold improvements               | 4,004          | 3,660             |
| Vehicle fleet                                   | 865            | 815               |
| Total, at cost                                  | 24,424         | 24,057            |
| Less: accumulated depreciation and amortization | 6,095          | 5,309             |
| Property and equipment, net                     | \$18,329       | \$ 18,748         |

Depreciation and amortization expense for property and equipment was \$786 thousand and \$341 thousand for the six months ended June 30, 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 including a parking garage.

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## NOTE 7. GOODWILL AND OTHER INTANGIBLE ASSETS

## Goodwill and Intangible Assets

At June 30, 2018 and December 31, 2017 goodwill (see Note 2) was \$152.5 million and intangible assets were \$88.4 million and \$101.6 million, respectively. The Company has determined the useful life of the value of the business acquired from the NBIC acquisition 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<br>(in<br>thousands) |
|---------------------------------|-------------------------------|
| Balance as of December 31, 2017 | \$ 152,459                    |
| Goodwill acquired               | —                             |
| Impairment                      | —                             |
| Balance as of June 30, 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 for the three months ended June 30, 2018 and 2017 was \$ \$6.6 million and \$558 thousand and \$13.3 million and \$3.0 million for the six months ended June 30, 2018 and 2017, respectively. No impairment in the value of amortizing or non-amortizing intangible assets was recognized during the six months ended June 30, 2018 or 2017.

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 | \$11,520 |
| 2019           | \$8,208  |
| 2020           | \$6,365  |
| 2021           | \$6,351  |
| 2022           | \$6,351  |
| 2023           | \$6,351  |
| Thereafter     | \$41,910 |
| Total          | \$87,056 |

(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.

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## 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<br>Ended June 30, |            | For the Six Months Ended<br>June 30, |            |
|--|--|------------|--------------------------------------|------------|
|  | 2018                                   | 2017       | 2018                                 | 2017       |
| <b>Basic earnings per share:</b>                       |  |            |                                      |            |
| Net income attributable to common stockholders (000's) | \$2,408                                | \$6,642    | \$17,238                             | \$12,625   |
| Weighted average shares outstanding                    | 25,631,871                             | 28,283,587 | 25,679,448                           | 28,543,703 |
| Basic earnings per share:                              | \$0.09                                 | \$0.23     | \$0.67                               | \$0.44     |
| <b>Diluted earnings per share:</b>                     |  |            |                                      |            |
| Net income attributable to common stockholders (000's) | \$2,408                                | \$6,642    | \$17,238                             | \$12,625   |
| Weighted average shares outstanding                    | 25,631,871                             | 28,283,587 | 25,679,448                           | 28,543,703 |
| Weighted average dilutive shares                       | 684,726                                | —          | 801,259                              | —          |
| Total weighted average dilutive shares                 | 26,316,597                             | 28,283,587 | 26,480,707                           | 28,543,703 |
| Diluted earnings per share:                            | \$0.09                                 | \$0.23     | \$0.65                               | \$0.44     |

The Company excludes shares potentially issuable under the Company’s Omnibus plan that could dilute basic net EPS in the future from the calculation of diluted net earnings (loss) per share, as their effect, if included, would have been anti-dilutive for the periods presented.

## 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.

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 and six months ended June 30, 2018 and 2017:

|                                   | For the Three<br>Months Ended June<br>30, |          | For the Six Months<br>Ended June 30, |          |
|-----------------------------------|---|----------|--------------------------------------|----------|
|                                   | 2018                                      | 2017     | 2018                                 | 2017     |
|                                   | (In thousands)                            |          |                                      |          |
| Beginning Balance                 | \$53,862                                  | \$41,215 | \$41,678                             | \$42,779 |
| Policy acquisition costs deferred | 31,572                                    | 22,315   | 55,940                               | 44,193   |
| Amortization                      | (15,786)                                  | (21,738) | (27,970)                             | (45,180) |
| Ending Balance                    | \$69,648                                  | \$41,792 | \$69,648                             | \$41,792 |



NOTE 10. INCOME TAXES

During the six months ended June 30, 2018 and 2017, the Company recorded \$6.0 million and \$7.9 million, respectively, of income tax expense which corresponds to an estimated annual effective tax rate of 26.03% and 38.5%, respectively. Effective tax rates are dependent upon components of pre-tax earnings and the related tax effects. 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.

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

|                                      | June 30,<br>2018 | December<br>31, 2017 |
|--------------------------------------|------------------|----------------------|
| Deferred tax assets:                 | (In thousands)   |                      |
| Unearned premiums                    | \$9,833          | \$ 12,488            |
| Unearned commission                  | 10,266           | 11,987               |
| Net operating loss                   | —                | 4,727                |
| Tax-related discount on loss reserve | 1,427            | 1,250                |
| Unrealized loss                      | 2,922            | —                    |
| Stock-based compensation             | 809              | —                    |
| Prepaid expenses                     | 1,582            | 1,950                |
| Other                                | 519              | 331                  |
| Total deferred tax asset             | 27,358           | 32,733               |
| Deferred tax liabilities:            |                  |                      |
| Deferred acquisition costs           | 16,759           | 9,775                |
| Prepaid expenses                     | 369              | 27,568               |
| Unrealized gains                     | —                | 30                   |
| Property and equipment               | 358              | —                    |
| Note discount                        | 2,655            | 3,818                |
| Basis in purchased investments       | 200              | 335                  |
| Basis in purchased intangibles       | 21,114           | 24,250               |
| Other                                | 1,253            | 1,290                |
| Total deferred tax liabilities       | 42,708           | 67,066               |
| Net deferred tax liability           | \$(15,350)       | \$(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 June 30, 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.

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 June 30, 2018 and December 31, 2017, we had no significant uncertain tax positions.

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## 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.

### 2018 – 2019 Reinsurance Program

In order to limit our potential exposure to catastrophic events, we purchase significant reinsurance from third party reinsurers and sponsor catastrophe bonds issued by Citrus Re. The catastrophe reinsurance may be on an excess of loss or quota share basis. We also purchase reinsurance for non-catastrophe losses on a quota share, per risk or facultative basis. Purchasing a sufficient amount of reinsurance to consider catastrophic losses from single or multiple events or significant non-catastrophe losses is an important part of our risk strategy, and premiums paid (or ceded) to reinsurers is one of our largest cost components. Reinsurance involves transferring, or "ceding", a portion of the risk exposure on policies we write to another insurer, known as a reinsurer. To the extent that our reinsurers are unable to meet the obligations they assume under our reinsurance agreements, we remain liable for the entire insured loss.

Our reinsurance agreements are, prospective contracts. We record an asset, prepaid reinsurance premiums, and a liability, reinsurance payable, for the entire contract amount upon commencement of our new reinsurance agreements. We generally amortize our catastrophe reinsurance premiums over the 12-month contract period on a straight-line basis, which is June 1 through May 31. Our quota share reinsurance is amortized over the 12-month contract period and may be purchased on a calendar or fiscal year basis.

In the event that we incur losses and loss adjustment expenses recoverable under our reinsurance program, we record amounts recoverable from our reinsurers on paid losses plus an estimate of amounts recoverable on unpaid losses. The estimate of amounts recoverable on unpaid losses is a function of our liability for unpaid losses associated with the reinsured policies; therefore, the amount changes in conjunction with any changes to our estimate of unpaid losses. As a result, a reasonable possibility exists that an estimated recovery may change significantly in the near term from the amounts included in our consolidated financial statements.

Our insurance regulators require all insurance companies, like us, to have a certain amount of capital and reinsurance coverage in order to cover losses and loss adjustment expenses upon the occurrence of a catastrophic event. Our 2018-2019 reinsurance program provides reinsurance in excess of our state regulator requirements, which are based on the probable maximum loss that we would incur from an individual catastrophic event estimated to occur once in every 100 years based on our portfolio of insured risks. The nature, severity and location of the event giving rise to such a probable maximum loss differs for each insurer depending on the insurer's portfolio of insured risks, including, among other things, the geographic concentration of insured value within such portfolio. As a result, a particular catastrophic event could be a one-in-100-year loss event for one insurance company while having a greater or lesser probability of occurrence for another insurance company. We also purchase reinsurance coverage to protect against the potential for multiple catastrophic events occurring in the same year. We share portions of our reinsurance program coverage among our insurance company affiliates.

### Catastrophe Excess of Loss Reinsurance

Effective June 1, 2018, we entered into catastrophe excess of loss reinsurance agreements covering Heritage P&C, Zephyr and NBIC. The catastrophe reinsurance 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”). The FHCF covers Florida risks only and we participate at 45%. Citrus Re, which provides fully collateralized multi-year coverage, covers catastrophe losses incurred by Heritage P&C only through the 2016 Class D and 2017-1 Notes, and covers catastrophe losses incurred by Heritage P&C, Zephyr and NBIC through the 2016 Class E Note. Our third-party reinsurers are either rated “A- “or higher by A.M. Best or S&P or are fully collateralized, to reduce credit risk.

The reinsurance program, which is segmented into layers of coverage, protects the Company for excess property catastrophe losses and loss adjustment expenses. The 2018-2019 reinsurance program provides first event coverage up to \$1.6 billion for Heritage P&C, first event coverage up to \$801 million for Zephyr, and first event coverage up to \$1.0 billion for NBIC. Our first event retention for each insurance company subsidiary follows: Heritage P&C - \$20.0 million [given small amount did not reduce HPCI net retention for first event by \$4.0 million for Osprey portion]; Zephyr - \$20.0 million; NBIC – \$12.8 million. Our second event retention for each insurance company subsidiary follows: Heritage P&C - \$16.0 million; Zephyr - \$16 million; NBIC – \$8.8 million. Our third and subsequent event retention for each insurance company subsidiary follows: Heritage P&C - \$16.0 million; Zephyr - \$16.0 million; NBIC – \$8.8 million.

Our program was placed on a cascading basis which provides greater horizontal protection in a multiple small events scenario and features additional coverage enhancements. This coverage exceeds the requirements established by the Companies' rating agency, Demotech, Inc., the Florida Office of Insurance Regulation, the Hawaii Insurance Division, and the Rhode Island Department of Business Regulation. For the twelve months ending May 31, 2019, no single uncollateralized private reinsurer represented more than 10% of the overall limit purchased from our total reinsurance coverage.

We are responsible for all losses and loss adjustment expenses in excess of our reinsurance program. For second or 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 \$3.4 billion of limit purchased in 2018 includes reinstatement through the purchase of reinsurance reinstatement premium. In total, we have purchased \$3.5 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.

The Company's estimated net cost for the 2018-2019 catastrophe reinsurance programs is approximately \$252.0 million.

#### Gross Quota Share Reinsurance

NBIC purchased an 8% gross quota share reinsurance treaty effective June 1, 2018 which provides ground up loss recoveries of up to \$1.0 billion. Prior to this treaty, NBIC's gross quota share treaty was 18.75%.

#### Net Quota Share Reinsurance

NBIC's net quota share coverage 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 \$20.0 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.

#### Aggregate Coverage Heritage P&C and Zephyr

\$1.1 billion of limit is structured on an aggregate basis (Top and Aggregate, Layer 1, Layer 2, Layer 3, Layer 4, Stub layers, Multi-Zonal, 2017-1 Notes and 2016 Class E 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 \$669.0 million of this coverage, which can be a reinstated one time. Layers (with exception to FHCF and 2016 Class D Notes) are "net" of a \$40.0 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.

#### Aggregate Coverage - NBIC

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

• Section 1: \$20.0 million excess \$21.5 million in the aggregate for all catastrophe losses excluding named tropical storms.

• Section 2: \$12.0 million excess \$8.0 million for named tropical storm losses.

NBIC placed 25% of an aggregate contract, which covers all catastrophe losses excluding named storms, 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.

NBIC placed 42.50% of an aggregate contract, which covers all catastrophe losses excluding named storms, on May 31, 2018, expiring December 31, 2018. The limit on the contract is \$20.0 million, retention of \$3.0 million and franchise deductible of \$1.5 million.

NBIC placed 92.00% of an occurrence contract, which covers all catastrophe losses excluding named storms, on May 31, 2018, expiring December 31, 2018. The limit on the contract is \$20.0 million with a retention of \$20.0 million.

#### Per Risk Coverage

The Company also purchased property per risk coverage for losses and loss adjustment expenses in excess of \$1.0 million per claim. The limit recovered for an individual loss is \$9.0 million and total limit for all losses is \$27.0 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 \$10.0 million for any commercial properties it insured where the total insured value exceeded \$10.0 million.

#### 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 92% placed with the gross quota share providing the additional 8% 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 \$3.75 million.

#### 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 \$731.0 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 ended 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 \$20.0 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 \$20.0 million (\$15.0 million plus \$5.0 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 \$16.0 million and the remainder of the losses are ceded to third parties. In a first event exceeding



approximately \$878.0 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 \$420.0 million, results in an additional Company co-participation of 11.5% subject to a maximum co-participation of \$36.0 million. Heritage P&C has a \$16.0 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 \$372.0 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 \$352.0 million of this reinsurance one time. There is \$20.0 million of shared coverage subject to a seasonal aggregate of \$68.0 million.

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**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 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 \$5.0 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 \$35.0 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 \$250.0 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 \$150.0 million of coverage and the Class E notes provide \$100.0 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 \$30.0 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

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and its obligations to Heritage P&C under the reinsurance agreements. The notes provide \$125.0 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 \$150.0 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 \$254.0 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. \$984.0 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 \$606.0 million of this coverage, which can be reinstated one time. Layers (with exception to FHCF, 2016 Class D & E Notes, and 2015 Class B & C Notes) are “net” of a \$40.0 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 \$20.0 million (\$15.0 million plus \$5.0 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 \$16.0 million and the remainder of losses are ceded to third parties. In a first event exceeding approximately \$386.0 million, there is an additional co-participation of 3.8% subject to a maximum co-participation of \$12.0 million. Assuming a 1-100-year event, a second event exceeding approximately \$386.0 million results in an additional co-participation of 117.7%, subject to a maximum co-participation of \$56 million. Zephyr has a \$16.0 million primary retention for events beyond the second catastrophic event.

**Shared Layers above retention.** Immediately above the retention, the Company has purchased \$372.0 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 \$352.0 million of this reinsurance one time. There is \$20.0 million of shared coverage subject to a seasonal aggregate of \$68.0 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 \$302.0 million of reinsurance coverage purchased on this basis, of which \$254.0 million can be reinstated through the payment of reinsurance restatement premium. The multi-zonal occurrence layer provides first and second event coverage of \$254.0 million for Hawaii and second event coverage of \$254.0 million for Florida. A Top and Aggregate multi-zonal layer provides first event coverage of \$48.0 million for Hawaii and second or subsequent event coverage of \$48.0 million for Florida.

•**Top Hawaii only layer.** Zephyr has an additional layer purchased from third party reinsurers which provides \$26.0 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 \$700.0 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

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first catastrophic event, it provides coverage commencing at its reduced retention for second and subsequent events where underlying coverage has been previously exhausted. \$632.0 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 \$731.0 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 \$632.0 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, \$250.0 million of coverage for two-year period and \$160.0 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 \$1.0 million per claim. The limit recovered for an individual loss is \$9.0 million and total limit for all losses is \$27.0 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 \$10.0 million for any commercial properties it insured where the total insured value exceeded \$10.0 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 \$1.0 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 \$20.0 million is further reduced with a net quota share reinsurance contract described below.

#### 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.

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### Aggregate Contract

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

Section 1: \$20.0 million excess \$21.5 million in the aggregate for all catastrophe losses excluding named tropical storms.

Section 2: \$12.0 million excess \$8.0 million for named tropical storm losses.

NBIC placed 25% of an aggregate contract on December 31, 2017, which expired on 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 \$1.0 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 \$20.0 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 \$1.0 million with 90% quota share, subject to an additional limit of liability of up to \$4.0 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.

### 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 \$9.0 million and total limit for all losses is \$27.0 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 \$10.0 million for any commercial properties it insured for which the total insured value exceeded \$10.0 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.

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The table below summarizes the activity related to the Company's reserve for unpaid losses for the three and six months ended June 30, 2018 and 2017:

|  | For the Three     |           | For the Six Months |           |
|--|-------------------|-----------|--------------------|-----------|
|  | Months Ended June |           | Ended June 30,     |           |
|  | 2018              | 2017      | 2018               | 2017      |
|  | (in thousands)    |           | (in thousands)     |           |
| Balance, beginning of period                   | \$547,736         | \$131,572 | \$470,083          | \$140,137 |
| Less: reinsurance recoverable on unpaid losses | 385,397           | 1,321     | 315,353            | 586       |
| Net balance, beginning of period               | 162,339           | 130,251   | 154,730            | 139,551   |
| Incurred related to:                           |                   |           |                    |           |
| Current year                                   | 49,852            | 46,944    | 101,214            | 94,819    |
| Prior years                                    | 16,137            | (897)     | 17,866             | (2,126)   |
| Total incurred                                 | 65,989            | 46,047    | 119,080            | 92,693    |
| Paid related to:                               |                   |           |                    |           |
| Current year                                   | 23,068            | 28,001    | 21,816             | 39,238    |
| Prior years                                    | 31,958            | 28,010    | 78,692             | 72,719    |
| Total paid                                     | 55,026            | 56,011    | 100,508            | 111,957   |
| Net balance, end of period                     | 173,302           | 120,287   | 173,302            | 120,287   |
| Plus: reinsurance recoverable on unpaid losses | 315,308           | 2,498     | 315,308            | 2,498     |
| Balance, end of period                         | \$488,610         | \$122,785 | \$488,610          | \$122,785 |

As of June 30, 2018, we reported \$173.3 million in unpaid losses and loss adjustment expenses, net of reinsurance which included \$113.9 million attributable to IBNR net of reinsurance recoverable, or 65.7% of net reserves for unpaid losses and loss adjustment expenses.

The Company's losses incurred for the six months ended June 30, 2018 and 2017 reflect prior year development of \$17.8 million and a redundancy of \$2.1 million, respectively, associated with management's best estimate of the actuarial loss and LAE reserves with consideration given to Company specific historical loss experience. Most of the unfavorable development during the six months ended June 30, 2017 was personal lines. Also, most of the unfavorable emergence was from 2015 and 2106 accident years and related to litigated claims. NBIC incurred losses in the first quarter of the year from seven different winter storms in the northeast, three of which were named storms. Gross losses for winter storms during the first 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 June 30, 2018, we recognized proceeds of \$74.0 million on the issuance of the Secured Notes, net of issuance costs which totaled approximately \$5.3 million. During the six months ended June 30, 2018 and 2017, the Company made interest payments of approximately \$4.3 million and \$3.9 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 June 30, 2018, we recognized proceeds of \$90.5 million on the issuance of the Convertible Notes, net of issuance and debt discount costs which totaled approximately, \$11.0 million. For the six months ended June 30, 2018, the Company made interest payments of approximately \$3.7 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. In April 2018, the Parent reacquired \$10.6 million of its outstanding Convertible Notes in the open market at a cost of \$13.4 million. Based on the reacquisitions of the Convertible Notes, the Companies derecognized the related debts and conversion option liabilities. 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. For the six months ended June 30, 2018, the Company paid in principal and interest \$446 thousand.

The following table summarizes the Company's long-term debt at June 30, 2018 and December 31, 2017:

|   | June 30,<br>2018 | December<br>31, 2017 |
|---|------------------|----------------------|
|   | (in thousands)   |                      |
| Convertible debt                                    | \$ 105,024       | \$ 115,624           |
| Mortgage loan                                       | 12,527           | 12,658               |
| Senior Note payable                                 | 79,500           | 79,500               |
| Total principal amount                              | \$ 197,051       | \$ 207,782           |
| Less: unamortized discount and issuance costs       |                  |                      |
| Debt discount and issuance cost on convertible debt | 14,506           | 17,605               |
| Debt issuance cost on senior note payable           | 5,288            | 5,772                |
| Total long-term debt                                | \$ 177,257       | \$ 184,405           |

#### NOTE 14. ACCOUNTS PAYABLE AND OTHER LIABILITIES

Other liabilities consist of the following at June 30, 2018 and December 31, 2017:

| Description                         | June 30,<br>2018 | December<br>31, 2017 |
|-------------------------------------|------------------|----------------------|
|                                     | (In thousands)   |                      |
| Deferred ceding commission          | \$ 42,836        | \$ 51,109            |
| Outstanding claim checks            | 45,338           | 79,666               |
| Accounts payable and other payables | 10,713           | 17,948               |
| Accrued interest and issuance costs | 3,148            | 3,117                |
| Accrued dividends                   | 1,594            | —                    |
| Other liabilities                   | 1,902            | 5,088                |
| Commission payables                 | 13,759           | 12,609               |
| Total other liabilities             | \$ 119,290       | \$ 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 combined statutory surplus at June 30, 2018 and December 31, 2017 was \$342.5 million and \$376.2 million, respectively. On a combined basis, the Company's insurance subsidiaries reported statutory net loss for the six months of June 30, 2018 and 2017 of \$61.1 million and \$4.5 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 June 30, 2018, 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

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 six months ended June 30, 2018, the Company paid consulting fees to Ms. Lucas of approximately \$302 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 six-month period ended June 30, 2018 and 2017, the Heritage P&C's contributions to the plan on behalf of the participating employees were approximately \$345 thousand and \$425 thousand, respectively.

Heritage P&C provides for its employees a partially self-insured healthcare plan and benefits. For the six months ended June 30, 2018 and 2017, Heritage P&C incurred medical premium costs in the aggregate of \$1.8 million and \$1.5 million, respectively. Heritage P&C also recorded approximately \$150 thousand as unpaid claims as of June 30, 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. For the six-month period ended June 30, 2018, NBIC contributions to the plan on behalf of the participating employees were approximately \$224 thousand.

#### 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 June 30, 2018, the Company had 25,769,804 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 \$294.2 million as of such date.

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. 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. The repurchase plan expired on June 30, 2018.

On August 1, 2018, the Company announced that its Board of Directors authorized a stock repurchase program authorizing the Company to repurchase up to \$50 million of its common stock through December 31, 2020 under our current Rule 10b5-1 trading plan, which allows the Company to repurchase shares below a predetermined price per share. The timing and amount of any repurchases will be determined based on market conditions and other factors and the program may be discontinued or suspended at any time.

#### 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.

On May 7, 2018, the Company's 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.

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 June 30, 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 June 30, 2018 is as follows:

|                                  | Number<br>of shares | Weighted-Average<br>Grant-Date Fair<br>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 June 30, 2018     | 800,000             | \$ 20.61   |

Awards are being amortized to expense over the five-year vesting period. The Company recognized \$2.6 million and \$2.4 million of compensation expense for the six months ended June 30, 2018 and 2017, respectively. There was approximately \$13.1 million of unrecognized compensation expense related to the un-vested restricted stock at June 30, 2018. The Company expects to recognize the remaining compensation expense over a weighted average period of 2.7 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 June 30, 2018.

On August 1, 2018, the Company announced that its Board of Directors declared a \$0.06 per share quarterly dividend payable on October 3, 2018 to stockholders of record as of September 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 Six Months Ended June 30, 2018

• Premium in force at June 30, 2018 was approximately \$930.5 million with approximately 521,000 policies in force at June 30, 2018.

• Gross premiums written of \$468.0 million and total revenue of \$230.0 million.

• Net premiums earned of \$217.3 million.

• Operating income of \$33.0 million.

• Combined ratio of 90.7% on a net basis.

• Cash, cash equivalents and investments of approximately \$743.2 million, with total assets of \$2.0 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 six months ended June 30, 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 and six months ended June 30, 2018 and 2017:

|  | For the Three Months<br>Ended June 30, |           |             | For the Six Months<br>Ended June 30, |           |             |
|--|--|-----------|-------------|--------------------------------------|-----------|-------------|
|  | 2018<br>(in thousands)                 | 2017      | %<br>Change | 2018<br>(in thousands)               | 2017      | %<br>Change |
| <b>REVENUE:</b>                        |  |           |             |                                      |           |             |
| Gross premiums written                 | \$263,664                              | \$159,255 | 39.6        | \$468,030                            | \$301,490 | 35.6        |
| Change in gross unearned premiums      | (32,693 )                              | (6,901 )  | 78.9        | (9,896 )                             | 5,472     | 155.3       |
| Gross premiums earned                  | 230,971                                | 152,354   | 34.0        | 458,134                              | 306,962   | 33.0        |
| Ceded premiums                         | (119,767)                              | (61,902 ) | 48.3        | (240,822)                            | (124,334) | 48.4        |
| Net premiums earned                    | 111,204                                | 90,452    | 18.7        | 217,312                              | 182,628   | 16.0        |
| Net investment income                  | 2,555                                  | 2,973     | (16.3 )     | 5,857                                | 5,475     | 6.5         |
| Net realized (losses) gains            | (85 )                                  | (125 )    | (46.5 )     | (312 )                               | 646       | 306.9       |
| Other revenue                          | 4,298                                  | 3,638     | 15.3        | 7,141                                | 7,482     | (4.8 )      |
| Total revenue                          | \$117,972                              | \$96,938  | 17.8        | \$229,998                            | \$196,231 | 14.7        |
| <b>OPERATING EXPENSES:</b>             |  |           |             |                                      |           |             |
| Losses and loss adjustment expenses    | 65,989                                 | 46,046    | 30.2        | 119,080                              | 92,693    | 22.2        |
| Policy acquisition costs               | 19,411                                 | 21,738    | (12.0 )     | 31,598                               | 45,180    | (43.0 )     |
| General and administrative expenses    | 24,422                                 | 16,092    | 34.1        | 46,352                               | 33,406    | 27.9        |
| Total operating expenses               | 109,822                                | 83,876    | 23.6        | 197,030                              | 171,279   | 13.1        |
| Operating income                       | 8,150                                  | 13,062    | (60.3 )     | 32,968                               | 24,952    | 24.3        |
| Interest expense, net                  | 5,386                                  | 2,231     | 58.6        | 10,206                               | 4,412     | 56.8        |
| Other non-operating (income)/loss, net | (542 )                                 | —         | 100.0       | (542 )                               | —         | 100.0       |
| Income before income taxes             | 3,306                                  | 10,831    | (227.6 )    | 23,304                               | 20,540    | 11.9        |
| Provision for income taxes             | 898                                    | 4,189     | (366.4 )    | 6,066                                | 7,915     | (30.5 )     |
| Net income                             | \$2,408                                | \$6,642   | (175.8 )    | \$17,238                             | \$12,625  | 26.8        |
| Basic earnings per share               | \$0.09                                 | \$0.23    |             | \$0.67                               | \$0.44    |             |
| Diluted earnings per share             | \$0.09                                 | \$0.23    |             | \$0.65                               | \$0.44    |             |

## Comparison of the Three Months Ended June 30, 2018 and 2017

## Revenue

## Gross premiums written

Gross premiums written increased to \$263.7 million for the three months ended June 30, 2018 as compared to \$159.3 million for the three months ended June 30, 2017. This increase relates primarily to gross premiums written by NBIC, acquired on November 30, 2017 of \$89.6 million, included in the second quarter of 2018 as well as an increase in gross premiums written by Heritage P&C.

## Gross premiums earned

Gross premiums earned increased to \$231.0 million for the three months ended June 30, 2018 as compared to \$152.4 million for the three months ended June 30, 2017. This increase relates primarily to gross premiums earned by NBIC of \$82.8 million, included in the second quarter of 2018, slightly offset by a decrease in gross premiums earned by the Heritage P&C and Zephyr of approximately \$4 million.

Ceded premiums

Ceded premiums increased to \$119.8 million for the three months ended June 30, 2018 as compared to \$61.9 million for the three months ended June 30, 2017. This increase relates primarily to premiums ceded by NBIC of \$64.8 million, included in the second quarter of 2018. This was partially offset by a reduction in premium ceded by Heritage P&C and Zephyr of nearly \$7 million associated with exposure management and reinsurance synergies associated with the NBIC acquisition.

#### Net premiums earned

Net premiums earned increased to \$111.2 million for the three months ended June 30, 2018 as compared to \$90.5 million for the three months ended June 30, 2017. The change resulted from the earned and ceded premium variances described above.

#### Net investment income

Net investment income, inclusive of realized investment gain or loss, decreased slightly to \$2.5 million for the three months ended June 30, 2018 as compared to \$2.8 million for the three months ended June 30, 2017.

#### Other revenue

Other revenue increased to \$4.3 million for the three months ended June 30, 2018 as compared to \$3.6 million for the three months ended June 30, 2017.

#### Total revenue

Total revenue increased to \$118.0 million for the three months ended June 30, 2018 as compared to \$96.9 million for the three months ended June 30, 2017. This increase relates primarily to revenue earned by NBIC of \$19.0 million, included in the second quarter of 2018.

#### Expenses

##### Losses and loss adjustment expenses

Losses and loss adjustment expenses (“LAE”) increased to \$66.0 million for the three months ended June 30, 2018 as compared to \$46.0 million for the three months ended June 30, 2017. Approximately \$9.8 million of the increase relates to the inclusion of NBIC. Approximately \$10 million of the increase relates to legacy consolidated entity losses associated with reserve strengthening as well as non-catastrophe weather losses during the second quarter of 2018, which was partially mitigated by profitability arising from utilization of our vertically integrated affiliate, Contractors Alliance Network.

##### Policy acquisition costs

Policy acquisition costs decreased to \$19.4 million for the three months ended June 30, 2018 as compared to \$21.7 million for the three months ended June 30, 2017. The decrease relates to NBIC ceding commission income allocated to policy acquisition costs coupled with a decrease of approximately of \$0.8 million for the legacy entities. 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.

##### General and administrative expenses

General and administrative expenses increased to \$24.4 million for the three months ended June 30, 2018 from \$16.1 million for the three months ended June 30, 2017. The increase relates to inclusion of NBIC for the second quarter of 2018 coupled with an increase in costs associated with infrastructure growth and post acquisition costs associated with NBIC systems implementation.

Interest and amortization of debt issuance costs

Interest and amortization of debt issuance costs, inclusive of other non-operating income/loss increased to \$4.8 million for the three months ended June 30, 2018 from \$2.2 million for the three months ended June 30, 2017. The increase is associated with interest and amortization of costs associated with convertible notes issued in August and September of 2017 coupled with an increase in interest rates on the senior notes. This is offset by a \$0.5 million net gain in other non-operating income from the repurchase of debt in the second quarter of 2018.

Provision for income taxes

The provision for income taxes was \$898 thousand and \$4.2 million for the three months ended June 30, 2018 and 2017, respectively. Our effective tax rate for the three months ended June 30, 2018 and 2017 was 27.2% and 38.7%, respectively. The effective tax rate can fluctuate throughout the year as estimates used in the tax provision for each 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 – Income Tax of these unaudited financial statements, which decreased the enacted federal statutory tax rate from 35% to 21%.

#### Net income

Our results of operations for the three months ended June 30, 2018 reflect net income of \$2.4 million, or \$0.09 earnings per diluted common share, compared to net income of \$6.6 million, or \$0.23 earnings per diluted common share, for the three months ended June 30, 2017.

#### Comparison of the Six Months Ended June 30, 2018 and 2017

##### Revenue

##### Gross premiums written

Gross premiums written increased to \$468.0 million for the six months ended June 30, 2018 as compared to \$301.5 million for the six months ended June 30, 2017. The increase in gross premiums written relates to inclusion of \$160.1 million of gross premium written by NBIC, which was acquired on November 30, 2017, as well as an increase in gross premium written by the legacy Heritage insurers of approximately \$6.5 million.

##### Gross premiums earned

Gross premiums earned increased to \$458.1 million for the six months ended June 30, 2018 as compared to \$307.0 million for the six months ended June 30, 2017. Approximately \$163.9 million of the increase relates to the inclusion of premium earned by NBIC, offset by a reduction in gross premium earned by the legacy Heritage insurers of approximately \$12.7 million.

##### Ceded premiums

Ceded premiums increased to \$240.8 million for the six months ended June 30, 2018 as compared to \$124.3 million for the six months ended June 30, 2017. The increase in ceded premiums relates to the inclusion of premium ceded by NBIC of \$130.0 million offset by a \$13.4 million reduction in premium ceded by the legacy consolidated Heritage entities. 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 as well as reinsurance synergies in the 2018 program. Catastrophe excess of loss contracts for the 2018 hurricane season cover the period from June 1, 2018 to May 31, 2019. 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 \$217.3 million for the six months ended June 30, 2018 as compared to \$182.6 million for the six months ended June 30, 2017. The increase in net premiums earned relates primarily to inclusion of net premium earned by NBIC of \$33.9 million.

##### Net investment income



Net investment income, inclusive of realized investment gains, decreased slightly to \$5.5 million for the six months ended June 30, 2018 as compared to \$6.1 million for the six months ended June 30, 2017.

Other revenue

Other revenue decreased slightly to \$7.1 million for the six months ended June 30, 2018 as compared to \$7.5 million for the six months ended June 30, 2017.

Total revenue

Total revenue increased to \$230.0 million for the six months ended June 30, 2018 as compared to \$196.2 million for the six months ended June 30, 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 \$119.1 million for the six months ended June 30, 2018 as compared to \$92.7 million for the six months ended June 30, 2017. The increase in losses and loss adjustment expenses relates primarily to inclusion of losses and LAE net of reinsurance associated with NBIC of \$24.5 million.

### Policy acquisition costs

Policy acquisition costs decreased to \$31.6 million for the six months ended June 30, 2018 as compared to \$45.2 million for the six months ended June 30, 2017. The decrease is primarily attributable to ceding commission of \$27.7 million associated with NBIC quota share reinsurance treaties which significantly reduced policy acquisition costs which more than offset the entire additional policy acquisition costs associated with inclusion of NBIC. 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.

### General and administrative expenses

General and administrative expenses increased to \$46.4 million for the six months ended June 30, 2018 as compared to \$33.4 million for the six months ended June 30, 2017. The increase was due to expenses associated with NBIC as well as an increase in general and administrative expenses associated with overall infrastructure growth and systems integration. The increase in expenses was reduced by \$9.2 million of NBIC ceding commission income allocable to other underwriting expenses. 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.

### 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 and amortization of debt issuance costs of \$10.2 million for the six months ended June 30, 2018 compared to \$4.4 million for the six months ended June 30, 2017. The increase relates to inclusion of interest on the convertible notes in 2018 coupled with a higher interest rate on the senior notes.

### Provision for income taxes

Provision for income taxes was \$6.0 million and \$7.9 million for the six months ended June 30, 2018 and 2017, respectively. Our effective tax rate for the six months ended June 30, 2018 and 2017 was 26.0% and 38.5%, 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 – Income Tax of these unaudited financial statements, which decreased the enacted federal statutory tax rate from 35% to 21%.

### Net income

Our net income for the six months ended June 30, 2018 is \$17.2 million, or \$0.65 earnings per diluted common share, compared to net income of \$12.6 million, or \$0.44 earnings per diluted common share, for the six months ended June 30, 2017. The increase relates to inclusion of NBIC net income partially offset by increases in losses and general and administrative expenses described above.

## Ratios

|  | For the Three<br>Months<br>Ended June<br>30,<br>2018 2017 |       |
|--|---|-------|
| Ratios to Gross Premiums Earned: (unaudited) |   |       |
| Ceded premium ratio                          | 51.9%   | 40.6% |
| Loss ratio                                   | 28.6%   | 30.2% |
| Operating expense ratio                      | 19.0%   | 24.9% |
| Combined ratio                               | 99.5%   | 95.7% |
| Ratios to Net Premiums Earned:               |   |       |
| Loss ratio                                   | 59.3%   | 50.9% |
| Operating expense ratio                      | 39.4%   | 41.8% |
| Combined ratio                               | 98.7%   | 92.7% |

## Ceded premium ratio

Our ceded premium ratio increased to 51.9% for the three months ended June 30, 2018 compared to 40.6% for the three months ended June 30, 2017. The increase relates primarily to inclusion of NBIC gross and net quota share reinsurance programs.

## Gross loss ratio

Our gross loss ratio decreased to 28.6% for the three months ended June 30, 2018 compared to 30.2% for the three months ended June 30, 2017. The reduction relates primarily to a lower loss ratio for NBIC resultant from its quota share reinsurance programs. The reduction due to NBIC was offset by an increase in the gross loss ratio for the consolidated legacy Heritage entities, which increased to 37.9% for the quarter ended June 30, 2018 to 30.2% for the quarter ended June 30, 2017. This increase was driven primarily by non-catastrophe weather losses as well as reserve strengthening. As 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 had a favorable impact on our loss ratio for the quarter ended June 30, 2018.

## Net loss ratio

Our net loss ratio increased to 59.3% for the three months ended June 30, 2018 compared to 50.9% for the three months ended June 30, 2017. The increase in the net loss ratio relates primarily to a higher net loss ratio for the legacy consolidated Heritage entities largely driven by weather losses and reserve strengthening.

## Gross operating expense ratio

Our gross operating expense ratio decreased to 19.0% for the three months ended June 30, 2018 compared to 24.9% for the three months ended June 30, 2017. The decrease is associated with ceding commission income which is reported as an offset to operating expenses. 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. The decrease associated with ceding commission income was offset by an

increase in the gross operating expense ratio for the legacy consolidated Heritage entities. That increase relates primarily to infrastructure growth and costs associated with systems integration associated with the NBIC acquisition.

Net operating expense ratio

Our net operating expense ratio decreased to 39.4% for the three months ended June 30, 2018 compared to 41.8% for the three months ended June 30, 2017, primarily due to the decrease in the gross expense ratio discussed above, coupled with the higher ceded premium ratio.

Combined ratio

Our combined ratio on a gross basis increased to 99.5% for the three months ended June 30, 2018 compared to 95.7% for the three months ended June 30, 2017. The increase in the combined ratio on a gross basis relates primarily a higher loss ratio at the consolidated legacy Heritage entities. Our combined ratio on a net basis increased to 98.7% for the three months ended June 30, 2018

compared to 92.7% for the three months ended June 30, 2017. The combined ratio on a net basis increased primarily due to the higher net loss ratio as described above.

## Ratios

|   | For the Six<br>Months<br>Ended June<br>30,<br>2018 2017 |       |
|---|---|-------|
| <b>Ratios to Gross Premiums Earned: (unaudited)</b> |   |       |
| Ceded premium ratio                                 | 52.6%   | 40.5% |
| Loss ratio  | 26.0%   | 30.2% |
| Operating expense ratio                             | 17.0%   | 25.6% |
| Combined ratio                                      | 95.6%   | 96.3% |
| <b>Ratios to Net Premiums Earned:</b>               |   |       |
| Loss ratio  | 54.8%   | 50.8% |
| Operating expense ratio                             | 35.9%   | 43.0% |
| Combined ratio                                      | 90.7%   | 93.8% |

### Ceded premium ratio

Our ceded premium ratio increased to 52.6% for the six months ended June 30, 2018 compared to 40.5% for the six months ended June 30, 2017. The increase relates primarily to NBIC, resulting from its gross and net quota share reinsurance treaties, which was partially offset by a reduction in the ceded premium ratio for the legacy consolidated Heritage entities.

### Gross loss ratio

Our gross loss ratio decreased to 26.0% for the six months ended June 30, 2018 compared to 30.2% for the six months ended June 30, 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 first quarter of the year. The gross loss ratio for legacy consolidated Heritage entities increased nearly two points from the prior year, largely due to weather losses and reserve strengthening, which was partially mitigated by profitability arising from utilization of our vertically integrated affiliate, Contractors Alliance Network. As 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 six months ended June 30, 2018.

### Net loss ratio

Our net loss ratio increased to 54.8% for the six months ended June 30, 2018 compared to 50.8% for the six months ended June 30, 2017. The increase in the net loss ratio was largely driven by the weather losses and reserve strengthening, which was partially mitigated by profitability arising from utilization of our vertically integrated affiliate, Contractors Alliance Network.

### Gross expense ratio

Our gross expense ratio decreased to 17.0% for the six months ended June 30, 2018 compared to 25.6% for the six months ended June 30, 2017, primarily due to the benefit of ceding commission income of approximately \$36.9 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 35.9% for the six months ended June 30, 2018 compared to 43.0% for the six months ended June 30, 2017, primarily due to the decrease in the gross expense ratio discussed above, coupled with the higher ceded premium ratio.

#### Combined ratio

Our combined ratio on a gross basis decreased to 95.6% for the six months ended June 30, 2018 compared to 96.3% for the six months ended June 30, 2017. Our combined ratio on a net basis decreased to 90.7% for the six months ended June 30, 2018 compared to 93.8% for the six months ended June 30, 2017. The combined ratio decreased primarily due to the favorable impact of the NBIC

acquisition on the loss and operating expense ratios as described above, partially offset by an increase in the consolidated loss ratio of the legacy Heritage entities as described above.

### Liquidity and Capital Resources

As of June 30, 2018, we had \$218.3 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 \$16.98 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 June 30, 2018, approximately \$22 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.

### Cash Flows

|  | For the Six Months Ended |          |          |
|--|--------------------------|----------|----------|
|  | June 30,                 |          |          |
|  | 2018                     | 2017     | Change   |
|  | (in thousands)           |          |          |
| Net cash provided by (used in):                      |                          |          |          |
| Operating activities                                 | \$48,332                 | \$32,975 | \$15,357 |
| Investing activities                                 | 30,938                   | 5,029    | 25,909   |
| Financing activities                                 | (18,573)                 | (12,174) | (6,399)  |
| Net increase (decrease) in cash and cash equivalents | \$60,697                 | \$25,830 | \$34,867 |

#### Operating Activities

Cash provided by operating activities was \$48.3 million for the six months ended June 30, 2018 compared to cash provided of \$33.0 million for the six months ended June 30, 2017. The increase in cash from operating activities was primarily due the timing of reinsurance payments. Additionally, cash was used to pay winter storm claims in the northeast.

#### Investing Activities

Net cash provided by investing activities for the six months ended June 30, 2018 was \$30.9 million as compared to \$5.0 million for the comparable period in 2017. The cash provided by investing activities relates to draws on short term investments during the quarter, primarily to fund payments of Hurricane Irma claims pending reinsurance recoveries.

#### Financing Activities



Net cash used in financing activities for the six months ended June 30, 2018 was \$18.6 million, as compared to of \$12.2 million for the comparable period in 2017. The increase in cash used in financing activities relates primarily to the repurchase of convertible notes.

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## Contractual Obligations

The following table represents our contractual obligations for which cash flows are fixed or determinable as of June 30, 2018:

|                                      | Total            | Less<br>Than 1<br>Year | 1-3<br>Years    | 3-5<br>Years    | More<br>than 5<br>Years |
|--------------------------------------|------------------|------------------------|-----------------|-----------------|-------------------------|
|                                      | (in thousands)   |                        |                 |                 |                         |
| Convertible senior notes             | \$182,256        | \$3,191                | \$18,510        | \$18,510        | \$142,045               |
| Senior secured notes                 | 118,605          | 9,988                  | 40,906          | 67,711          | —                       |
| Mortgage loan                        | 21,725           | 446                    | 2,678           | 2,678           | 15,923                  |
| <b>Total Contractual Obligations</b> | <b>\$322,586</b> | <b>\$13,625</b>        | <b>\$62,094</b> | <b>\$88,899</b> | <b>\$157,968</b>        |

## 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 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 June 30, 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 June 30, 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              | \$ 452,697                        | \$ (56,224) | (11.0)                             | )% |
| 200 basis point increase              | \$ 471,435                        | \$ (37,486) | (7.4)                              | )% |
| 100 basis point increase              | \$ 490,176                        | \$ (19,230) | (3.8)                              | )% |
| 100 basis point decrease              | \$ 527,669                        | \$ 18,748   | 3.7                                | %  |
| 200 basis point decrease              | \$ 546,219                        | \$ 37,298   | 7.3                                | %  |
| 300 basis point decrease              | \$ 560,103                        | \$ 51,182   | 10.1                               | %  |

#### 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 June 30, 2018 (in thousands):

| Rating | % of Total                |                |                      | % of total           |   |
|--------|---------------------------|----------------|----------------------|----------------------|---|
|        | Comparable Amortized Cost | Amortized Cost | Estimated Fair Value | Estimated Fair Value |   |
| AAA    | \$ 146,219                | 28.1           | % \$ 142,649         | 28.0                 | % |
| AA+    | \$ 108,793                | 20.9           | % \$ 106,686         | 21.0                 | % |
| AA     | \$ 68,411                 | 13.2           | % \$ 67,275          | 13.2                 | % |
| AA-    | \$ 40,922                 | 7.9            | % \$ 40,288          | 7.9                  | % |
| A+     | \$ 42,172                 | 8.1            | % \$ 41,290          | 8.1                  | % |
| A      | \$ 31,482                 | 6.1            | % \$ 30,960          | 6.1                  | % |
| A-     | \$ 28,562                 | 5.5            | % \$ 27,758          | 5.5                  | % |

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|           |            |       |              |       |   |
|-----------|------------|-------|--------------|-------|---|
| BBB+      | \$ 25,794  | 5.0   | % \$ 25,142  | 4.9   | % |
| BBB       | \$ 15,416  | 3.0   | % \$ 15,001  | 2.9   | % |
| BBB-      | \$ 7,291   | 1.4   | % \$ 7,096   | 1.4   | % |
| BB        | \$ 699     | 0.1   | % \$ 702     | 0.1   | % |
| BB+       | \$ 2,003   | 0.4   | % \$ 1,975   | 0.4   | % |
| B+        | \$ 240     | 0.0   | % \$ 234     | 0.0   | % |
| B         | \$ 833     | 0.1   | % \$ 838     | 0.2   | % |
| NA and NR | \$ 1,038   | 0.2   | % \$ 1,026   | 0.3   | % |
| Total     | \$ 519,875 | 100.0 | % \$ 508,921 | 100.0 | % |

Equity Price Risk

Our equity investment portfolio at June 30, 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 June 30, 2018 (in thousands):

|                                      | Estimated  | % of<br>Total<br>Estimated |   |
|--------------------------------------|------------|----------------------------|---|
|                                      | Fair Value | Fair value                 |   |
| <b>Stocks by sector:</b>             |            |                            |   |
| Financial                            | \$ 1,757   | 11.0                       | % |
| Energy                               | 2,523      | 15.8                       | % |
| Other                                | 11,678     | 73.2                       | % |
| Subtotal                             | \$ 15,958  | 100.0                      | % |
| <b>Mutual Funds and ETF By type:</b> |            |                            |   |
| Equity                               | \$ —       | 0.0                        | % |
| Total                                | \$ 15,958  | 100.0                      | % |

#### Foreign Currency Exchange Risk

At June 30, 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 June 30, 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

See “Share Repurchase Program,” of Note 9, Equity “Stock Repurchase Program”, to the condensed consolidated financial statements for further discussion of our share repurchase program.

Item 4. Mine Safety Disclosures

None

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: August 8, 2018 By: /s/ BRUCE LUCAS  
Bruce Lucas  
Chairman and Chief Executive Officer  
  
(Principal Executive Officer)

Date: August 8, 2018 By: /s/ KIRK LUSK  
Kirk Lusk  
Chief Financial Officer  
  
(Principal Financial and Accounting Officer)