

HCI Group, Inc.  
Form 10-K  
March 12, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON D.C. 20549**

**Form 10-K**

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

**For the fiscal year ended December 31, 2013**

**OR**

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

**Commission File Number**

**001-34126**

**HCI Group, Inc.**

**(Exact name of Registrant as specified in its charter)**

**Florida**  
**(State of Incorporation)**

**20-5961396**  
**(IRS Employer**  
**Identification No.)**

**5300 West Cypress Street, Suite 100**

**Tampa, FL 33607**

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

**(813) 849-9500**

**(Registrant's telephone number, including area code)**

**Securities registered pursuant to Section 12(b) of the Act:**

| <b>Title of Each Class</b>   | <b>Name of Each Exchange on Which Registered</b> |
|--|--|
| <b>Common Shares, no par value</b>                                     | <b>New York Stock Exchange</b>                   |
| <b>Preferred Share Purchase Rights</b>                                 | <b>New York Stock Exchange</b>                   |
| <b>7% Series A Cumulative Redeemable Preferred Stock, no par value</b> | <b>NASDAQ Capital Market</b>                     |
| <b>8.00% Senior Notes due 2020</b>                                     | <b>New York Stock Exchange</b>                   |

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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 market value of the common stock held by non-affiliates of the registrant as of June 28, 2013, computed by reference to the price at which the common stock was last sold on June 28, 2013, was \$293,623,142.

The number of shares outstanding of the registrant's common stock, no par value, on March 3, 2014 was 11,146,459.

**DOCUMENTS INCORPORATED BY REFERENCE**

The information required by Part III of this Form 10-K is incorporated by reference from the registrant's definitive proxy statement which will be filed not later than 120 days after the end of the fiscal year covered by this Form 10-K.

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**PART I**

**ITEM 1 *Business***

**General**

HCI Group, Inc. ( HCI ), formerly known as Homeowners Choice, Inc., is a Florida-based company owning subsidiaries primarily engaged in the property and casualty insurance business. HCI was incorporated in 2006. References to we, our, us, the Company, or HCI in this Form 10-K generally refer to HCI Group, Inc. and its subsidiaries. Our principal executive offices are located at 5300 West Cypress Street, Suite 100, Tampa, Florida 33607, and our telephone number is (813) 849-9500.

Over the years, we have broadened and diversified our business portfolio through acquisitions to include information technologies and investment real estate. Based on the organizational structure, revenue sources, and evaluation of financial and operating performances by management, we have one reportable segment, which includes the following operations:

a) Insurance Operations

*Property and casualty insurance*

*Reinsurance*

b) Other Operations

*Real estate*

*Information technology*

**Insurance Operations**

***Property and Casualty Insurance***

Our principal operating subsidiary, Homeowners Choice Property & Casualty Insurance Company, Inc. ( HCPCI ), was incorporated and began operations in 2007. Through HCPCI, we currently provide property and casualty homeowners insurance, condominium-owners insurance, tenants insurance, and dwelling fire insurance to individuals owning or occupying property in Florida under our *Homeowners Choice* brand. HCPCI s operations are supported by certain of HCI s wholly-owned subsidiaries as well as HCI Group, Inc.:

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Homeowners Choice Managers, Inc. acts as managing general agent and provides marketing, underwriting, claims settlement, accounting and financial services to HCPCI; and

Southern Administration, Inc. provides policy administration services to HCPCI.

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HCPCI began operations by participating in a take-out program through which we assumed insurance policies held by Citizens Property Insurance Corporation ( Citizens ), a Florida state- supported insurer. The take-out program is a legislatively mandated program designed to reduce the State s risk exposure by encouraging private companies to assume policies from Citizens. We have assumed policies in ten separate transactions, which took place from July 2007 through November 2013. In addition, we completed a transaction with HomeWise Insurance Company ( HomeWise ) in November 2011 through which we acquired its Florida policies. Substantially all of our premium revenue since inception has come from the policies acquired in these assumption transactions and subsequent renewals. Through the Citizens assumptions and HomeWise policies, we have increased our geographic diversification within the state of Florida. As of December 31, 2013, we had approximately 160,000 policies in force and \$390 million in annualized gross premiums.

Citizens has historically required us to offer renewals on the policies we acquire in the take-out program for a period of three years subsequent to the initial expiration of the assumed policies. The policyholders have the option to renew with us or they may place their coverage with another insurance company. Policyholders also have the option to opt out of the assumption and return to Citizens. With respect to our November 2012 and 2013 assumptions, the opt-out provision was limited to the thirty-day period preceding and following the assumption date. We strive to retain these policies by offering competitive rates to our policyholders. We may selectively pursue additional assumption transactions with Citizens in the future.

We face various challenges to implementing our operating and growth strategies. Since we currently write policies that cover Florida homeowners, condominium owners, and tenants, we cover losses that may arise from, among other things, catastrophes, which could have a significant effect on our business, results of operations, and financial condition. To mitigate our risk of such catastrophic losses, we cede a portion of our exposure to reinsurers under contracts called catastrophe excess of loss reinsurance treaties. Even without catastrophic events, we may incur losses and loss adjustment expenses that deviate substantially from our estimates and that may exceed our reserves, in which case our net income and capital would decrease. Our operating and growth strategies may also be impacted by regulation of our business by the State of Florida, which must approve our policy forms and premium rates as well as monitor HCPCI s compliance with financial and regulatory requirements. Additionally, we may compete with large, well-established insurance companies, possessing greater financial resources, larger agency networks, and greater name recognition. See Item 1A, Risk Factors, below.

We plan to enter the property and casualty insurance market in the state of Alabama. Our subsidiary, Homeowners Choice Assurance Company, Inc. ( HCA ) was approved and licensed by the Alabama Department of Insurance in August 2013 and we expect to begin writing policies during 2014. Our presence in the state of Alabama will increase our geographic diversification and support our overall long-term growth strategy.

In addition, HCPCI began writing flood coverage in January 2014. The flood coverage will initially be offered on a limited basis as a policy endorsement to eligible new and pre-existing Florida customers who are likely most impacted by the significant rate increases that may result from the Biggert-Waters Flood Insurance Reform and Modernization Act of 2012.

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### *Competition*

We operate in highly competitive markets where we face competition from national, regional and residual market insurance companies. We believe that we have approximately 20 material competitors writing homeowners' property and casualty insurance in the state of Florida. Since beginning business in 2007, we have grown our business to become the fourth largest provider of homeowners' property and casualty insurance in the state of Florida based on September 30, 2013 data from the Florida Office of Insurance Regulation ( FLOIR ).

Many of our competitors have larger financial capacities, greater resource availability, and more diversification in terms of insurance coverage. Our competitors include companies which market their products through agents, as well as companies which sell insurance directly to their customers. Large national insurers may have certain competitive advantages such as increased name recognition, increased loyalty of their customer base, and reduced policy acquisition costs. We may also face competition from new or temporary entrants in our niche markets. In some cases, such entrants may, because of inexperience, desire for new business or other reasons, price their insurance products below ours. Although our pricing is inevitably influenced to some degree by that of our competitors, we believe that it is generally not in our best interest to compete solely on price.

Our competitive strategies focus on the following key areas:

Exceptional service We are committed to maintaining superior service to our policyholders and agents.

Claims settlement practices We focus on fair and timely settlement of policyholder claims.

Disciplined underwriting We analyze exposures and utilize available underwriting data to ensure policies meet our selective criteria.

Effective and efficient use of technology We strive to add or improve technology that can effectively and efficiently enhance service to our policyholders and agents.

New product offerings In addition to our recently announced flood program, we may cross-sell additional insurance products to our existing policyholders in order to broaden our lines of business and product mix.

Geographical expansion We continue to seek opportunities to expand our business within the states of Alabama and Florida and perhaps into other states to increase overall geographic diversification.

### *Seasonality of Our Business*

Our insurance business is seasonal as hurricanes and tropical storms typically occur during the period from June 1 through November 30 each year. With our reinsurance treaty year effective on June 1 each year, any variation in the cost of our reinsurance, whether due to changes in reinsurance rates or a change in the total insured value of our policy base, will occur and be reflected in our financial results beginning June 1 each year.





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*Government Regulation*

We are subject to the laws and regulations in Alabama and Florida, and the regulations of any other states in which we may seek to conduct business in the future. The regulations cover all aspects of our business and are generally designed to protect the interests of insurance policyholders opposed to the interests of shareholders. Such regulations relate to a wide variety of financial and non-financial matters including:

authorized lines of business;

capital and surplus requirements;

approval of allowable rates and forms;

approval of reinsurance contracts;

investment parameters;

underwriting limitations;

transactions with affiliates;

dividend limitations;

changes in control; and

market conduct.

Our failure to comply with certain provisions of applicable insurance laws and regulations could have a material, adverse effect on our business, results of operations or financial condition.

**Regulatory Uncertainty**

Certain states including Florida have adopted laws or are considering proposed legislation which, among other things, limit the ability of insurance companies to effect rate increases or to cancel, reduce or non-renew insurance coverage with respect to existing policies. The Florida legislature continuously considers bills affecting the residential property insurance market in the state. Current law penalizes insurers for noncompliance with the insurance code, establishes a private cause of action relating to claims payment practices, extends the notice period applicable to non-renewals of certain residential policies, prevents non-renewals and cancellation except for material misrepresentation and

non-payment of premium and establishes procedures governing rate filings. Any changes in such laws and regulations could materially and adversely affect our operations or our ability to expand.

*State Licensure and Approval*

Most states, including Florida, require licensure and regulatory approval prior to the marketing of insurance products. Typically, licensure review is comprehensive and includes a review of a company's business plan, solvency, reinsurance, character of its officers and directors, rates, forms and other financial and non-financial aspects of a company. The regulatory authorities may not allow entry into a new market by not granting a license. In addition, regulatory authorities may preclude or delay our entry into markets by disapproving or withholding approval of our product filings.

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*Statutory Reporting and Examination*

All insurance companies must file quarterly and annual statements with certain regulatory agencies and are subject to regular and special examinations by those agencies. In accordance with the National Association of Insurance Commissioners, all insurance companies are required to be examined once every five years. However, the FLOIR has the authority to conduct an examination of HCPCI whenever it is deemed appropriate. HCPCI's latest FLOIR financial examination related to the year ended December 31, 2010.

*Liability for Losses and Loss Adjustment Expenses*

Our liability for losses and loss adjustment expenses represents our estimate of the total cost of (i) claims that have been incurred, but not yet paid (case reserves), (ii) claims that have been incurred but not yet reported ( IBNR ), and (iii) loss adjustment expenses ( LAE ) which are intended to cover the ultimate cost of settling claims, including investigation and defense of lawsuits resulting from such claims. We base our estimates on various assumptions and actuarial data we believe to be reasonable under the circumstances. The process of estimating the liability is inherently judgmental and is influenced by many variables such as past loss experience, current claim trends and the prevailing social, economic and legal environments.

Significant time can elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. Our liability for losses and LAE, which represents the best estimate at a given point in time based on facts, circumstances and historical trends then known, may necessarily be adjusted to reflect additional facts that become available during the loss settlement period.

For a discussion and summary of the activity in the liability for losses and LAE for the years ended December 31, 2013, 2012 and 2011, see Note 12 Losses and Loss Adjustment Expenses to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

**Table of Contents***Loss Development*

Our liability for losses and LAE represent estimated costs ultimately required to settle all claims for a given period. The following table illustrates development of the estimated liability for losses and LAE for the years 2007 (inception) through 2013 (amounts in thousands):

**Schedule of Loss Development**

|  | Years Ended December 31, |           |            |            |            |            |            |
|--|--------------------------|-----------|------------|------------|------------|------------|------------|
|  | 2007                     | 2008      | 2009       | 2010       | 2011       | 2012       | 2013       |
| Original liability for losses and LAE <sup>1</sup> | \$ 1,688                 | \$ 14,763 | \$ 19,178  | \$ 22,146  | \$ 27,424  | \$ 41,168  | \$ 43,686  |
| Re-estimated losses and LAE <sup>2</sup> as of:    |                          |           |            |            |            |            |            |
| 1 year later                                       | 1,412                    | 10,879    | 18,399     | 26,776     | 27,309     | 38,712     |            |
| 2 years later                                      | 1,236                    | 10,991    | 19,866     | 26,003     | 28,536     |            |            |
| 3 years later                                      | 1,268                    | 11,661    | 19,361     | 27,226     |            |            |            |
| 4 years later                                      | 1,327                    | 11,528    | 19,617     |            |            |            |            |
| 5 years later                                      | 1,330                    | 11,424    |            |            |            |            |            |
| 6 years later                                      | 1,330                    |           |            |            |            |            |            |
| Cumulative redundancy (deficiency) <sup>3</sup>    | 358                      | 3,339     | (439)      | (5,080)    | (1,112)    | 2,456      |            |
| Cumulative amount of liability paid as of:         |                          |           |            |            |            |            |            |
| 1 year later                                       | 760                      | 7,725     | 10,481     | 16,833     | 15,652     | 22,365     |            |
| 2 years later                                      | 1,108                    | 9,229     | 15,336     | 20,708     | 21,707     |            |            |
| 3 years later                                      | 1,108                    | 10,339    | 17,065     | 23,732     |            |            |            |
| 4 years later                                      | 1,327                    | 10,947    | 17,992     |            |            |            |            |
| 5 years later                                      | 1,330                    | 11,121    |            |            |            |            |            |
| 6 years later                                      | 1,330                    |           |            |            |            |            |            |
| Gross premiums earned                              | \$ 9,546                 | \$ 61,925 | \$ 110,011 | \$ 119,757 | \$ 143,606 | \$ 233,607 | \$ 337,113 |

- 1 Represents management's original estimated liability for (i) unpaid claims, (ii) IBNR, and (iii) loss adjustment expenses.
- 2 Represents the re-estimated liabilities in later years for unpaid claims, IBNR and loss adjustment expenses for each of the respective years.
- 3 Represents the difference between the latest re-estimate and the original estimate. A redundancy indicates the original estimate is higher than the current estimate whereas a deficiency indicates the original estimate is lower than the current estimate.

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For the years ended December 31, 2013, 2012 and 2011, revenues from property and casualty insurance operations represented 95.0%, 93.0% and 91.9%, respectively, of total revenues of all operating segments. As a result, we have determined the property and casualty insurance operations is our only reportable operating segment.

### ***Reinsurance***

We have a Bermuda-based wholly-owned reinsurance subsidiary, Claddaugh Casualty Insurance Company Ltd., which participates in HCPCI's reinsurance program under our *Claddaugh* brand.

### **Other Operations**

#### ***Real Estate***

Operating under our *Greenleaf Capital* brand, real estate operations consist of several properties we own including our headquarters building in Tampa, Florida and a secondary site in Ocala, Florida, which is used by our insurance operations. In addition, the Ocala location is planned for use as alternative office space in the event we experience any significant disruption at our headquarters building. We also own investment real estate in Treasure Island, Florida and Tierra Verde, Florida with a combined 20 acres of waterfront property.

With the exception of the Ocala location, we lease office or retail space at each location to non-affiliates on various terms. In addition, we own and operate one full-service restaurant and two marinas that we acquired in connection with our purchase of the waterfront properties. The combined marina facilities offer to the general public: a) one dry-stack boat storage building with capacity for approximately 180 boats; b) approximately 70 wet slips; c) two fuel facilities; and d) open areas for parking and storage. Dry-stack boat storage space is generally rented on a monthly or annual basis while the wet slips are rented on a daily or monthly basis.

#### ***Information Technology***

Our information technology operations include a team of software developers with extensive experience in developing web-based products and applications for mobile devices. The operations, which are primarily in India, are focused on developing innovative products or services that can be marketed to the public and also on providing our affiliates with back-office technology support services that can facilitate and improve ongoing operations.

The technologies originally developed in-house for our own insurance operations were launched for use by third parties under our *Exzeo* brand. *Exzeo* is a free to join, web-based application available at Exzeo.com that enables seamless integration between organizations, co-workers and business partners. *Exzeo* allows users to manage projects through communication and collaboration with other participants in a real-time work environment.

**Table of Contents***Financial Highlights*

The following table summarizes our financial performance of combined operating segments during the years ended December 31, 2013, 2012 and 2011:

(Amounts in millions except per share amounts)

| <b>For the year ended December 31:</b>     | <b>2013</b> | <b>2012</b> | <b>2011</b> |
|--|-------------|-------------|-------------|
| Net premium earned                         | \$ 234.2    | \$ 157.7    | \$ 88.1     |
| Total revenue                              | \$ 241.1    | \$ 163.1    | \$ 93.8     |
| Losses and loss adjustment expenses        | \$ 65.1     | \$ 66.3     | \$ 48.2     |
| Income before income taxes                 | \$ 106.5    | \$ 49.6     | \$ 16.4     |
| Net income                                 | \$ 65.6     | \$ 30.2     | \$ 10.0     |
| Income available to common stockholders    | \$ 65.5     | \$ 29.8     | \$ 9.1      |
| <b>Earnings per share of common stock:</b> |             |             |             |
| Basic                                      | \$ 5.82     | \$ 3.45     | \$ 1.49     |
| Diluted                                    | \$ 5.63     | \$ 3.02     | \$ 1.34     |
| Dividends per common share                 | \$ 0.95     | \$ 0.88     | \$ 0.53     |
| Net cash provided by operating activities  | \$ 55.5     | \$ 106.3    | \$ 56.0     |
| Cash dividends paid on common stock        | \$ 10.8     | \$ 8.1      | \$ 3.2      |
| <b>At December 31:</b>                     |             |             |             |
| Total investments                          | \$ 146.0    | \$ 60.9     | \$ 58.8     |
| Cash and cash equivalents                  | \$ 293.4    | \$ 230.2    | \$ 100.4    |
| Total assets                               | \$ 526.0    | \$ 338.3    | \$ 214.8    |
| Total stockholders' equity                 | \$ 160.5    | \$ 121.3    | \$ 63.8     |
| Common shares outstanding (in millions)    | 10.9        | 10.9        | 6.2         |

**Environmental Matters**

Our subsidiaries, which own waterfront property including marina facilities, are subject to regulation under various federal, state, and local laws concerning the environment, including laws addressing the discharge of pollutants into the air and water and the management and disposal of hazardous substances and wastes and the cleanup of contaminated sites. For a discussion of the liability assumed in connection with our acquisition of such marina facilities and the ongoing remedial action, see Note 18 – Commitments and Contingencies to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

**Employees**

As of February 28, 2014, we employed 176 full-time individuals working primarily from our corporate offices in Florida and 78 employees located in India. In addition, our real estate operations have approximately 75 employees leased through professional employer organizations.

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**Available Information**

We file annual, quarterly, and current reports with the U.S. Securities and Exchange Commission ( SEC ). These filings are accessible free of charge on our website, [www.hcigroup.com](http://www.hcigroup.com) (click SEC filings at the Investor Information tab), as soon as reasonably practicable after they have been electronically filed with or furnished to the SEC. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers, which you can access via the SEC's website at [www.sec.gov](http://www.sec.gov). In addition, these filings are accessible at the SEC's Public Reference Room, which is located at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.

**ITEM 1A Risk Factors**

Our business is subject to a number of risks, including those described below, which could have a material effect on our results of operations, financial condition or liquidity and, additionally, could cause our operating results to vary significantly from period to period.

***Although we plan to enter the homeowners insurance market in Alabama and other states, our insurance business is currently in Florida only. Thus, any single catastrophic event or other condition affecting losses in Florida could adversely affect our financial condition and results of operations.***

A single catastrophic event, destructive weather pattern, general economic trend, regulatory developments or other conditions specifically affecting the state of Florida could have a disproportionately adverse impact on our business, financial condition, and results of operations. While we actively manage our exposure to catastrophic events through our underwriting process and the purchase of reinsurance, the fact that our business is concentrated in the state of Florida subjects it to increased exposure to certain catastrophic events and destructive weather patterns such as hurricanes, tropical storms, and tornados. Changes in the prevailing regulatory, legal, economic, political, demographic and competitive environment, and other conditions in the state of Florida could also make it less attractive for us to do business in Florida and would have a more pronounced effect on our business than it would on other insurance companies that are geographically diversified. Since our business is concentrated in this manner, the occurrence of one or more catastrophic events or other conditions affecting losses in the state of Florida could have an adverse effect on our business, financial condition, and results of operations.

***Our results may fluctuate based on many factors including cyclical changes in the insurance industry.***

The insurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity, as well as periods when shortages of capacity permitted an increase in pricing and, thus, more favorable underwriting profits. As premium levels increase, there may be new entrants to the market, which could then lead to a decrease in premium levels. Any of these factors could lead to a significant reduction in premium rates, less favorable policy terms and fewer opportunities to underwrite insurance risks, which could have a material, adverse effect on our results of operations and cash flows. In addition to these considerations, changes in the frequency and severity of losses suffered by insureds and insurers may affect the cycles of the insurance business significantly.



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We cannot predict whether market conditions will improve, remain constant or deteriorate. Negative market conditions may impair our ability to write insurance at rates that we consider appropriate relative to the risk assumed. If we cannot write insurance at appropriate rates, our business would be materially and adversely affected.

***Our business could be harmed if we lose the services of our key personnel.***

Our operations are highly dependent on the efforts of our senior executive officers, particularly our chief executive officer, Paresh Patel, as well as our chief financial officer, Richard Allen, and HCPCI's president, Scott Wallace. The loss of their leadership, industry knowledge and experience could negatively impact our operations. However, we are developing management succession plans to lessen any such negative impact. With the exception of Mr. Patel, Mr. Allen and Mr. Wallace, we have no employment agreements with any of our personnel nor do we offer any guarantee of any employee's ongoing service. We maintain key-man life insurance on Mr. Patel although such policy may be insufficient to cover us for the damage resulting to our company from the loss of Mr. Patel's services.

***We do not have significant redundancy in our operations.***

We conduct our business primarily from offices located in Tampa, Florida where tropical storms could damage our facilities or interrupt our power supply. The loss or significant impairment of functionality in these facilities for any reason could have a material, adverse effect on our business although we believe we have sufficient redundancies to replace our facilities if functionality is impaired. We contract with a third party vendor to maintain complete daily backups of our systems, which are stored at the vendor's facility in Atlanta, Georgia. Access to these databases is strictly controlled and limited to authorized personnel. While we have implemented daily off-site backups, we have not fully tested our plan to recover data in the event of a disaster. Additionally, effective February 28, 2013, we purchased an office building in Ocala, Florida to be used by our insurance operations and, also, as an alternative location in the event a catastrophic event impacts our home office and support operations. We are currently installing and testing systems at the Ocala facility.

***Our information technology systems may fail or suffer a loss of security, which could adversely affect our business.***

Our insurance business is highly dependent upon the successful and uninterrupted functioning of our computer and data processing systems. We rely on these systems to perform actuarial and other modeling functions necessary for writing business, as well as to handle our policy administration process (i.e., the printing and mailing of our policies, endorsements, renewal notices, etc.). The successful operation of our systems depends on a continuous supply of electricity. The failure of these systems or disruption in the supply of electricity could interrupt our operations and result in a material, adverse effect on our business.

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The development and expansion of our insurance business is dependent upon the successful development and implementation of advanced computer and data processing systems. Because HCPCI intends to expand its business by writing additional voluntary policies, we are enhancing our information technology systems to handle and process an increased volume of voluntary policies. The failure of these systems to function as planned could slow our growth and adversely affect our future business volume and results of operations.

Because we believe that our independent insurance agents will play a key role in our efforts to increase the number of voluntary policies written by HCPCI, we are also in the process of developing business platforms and distribution initiatives that will allow us to provide information to, and exchange information with, our agents in an effective and efficient manner. These systems are intended to provide us with current information regarding the insurance markets in which we operate, therefore permitting us to adjust our selective underwriting criteria as needed to rapidly respond to market changes. In the event the development of these systems does not proceed as planned, the expansion of our business could be delayed. Internet disruptions or system failures could also adversely affect our future business volume and results of operations.

In addition, a security breach of our computer systems could damage our reputation or result in liability. We retain confidential business and policyholder information in our computer systems. We may be required to spend significant capital and other resources to protect against security breaches or to alleviate problems caused by such breaches. It is critical that these facilities and infrastructure remain secure. Despite the implementation of security measures, this infrastructure may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. In addition, we could be subject to liability if hackers were able to penetrate our network security or otherwise misappropriate confidential information.

***Increased competition, competitive pressures, industry developments, and market conditions could affect the growth of our business and adversely impact our financial results.***

The property and casualty insurance industry in Florida is cyclical and highly competitive. We compete not only with other stock companies but also with mutual companies, other underwriting organizations and alternative risk sharing mechanisms. Our principal lines of business are written by numerous other insurance companies. Competition for any one account may come from very large, well-established national companies, smaller regional companies, other specialty insurers in our field, and other companies that write insurance only in Florida. Many of these competitors have greater financial resources, larger agency networks and greater name recognition than our company. We compete for business not only on the basis of price, but also on the basis of financial strength, types of coverage offered, availability of coverage desired by customers, commission structure, and quality of service. We may have difficulty continuing to compete successfully on any of these bases in the future. Competitive pressures coupled with market conditions may affect our rate of premium growth and financial results.

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Our ability to compete in the property and casualty insurance industry and our ability to expand our business may be negatively affected by the fact that we are not a long-established company. HCPCI has obtained a Demotech rating of

A Exceptional, which is accepted by major mortgage companies operating in the state of Florida and many other states. In addition, mortgage companies may require homeowners to obtain property insurance from an insurance company with an acceptable A.M. Best rating. Such a requirement could prevent us from expanding our business, which may in turn limit our ability to compete with large, national insurance companies and certain regional insurance companies. We currently do not have an A.M. Best rating but may seek to obtain such a rating. A downgrade or loss of our Demotech rating could result in a substantial loss of business in the event insureds move their business to insurers with a sufficient financial strength rating.

There are inherent limitations and risks related to our projections and our estimates of claims and loss reserves. If our actual losses exceed our loss reserves, our financial results, our ability to expand our business, and our ability to compete in the property and casualty insurance industry may be negatively affected. In addition, industry developments could further increase competition in our industry. These developments could include

an influx of new capital in the marketplace as existing companies attempt to expand their businesses and new companies attempt to enter the insurance business as a result of better pricing and/or terms;

new programs or changes to existing programs in which federally or state-sponsored entities provide property insurance in catastrophe-prone areas or other alternative markets;

changes in Florida or any other states' regulatory climate; and

the enactment of federal proposals for an optional federal charter that would allow some competing insurers to operate under regulations different or less stringent than those applicable to our insurance subsidiaries.

These developments and others could make the property and casualty insurance marketplace more competitive by increasing the supply of insurance available.

If competition limits our ability to write new business at adequate rates, our future results of operations would be adversely affected.

***If our actual losses from claims exceed our loss reserves, our financial results would be adversely affected.***

Our objective is to establish loss reserves that are adequate and represent management's best estimate; that is, the amounts initially recorded as reserves should approximate the ultimate cost to investigate and settle a specific claim. However, the process of establishing adequate reserves is complex and inherently uncertain, and the ultimate cost of a claim may vary materially from the amounts reserved. We regularly monitor and evaluate loss and loss adjustment expense reserve development to determine reserve adequacy.

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Due to these uncertainties, the ultimate losses may vary materially from current loss reserves which could have a material, adverse effect on our future financial condition, results of operations and cash flows.

***The failure of our claims department to pay claims accurately could adversely affect our insurance business, financial results and capital requirements.***

We rely on our claims department to accurately evaluate and pay the claims made under our policies. Many factors could affect the ability of our claims department to accurately evaluate and pay claims, including the accuracy of our external independent adjusters as they make their assessments and submit their estimates of damages; the training, background, and experience of our claims representatives; the ability of our claims department to ensure consistent claims handling given the input by our external independent adjusters; the ability of our claims department to translate the information provided by our external independent adjusters into acceptable claims settlements; and the ability of our claims department to maintain and update its claims handling procedures and systems as they evolve over time based on claims and geographical trends in claims reporting. Any failure to pay claims accurately could lead to material litigation, undermine our reputation in the marketplace, impair our corporate image and negatively affect our financial results.

***The effects of emerging claim and coverage issues on our business are uncertain.***

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect our business by either extending coverage beyond our underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until sometime after we have issued insurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a contract is issued and renewed, and our financial position and results of operations may be adversely affected.

***If we are unable to expand our business because our capital must be used to pay greater than anticipated claims, our financial results may suffer.***

Our future growth will depend on our ability to expand the number of insurance policies we write, to expand the kinds of insurance products we offer, and to expand the geographic markets in which we do business, all balanced by the insurance risks we choose to assume and cede. Our existing sources of funds include possible sales of our securities and our income from operations and investments. Unexpected catastrophic events in our market areas, such as the hurricanes experienced in Florida and other states, may result in greater claims losses than anticipated, which could require us to limit or halt our growth while we redeploy our capital to pay these unanticipated claims unless we are able to raise additional capital.

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***HCI Group, Inc. depends on the ability of its subsidiaries to generate and transfer funds to meet its debt obligations.***

HCI Group, Inc. does not have significant revenue generating operations of its own. Our ability to make scheduled payments on our debt obligations depends on the financial condition and operating performance of our subsidiaries. If the funds we receive from our subsidiaries are insufficient to meet our debt obligations, we may be required to raise funds through the issuance of additional debt or equity securities, reduce or suspend dividend payments, or sell assets.

***We may require additional capital in the future which may not be available or may only be available on unfavorable terms.***

Our future capital requirements depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. To the extent that our present capital is insufficient to meet future operating requirements or to cover losses, we may need to raise additional funds through financings or curtail our growth. Based on our current operating plan, we believe current capital together with our anticipated retained income will support our operations. However, we cannot provide any assurance in that regard, since many factors will affect our capital needs and their amount and timing, including our growth and profitability, and the availability of reinsurance, as well as possible acquisition opportunities, market disruptions and other unforeseeable developments. If we require additional capital, it is possible that equity or debt financing may not be available at all or may be available only on terms unfavorable to us. Equity financings could result in dilution to our shareholders, and in any case such securities may have rights, preferences and privileges that are senior to those of existing shareholders. If we cannot obtain adequate capital on favorable terms or at all, our business, financial condition or results of operations could be materially affected.

***Our financial results may be negatively affected by the fact that a portion of our income is generated by the investment of our available cash.***

A portion of our income is, and likely will continue to be generated by the investment of our available cash. The amount of income so generated is a function of our investment policy, available investment opportunities, and the amount of available cash invested. At December 31, 2013, approximately 31% of our available cash was invested in fixed-maturity and equity securities with the balance in cash and cash equivalents. We may alter our investment policy to accept higher levels of risk with the expectation of higher returns. Fluctuating interest rates and other economic factors make it impossible to estimate accurately the amount of investment income that will be realized. In fact, we may realize losses on our investments.

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***Reinsurance coverage may not be available to us in the future at commercially reasonable rates or at all and we risk non-collectability of reinsurance amounts due us from reinsurers with which we have contracted.***

Reinsurance is a method of transferring part of an insurance company's liability and premium under an insurance policy to another insurance company. We use reinsurance arrangements to limit and manage the amount of risk we retain, to stabilize our underwriting results and to increase our underwriting capacity. The cost of such reinsurance is subject to prevailing market conditions beyond our control such as the amount of capital in the reinsurance market and natural and man-made catastrophes. We cannot be assured that reinsurance will remain continuously available to us in the amounts we consider sufficient and at prices acceptable to us. As a result, we may determine to increase the amount of risk we retain or look for other alternatives to reinsurance, which could in turn have a material, adverse effect on our financial position, results of operations and cash flows.

With respect to the reinsurance treaties we currently have in effect, our ability to recover amounts due from reinsurers is subject to the reinsurance company's ability and willingness to pay and to meet their obligations to us. We attempt to select financially strong reinsurers with an A.M. Best rating of A- or better or we require the reinsurer to fully collateralize its exposure. While we monitor from time to time their financial condition, we rely principally on A.M. Best, our broker, and other rating agencies in determining their ability to meet their obligations to us. Any failure on the part of any one reinsurance company to meet its obligations to us could have a material, adverse effect on our financial condition or results of operations.

***We have exposure to unpredictable catastrophes, which can materially and adversely affect our financial results.***

We write insurance policies that cover homeowners, condominium owners, and tenants for losses that result from, among other things, catastrophes. We are therefore subject to losses, including claims under policies we have written, arising out of catastrophes that may have a significant effect on our business, results of operations, and financial condition. A significant catastrophe could also have an adverse effect on our reinsurers. Catastrophes can be caused by various events, including hurricanes, tropical storms, tornadoes, windstorms, earthquakes, hailstorms, explosions, power outages, fires and by man-made events, such as terrorist attacks. The incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Our policyholders are currently concentrated in Florida, which is especially subject to adverse weather conditions such as hurricanes and tropical storms. Therefore, although we attempt to manage our exposure to catastrophes through our underwriting process and the purchase of reinsurance protection, an especially severe catastrophe or series of catastrophes could exceed our reinsurance protection and may have a material, adverse impact on our results of operations and financial condition.

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***Industry trends, such as increased litigation against the insurance industry and individual insurers, the willingness of courts to expand covered causes of loss, rising jury awards, and the escalation of loss severity may contribute to increased costs and to the deterioration of the reserves of our insurance subsidiary.***

Loss severity in the property and casualty insurance industry may increase and may be driven by larger court judgments. In the event legal actions and proceedings are brought on behalf of classes of complainants, this may increase the size of judgments. The propensity of policyholders and third party claimants to litigate and the willingness of courts to expand causes of loss and the size of awards may render our loss reserves inadequate for current and future losses.

***The failure of the risk mitigation strategies we utilize could have a material, adverse effect on our financial condition or results of operations.***

We utilize a number of strategies to mitigate risk exposure within our insurance business, which include:

engaging in vigorous underwriting;

carefully evaluating terms and conditions of our policies;

focusing on our risk aggregations by geographic zones and other bases; and

ceding insurance risk to reinsurance companies.

However, there are inherent limitations in all of these tactics. We cannot provide assurance that an event or series of unanticipated events will not result in loss levels which could have a material, adverse effect on our financial condition or results of operations.

***The failure of any of the loss limitation methods we employ could have a material, adverse effect on our financial condition or our results of operations.***

Our insurance underwriting process is designed to limit our exposure to known risks, including but not limited to exclusions relating to homes in close proximity to the coastline. Various provisions of our policies, such as limitations or exclusions from coverage, which have been negotiated to limit our risks, may not be enforceable in the manner we intend.

In addition, the policies we issue contain conditions requiring the prompt reporting of claims to us and our right to decline coverage in the event of a violation of that condition. While our insurance product exclusions and limitations reduce the loss exposure to us and help eliminate known exposures to certain risks, it is possible that a court or regulatory authority could nullify or void an exclusion or legislation could be enacted modifying or barring the use of such endorsements and limitations in a way that would adversely affect our loss experience, which could have a material, adverse effect on our financial condition or results of operations.





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***In the future, we may rely on independent agents to write our insurance policies, and if we are not able to contract with and retain independent agents, our revenues would be negatively affected.***

Although voluntary policies comprise a small percentage of our business, we expect to increase the number of voluntary policies we write as our business expands. An inability to sell our products through independent agents would negatively affect our revenues.

We must compete with other insurers for independent agents' business. Our competitors may offer a greater variety of insurance products, lower premiums for insurance coverage, or higher commissions to their agents. If our products, pricing and commissions do not remain competitive, we may find it more difficult to attract business from independent agents to sell our products. A material reduction in the amount of our products that independent agents sell could negatively affect our revenues.

***Our success depends on our ability to accurately price the risks we underwrite.***

The results of our operations and our financial condition depend on our ability to underwrite and set premium rates accurately for a wide variety of risks, including risks associated with new product offerings. Rate adequacy is necessary to generate sufficient premiums to pay losses, loss adjustment expenses, and underwriting expenses and to earn a profit. In order to price our products accurately, we must collect and properly analyze a substantial amount of data; develop, test and apply appropriate rating formulas; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully, and as a result price our products accurately, is subject to a number of risks and uncertainties, some of which are outside our control, including

the availability of sufficient reliable data and our ability to properly analyze available data;

the uncertainties that inherently characterize estimates and assumptions;

our selection and application of appropriate rating and pricing techniques;

changes in legal standards, claim settlement practices, and restoration costs; and

legislatively imposed consumer initiatives.

In addition, we could underprice risks, which would negatively affect our profit margins. We could also overprice risks, which could reduce our sales volume and competitiveness. In either event, our profitability could be materially and adversely affected.

***Use of current operating resources may be necessary to develop future new insurance products.***

We may expand our product offerings by underwriting additional insurance products and programs, and marketing them through our independent agent network. For example, we recently announced plans to offer flood coverage to our policyholders. Moreover, Claddaugh may offer reinsurance products to unaffiliated insurance companies.

Expansion of our product offerings will result in increases in expenses due to additional costs incurred in actuarial rate justifications, software and personnel. Offering additional insurance products will also require regulatory approval, further increasing our costs and potentially affecting the speed with which we will be able to pursue new market opportunities. We cannot assure you that we will be successful bringing new insurance products to our marketplace.

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***Use of current operating resources may be necessary to expand our insurance businesses geographically.***

Although we currently conduct our homeowners insurance business in Florida, we plan to enter the homeowners insurance markets in other states. HCA, our Alabama insurance subsidiary, was recently approved and licensed by the Alabama Department of Insurance and is expected to begin writing policies in Alabama during 2014. We may offer insurance products in other states as well. Geographic expansion of our insurance business will result in increases in expenses due to additional costs incurred in actuarial rate justifications, software, personnel and regulatory compliance. Although we plan to enter other states judiciously with attention to profitability, we cannot assure you that our entry into other states will be successful.

***As an insurance holding company, we are currently subject to regulation by the states of Alabama and Florida and in the future may become subject to federal regulation.***

All states regulate insurance holding company systems. State statutes and administrative rules generally require each insurance company in the holding company group to register with the department of insurance in its state of domicile and to furnish information concerning the operations of the companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the group. As part of its registration, each insurance company must identify material agreements, relationships and transactions with affiliates, including without limitation, loans, investments, asset transfers, transactions outside of the ordinary course of business, certain management, service, and cost sharing agreements, reinsurance transactions, dividends, and consolidated tax allocation agreements.

Insurance holding company regulations generally provide that transactions between an insurance company and its affiliates must be fair and equitable, allocated between the parties in accordance with customary accounting practices, and fully disclosed in the records of the respective parties. Many types of transactions between an insurance company and its affiliates, such as transfers of assets among such affiliated companies, certain dividend payments from insurance subsidiaries and certain material transactions between companies within the system may be subject to prior approval by, or prior notice to, state regulatory authorities. If we are unable to obtain the requisite prior approval for a specific transaction, we would be precluded from taking the action, which could adversely affect our operations. In addition, state insurance regulations also frequently impose notice or approval requirements for the acquisition of specified levels of ownership in the insurance company or insurance holding company.

In addition to Florida and Alabama, we may in the future seek authorization to transact business in other states as well. We will therefore become subject to the laws and regulatory requirements of those states. These regulations may vary from state to state, and states occasionally may have conflicting regulations. Currently, the federal government's role in regulating or dictating the policies of insurance companies is limited. However, Congress, from time to time, considers proposals that would increase the role of the federal government in insurance regulation, either in addition to or in lieu of state regulation. The impact of any future federal insurance regulation on our insurance operations is unclear and may adversely impact our business or competitive position.

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*Our insurance subsidiaries are subject to extensive regulation, which may reduce our profitability or limit our growth. Moreover, if we fail to comply with these regulations, we may be subject to penalties, including fines and suspensions, which may adversely affect our financial condition and results of operations.*

The insurance industry is highly regulated and supervised. Our insurance subsidiaries are subject to the supervision and regulation of the states in which they are domiciled and the states in which they transact insurance business (currently Alabama and Florida). Such supervision and regulation is primarily designed to protect our policyholders rather than our shareholders. These regulations are generally administered by a department of insurance in each state and relate to, among other things

the content and timing of required notices and other policyholder information;

the amount of premiums the insurer may write in relation to its surplus;

the amount and nature of reinsurance a company is required to purchase;

participation in guaranty funds and other statutorily created markets or organizations;

business operations and claims practices;

approval of policy forms and premium rates;

standards of solvency, including risk-based capital measurements;

licensing of insurers and their products;

restrictions on the nature, quality and concentration of investments;

restrictions on the ability of insurance company subsidiaries to pay dividends to insurance holding companies;

restrictions on transactions between insurance companies and their affiliates;

restrictions on the size of risks insurable under a single policy;

requiring deposits for the benefit of policyholders;

requiring certain methods of accounting;

periodic examinations of our operations and finances;

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the form and content of records of financial condition required to be filed; and

the level of reserves.

The FLOIR and regulators in other jurisdictions where we may become licensed and offer insurance products conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to financial condition, holding company issues and other matters. These regulatory requirements may adversely affect or inhibit our ability to achieve some or all of our business objectives. These regulatory authorities also conduct periodic examinations into insurers' business practices. These reviews may reveal deficiencies in our insurance operations or non-compliance with regulatory requirements.

HCPCI is subject to assessments levied by the Florida Insurance Guaranty Association, Inc. While we can recover these assessments from policyholders through policy surcharges, our payment of the assessments and our recoveries may not offset each other in the same reporting period in our financial statements and may cause a material, adverse effect on our results of operations in a particular reporting period.

In addition, regulatory authorities have relatively broad discretion to deny or revoke licenses for various reasons, including the violation of regulations. In some instances, we follow practices based on our interpretations of regulations or practices that we believe may be generally followed by the industry. These practices may turn out to be different from the interpretations of regulatory authorities. If we do not have the requisite licenses and approvals or do not comply with applicable regulatory requirements, insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. This could adversely affect our ability to operate our business.

Finally, changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could adversely affect our ability to operate our business, reduce our profitability and limit our growth.

***Our marina operations are subject to regulation under various federal, state, and local laws concerning the environment.***

Our marina operations are subject to regulation under various federal, state, and local laws concerning the environment, including laws addressing the discharge of pollutants into the air and water and the management and disposal of hazardous substances and wastes and the cleanup of contaminated sites. We could incur substantial costs, including cleanup costs, fines and civil or criminal sanctions and third-party damage or personal injury claims, if in the future we were to violate or become liable under environmental laws relating to our marina operations. With respect to an existing environmental remediation plan for the real estate in Tierra Verde, Florida, there can be no assurance that the remediation plan will be successful or that the cost will not exceed the \$150,000 accrued at acquisition, of which \$117,000 had been paid at December 31, 2013.

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***Our restaurant operations expose us to additional risks, which could negatively impact our operating results and financial condition.***

In April 2012, we acquired real estate in Treasure Island, Florida that includes a restaurant. Our restaurant operations could expose us to business risks that are different from the insurance business. For example, restaurant operations are dependent in large part on food, beverage, and supply costs that are not within our control. Also, the restaurant industry is affected by changes in consumer preferences and discretionary spending patterns that could adversely affect revenues from restaurant operations. Moreover, the restaurant industry is affected by litigation and publicity concerning food quality, health, and other issues which can cause guests to avoid restaurants and that can result in liabilities. Any one of these risks, among others, could negatively impact our operating results and financial condition.

***Our operations in India expose us to additional risks, which could negatively impact our business, operating results, and financial condition.***

Our India operations expose us to additional risks including currency exchange rate fluctuations and risks related to other challenges caused by distance, language, and compliance with Indian labor laws and other complex foreign and U.S. laws and regulations that apply to our India operations. These numerous and sometimes conflicting laws and regulations include anti-corruption laws, such as the Foreign Corrupt Practices Act, and other local laws prohibiting corrupt payments to governmental officials, among others. Violations of these laws and regulations could result in fines and penalties, or criminal sanctions against us, our officers, or our employees. Although policies and procedures are designed to ensure compliance with these laws and regulations, there can be no assurance that our employees, contractors, or agents will not violate our policies.

***Unintended consequences of the anti-takeover provisions of our shareholder rights agreement.***

Our shareholder rights agreement is intended to deter coercive or unfair takeover tactics and to protect our shareholders' interests by encouraging anyone seeking control of our company to negotiate with our board of directors. However, these rights may discourage, delay or prevent a tender offer or takeover attempt, including offers or attempts that could be beneficial to our shareholders. In addition, the rights agreement may deter investors from participating in any future equity offerings we propose.

**ITEM 1B *Unresolved Staff Comments***

Not applicable.

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**ITEM 2 *Properties***

**Real Estate Owned and Used in Operations**

*Tampa, Florida.* The real estate consists of 3.5 acres of land, a building with gross area of 122,000 square feet, and a four-level parking garage. This facility is used by us and our U.S. subsidiaries and serves as our principal executive and operational office. In addition, we lease an aggregate of approximately 45,000 square feet to non-affiliates.

*Ocala, Florida.* The real estate consists of 1.6 acres of land and an office building with gross area of approximately 16,000 square feet. The facility is designated for our insurance operations and will be used as an alternative location in the event a catastrophic event impacts our operations in Tampa, Florida.

**Investment Real Estate**

*Treasure Island, Florida.* The real estate consists of approximately 10 acres of waterfront property and land improvements, a restaurant and a marina facility. The marina facility and the restaurant are currently operated by us.

*Tierra Verde, Florida.* The real estate consists of 7.1 acres of land, a dry rack storage building with gross area of 57,500 square feet, and three buildings with retail space having an aggregate gross area of 25,082 square feet. This marina facility is being operated by us. Approximately 71% of the available retail space is leased to non-affiliates.

**Leased Property**

*Noida, India.* We lease 15,000 square feet of office space for our information technology operations. The lease has an initial term of nine years commencing January 15, 2013. We are entitled to terminate the lease after the 36-month period following the commencement date by providing 3 months written notice to the landlord.

Rental expense under all facility leases was \$248,000, \$527,000 and \$239,000 during the years ended December 31, 2013, 2012 and 2011, respectively, which includes in 2012 and 2011 expense related to our former corporate headquarters.



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**ITEM 3 *Legal Proceedings***

We are 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 asserted against us, we do not believe that any currently pending legal proceeding to which we are a party will have a material, adverse effect on our consolidated financial position, results of operations or cash flows.

**ITEM 4 *Mine Safety Disclosures***

Not applicable.

**Table of Contents****PART II****ITEM 5 *Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Markets for Common Stock**

Our common stock is trading on the New York Stock Exchange under the symbol HCI. Prior to October 25, 2012, our common stock was traded on the NASDAQ Global Select Market under the symbol HCII. The following table represents the high and low sales prices for our common stock as reported by the NASDAQ Global Select Market and the New York Stock Exchange for the periods indicated:

|                              | Common Stock Price |       |
|------------------------------|--------------------|-------|
|                              | High               | Low   |
| <u>Calendar Quarter 2013</u> |                    |       |
| First Quarter                | \$ 27.25           | 20.16 |
| Second Quarter               | \$ 35.21           | 24.66 |
| Third Quarter                | \$ 41.66           | 29.99 |
| Fourth Quarter               | \$ 53.50           | 37.79 |
| <u>Calendar Quarter 2012</u> |                    |       |
| First Quarter                | \$ 14.14           | 7.88  |
| Second Quarter               | \$ 17.60           | 11.85 |
| Third Quarter                | \$ 23.98           | 16.51 |
| Fourth Quarter               | \$ 26.60           | 18.29 |

**Holders**

As of February 28, 2014, the market price for our common stock was \$48.42 and there were 132 holders of record of our common stock.

**Table of Contents****Dividends**

The declaration and payment of dividends is at the discretion of our board of directors. Our ability to pay dividends depends on many factors, including the Company's operating results, financial condition, capital requirements, and legal and regulatory constraints and requirements on the payment of dividends and such other factors as our board of directors deems relevant. The following table represents the frequency and amount of all cash dividends declared on common equity for the two most recent fiscal years:

| Declaration<br>Date | Payment<br>Date | Date of<br>Record | Per Share<br>Amount |
|---------------------|-----------------|-------------------|---------------------|
| 1/16/2012           | 3/16/2012       | 2/17/2012         | \$0.150             |
| 3/28/2012           | 6/15/2012       | 5/17/2012         | \$0.200             |
| 7/25/2012           | 9/21/2012       | 8/17/2012         | \$0.200             |
| 10/19/2012          | 12/21/2012      | 11/16/2012        | \$0.225             |
| 10/19/2012          | 12/21/2012      | 11/16/2012        | \$0.100             |
| 1/22/2013           | 3/15/2013       | 2/15/2013         | \$0.225             |
| 4/8/2013            | 6/21/2013       | 5/17/2013         | \$0.225             |
| 7/16/2013           | 9/20/2013       | 8/16/2013         | \$0.225             |
| 10/18/2013          | 12/20/2013      | 11/15/2013        | \$0.275             |

Under Florida law, a domestic insurer such as HCPCI may not pay any dividend or distribute cash or other property to its stockholder unless certain requirements, which are discussed in Note 20 Regulatory Requirements and Restrictions to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K, are met.

We currently expect that we will continue to pay cash dividends on our common stock at a rate comparable to our historical dividend payments, although we are not obligated to do so and may discontinue cash dividends or change the cash-dividend rate on our common stock at any time and for any reason.

**Securities Authorized for Issuance Under Equity Compensation Plans**

The following table summarizes our equity compensation plans as of December 31, 2013. We currently have no equity compensation plans not approved by our stockholders.

| Plan Category | (a)   | (b)   | (c)  |
|---------------|---|---|--|
|               | Number of Securities<br>To be Issued<br>Upon<br>Exercise of<br>Outstanding<br>Options | Weighted-Average<br>Exercise<br>Price of<br>Outstanding Options | Number of Securities<br>Remaining<br>Available<br>for Future<br>Issuance<br>under Equity<br>Compensation<br>Plans<br>(Excluding Securities<br>Reflected in Column (a)) |

|   |         |    |      |           |
|---|---------|----|------|-----------|
| Equity Compensation Plans<br>Approved by Stockholders | 280,000 | \$ | 2.91 | 4,344,350 |
|---|---------|----|------|-----------|

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**Performance Graph**

The following graph compares the 5-year cumulative total dollar return to shareholders on our common stock relative to the cumulative total returns of the Russell 2000 Index and the NASDAQ Insurance Index. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each index on December 31, 2008 and its relative performance is tracked through December 31, 2013. The returns shown are based on historical results and are not intended to suggest future performance.

**Table of Contents****Recent Sales of Unregistered Securities**

All information related to sales of unregistered securities had been reported in a current report on Form 8-K.

**Issuer Purchases of Equity Securities**

The table below includes the number of shares of common stock surrendered by employees to satisfy their minimum federal income tax liability associated with the vesting of restricted shares and also the number of common shares repurchased under a prepaid forward contract (share amounts not in thousands) in conjunction with our December 2013 convertible note offering:

| <b>For the Month Ended</b> | <b>Total Number<br/>of Shares<br/>Purchased</b> | <b>Average<br/>Price Paid<br/>Per<br/>Share</b> | <b>Total Number of<br/>Shares Purchased<br/>Part of<br/>Publicly<br/>Announced<br/>Plans<br/>or Programs<br/>(a)</b> | <b>Maximum Number<br/>of Shares That May<br/>Yet Be<br/>Purchased<br/>Under The<br/>Plans<br/>or Programs<br/>(a)</b> |
|----------------------------|---|---|--|---|
| October 31, 2013           | 1,641   | \$ 42.24  | n/a  | n/a   |
| November 30, 2013          |   |   | n/a  | n/a   |
| December 31, 2013 (b)      | 622,751   | 48.05   | n/a  | n/a   |
|                            | 624,392   | \$ 48.03  |  |   |

(a) As of December 31, 2013, there was no established share repurchase plan.

(b) 622,751 represents the number of shares repurchased under the prepaid forward contract (see Note 15 Stockholders' Equity to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K).

**Table of Contents****ITEM 6 Selected Financial Data**

The following selected consolidated financial data should be read in conjunction with Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes appearing in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10-K. The consolidated statements of income data for the years ended December 31, 2013, 2012, and 2011 and the consolidated balance sheet data at December 31, 2013 and 2012 are derived from our audited consolidated financial statements appearing in Item 8 of this Annual Report on Form 10-K. The consolidated statements of income data for the years ended December 31, 2010 and 2009, and the consolidated balance sheet data at December 31, 2011, 2010, and 2009, are derived from our audited consolidated financial statements that are not included in this Annual Report on Form 10-K. The historical results are not necessarily indicative of the results to be expected in any future period.

|  | <b>As of or for the Years Ended December 31,</b> |             |             |             |             |
|--|--|-------------|-------------|-------------|-------------|
|  | <b>2013</b>                                      | <b>2012</b> | <b>2011</b> | <b>2010</b> | <b>2009</b> |
|  | (Amounts in thousands, except per share amounts) |             |             |             |             |
| <b>Operating Revenue</b>                           |  |             |             |             |             |
| Gross premiums earned                              | \$ 337,113                                       | \$ 233,607  | \$ 143,606  | \$ 119,757  | \$ 110,011  |
| Premiums ceded                                     | (102,865)  | (75,939)    | (55,525)    | (57,322)    | (44,674)    |
| Net premiums earned                                | 234,248  | 157,668     | 88,081      | 62,435      | 65,337      |
| Net investment income                              | 1,469  | 980         | 2,061       | 1,962       | 1,793       |
| Policy fee income                                  | 3,098  | 2,538       | 1,438       | 1,464       | 1,226       |
| Net realized investment gains                      | 80   | 276         | 290         | 2,003       |             |
| Gain on bargain purchase                           |  | 179         | 936         |             |             |
| Other income                                       | 2,193  | 1,424       | 1,003       | 751         | 22          |
| Total operating revenue                            | 241,088  | 163,065     | 93,809      | 68,615      | 68,378      |
| <b>Operating Expenses</b>                          |  |             |             |             |             |
| Losses and loss adjustment expenses                | 65,123   | 66,310      | 48,243      | 37,667      | 35,230      |
| Policy acquisition and other underwriting expenses | 31,619   | 25,930      | 18,129      | 14,878      | 9,611       |
| Interest expense                                   | 3,607  |             |             |             |             |
| Goodwill impairment loss                           |  | 161         |             |             |             |
| Other operating expenses                           | 34,286   | 21,084      | 11,032      | 7,484       | 5,788       |
| Total operating expenses                           | 134,635  | 113,485     | 77,404      | 60,029      | 50,629      |
| Income before income taxes                         | 106,453  | 49,580      | 16,405      | 8,586       | 17,749      |
| Income tax expense                                 | 40,891   | 19,423      | 6,441       | 3,164       | 6,839       |
| Net income   | \$ 65,562  | \$ 30,157   | \$ 9,964    | \$ 5,422    | \$ 10,910   |
| Preferred stock dividends                          | (104)  | (322)       | (815)       |             |             |
| Income available to common stockholders            | \$ 65,458  | \$ 29,835   | \$ 9,149    | \$ 5,422    | \$ 10,910   |

**Per Share Data:**

|                                   |         |         |         |         |         |
|-----------------------------------|---------|---------|---------|---------|---------|
| Basic earnings per common share   | \$ 5.82 | \$ 3.45 | \$ 1.49 | \$ 0.88 | \$ 1.62 |
| Diluted earnings per common share | \$ 5.63 | \$ 3.02 | \$ 1.34 | \$ 0.81 | \$ 1.52 |
| Dividends per common share        | \$ 0.95 | \$ 0.88 | \$ 0.53 | \$ 0.30 | \$      |

**Ratios to Net Premium Earned:**

|                |        |        |        |        |        |
|----------------|--------|--------|--------|--------|--------|
| Loss Ratio     | 27.80% | 42.06% | 54.77% | 60.33% | 53.92% |
| Expense Ratio  | 29.67% | 29.92% | 33.11% | 35.82% | 23.57% |
| Combined Ratio | 57.47% | 71.98% | 87.88% | 96.15% | 77.49% |

**Ratios to Gross Premiums Earned:**

|                |        |        |        |        |        |
|----------------|--------|--------|--------|--------|--------|
| Loss Ratio     | 19.32% | 28.39% | 33.59% | 31.45% | 32.02% |
| Expense Ratio  | 20.62% | 20.19% | 20.31% | 18.67% | 14.00% |
| Combined Ratio | 39.94% | 48.58% | 53.90% | 50.12% | 46.02% |

**Consolidated Balance Sheet Data:**

|                                 |            |            |            |            |            |
|---------------------------------|------------|------------|------------|------------|------------|
| Total investments               | \$ 146,028 | \$ 60,916  | \$ 58,759  | \$ 43,481  | \$ 48,343  |
| Total cash and cash equivalents | \$ 293,398 | \$ 230,214 | \$ 100,355 | \$ 54,849  | \$ 43,453  |
| Total assets                    | \$ 526,316 | \$ 338,288 | \$ 214,818 | \$ 140,948 | \$ 137,892 |
| Total stockholders equity       | \$ 160,521 | \$ 121,253 | \$ 63,830  | \$ 46,629  | \$ 45,378  |



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### **ITEM 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this annual report on Form 10-K. All dollar amounts, except per share amounts stated in this Management's Discussion and Analysis of Financial Condition and Results of Operations are in thousands unless specified otherwise.

#### ***Forward-Looking Statements***

***In addition to historical information, this annual report on Form 10-K contains forward-looking statements as defined under federal securities laws. Such statements involve risks and uncertainties, such as statements about our plans, objectives, expectations, assumptions or future events. These statements involve estimates, assumptions, known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from any future results, performances or achievements expressed or implied by the forward-looking statements. The important factors that could cause actual results to differ materially from those indicated by such forward-looking statements include but are not limited to the effect of governmental regulation; changes in insurance regulations; the frequency and extent of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability of or collectability of reinsurance; restrictions on our ability to change premium rates; increased rate pressure on premiums; and other risks and uncertainties and other factors listed under Item 1A Risk Factors and elsewhere in this annual report on Form 10-K and in our other Securities and Exchange Commission filings.***

## **OVERVIEW**

### **General**

HCI is a Florida-based holding company primarily providing property and casualty insurance to homeowners, condominium owners, and tenants in the state of Florida through its subsidiaries. We offer insurance products at competitive rates, while pursuing profitability using selective underwriting criteria.

We began operations in 2007 by participating in a take-out program which is a legislatively mandated program designed to encourage private companies to assume policies from Citizens. Our growth since inception has resulted primarily from a series of policy assumptions from Citizens and one assumption transaction with HomeWise Insurance Company ( HomeWise ). This growth track has been beneficial to us in terms of reduced policy acquisition and reinsurance costs. Even though expanding our policyholder base through opportunistic assumptions continues to be important to our growth plan, we plan to seek opportunities to expand and to provide new product offerings such as our flood product, which we began offering in January 2014.

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**Recent Developments**

On February 4, 2014, we announced our Board of Directors fixed April 1, 2014 as the cancellation date for the conversion rights on our 7% Series A cumulative convertible preferred stock ( Series A Preferred ). As such, the record holders of the Series A Preferred will no longer have conversion rights on and after April 1, 2014. In addition, on February 27, 2014 we voluntarily delisted our Series A Preferred from the NASDAQ Capital Market.

On January 23, 2014, our Board of Directors declared a quarterly dividend of \$0.275 per common share. The dividends will be paid March 21, 2014 to stockholders of record on February 21, 2014. In addition, HCPCI, our wholly-owned insurance subsidiary, announced it began writing flood insurance coverage in the state of Florida to eligible new and pre-existing *Homeowners Choice* customers.

On January 13, 2014, we announced that a U.S. appeals court affirmed a trial court decision in our favor in connection with a dispute with insurance intermediary Aon Benfield relating to a 2009 revenue sharing agreement.

In December 2013, we completed the issuance of our 3.875% convertible senior notes due 2019 for aggregate proceeds of \$103,000 in a private offering. We used \$29,923 of the proceeds to repurchase shares of our common stock.

Effective November 5, 2013, we assumed approximately 34,000 policies upon completion of our tenth assumption transaction with Citizens representing approximately \$78,000 in additional annualized premiums.

**RESULTS OF OPERATIONS**

***Comparison of the Year Ended December 31, 2013 to the Year Ended December 31, 2012***

Our results of operations for the year ended December 31, 2013 reflect income available to common stockholders of \$65,458, or \$5.63 earnings per diluted common share, compared with income available to common stockholders of \$29,835, or \$3.02 earnings per diluted common share, for the year ended December 31, 2012.

**Revenue**

*Gross Premiums Earned* for the years ended December 31, 2013 and 2012 were \$337,113 and \$233,607, respectively, and primarily reflect the revenue from policies acquired from HomeWise and Citizens and subsequent renewals. The increase in 2013 was primarily attributable to revenue from the Citizens assumptions completed in November 2013 and 2012.

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*Premiums Ceded* for the years ended December 31, 2013 and 2012 were \$102,865 and \$75,939, respectively. Our premiums ceded represent amounts paid to reinsurers to cover losses from catastrophes that exceed the thresholds defined by our catastrophe excess of loss reinsurance treaties. During the year ended December 31, 2013, premiums ceded were reduced by \$12,521 related to the provisions under certain reinsurance contracts. See *Economic Impact of Reinsurance Contracts with Retrospective Provisions* under *Critical Accounting Policies and Estimates*. Our reinsurance rates are based primarily on policy exposures reflected in gross premiums earned. Premiums ceded were 30.5% and 32.5% of gross premiums earned during the years ended December 31, 2013 and 2012, respectively.

*Net Premiums Earned* for the years ended December 31, 2013 and 2012 were \$234,248 and \$157,668, respectively, and reflect the gross premiums earned less reinsurance costs as described above.

*Net Premiums Written* during the years ended December 31, 2013 and 2012 totaled \$251,906 and \$203,240, respectively. Net premiums written represent the premiums charged on policies issued during a fiscal period less reinsurance costs.

The following is a reconciliation of our total Net Premiums Written to Net Premiums Earned for the years ended December 31, 2013 and 2012:

|                               | <b>Years Ended<br/>December 31,</b> |                   |
|-------------------------------|-------------------------------------|-------------------|
|                               | <b>2013</b>                         | <b>2012</b>       |
| Net Premiums Written          | \$ 251,906                          | \$ 203,240        |
| Increase in Unearned Premiums | (17,658)                            | (45,572)          |
| <b>Net Premiums Earned</b>    | <b>\$ 234,248</b>                   | <b>\$ 157,668</b> |

*Net Investment Income* for the years ended December 31, 2013 and 2012 was \$1,469 and \$980, respectively. The increase in 2013 is primarily due to higher returns on investments and lower operating losses related to certain of our real estate investments.

*Policy Fee Income* for the years ended December 31, 2013 and 2012 was \$3,098 and \$2,538, respectively, and reflects the policy fee income we earn with respect to our issuance of renewal policies.

*Other Income* for the years ended December 31, 2013 and 2012 was \$2,193 and \$1,424, respectively. The increase in other income in 2013 is primarily due to the recognition of income related to the Aon Benfield settlement.

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**Table of Contents****Expenses**

Our *Losses and Loss Adjustment Expenses* amounted to \$65,123 and \$66,310, respectively, during the years ended December 31, 2013 and 2012. During the year ended December 31, 2013, we experienced favorable development of \$2,456 with respect to our net unpaid losses and loss adjustment expenses established as of December 31, 2012, which contributed to the overall favorable variance of \$1,187 with respect to the total losses and loss adjustment expenses incurred in 2013 as compared with 2012. In addition, our losses and loss adjustment expenses for the year ended December 31, 2012 included approximately \$3,500 related to claims from Tropical Storm Debby and Tropical Storm Isaac, which occurred in June and August 2012, respectively. See *Reserves for Losses and Loss Adjustment Expenses* under *Critical Accounting Policies and Estimates*.

*Policy Acquisition and Other Underwriting Expenses* for the years ended December 31, 2013 and 2012 were \$31,619 and \$25,930, respectively, and primarily reflect the amortization of deferred acquisition costs, commissions payable to agents for production and renewal of policies, and premium taxes, marketing costs and policy fees. The increase in 2013 is primarily attributable to an increase in commissions and premium taxes related to the increase in policy renewals in 2013, the effect of which is offset by a one-time charge of \$1,210 in 2012 resulting from a change in accounting standards with respect to deferred acquisition costs.

*Interest Expense* totaled \$3,607 for the year ended December 31, 2013 and relates to the two debt offerings we completed during 2013. See Note 10 *Long-Term Debt* to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

*Other Operating Expenses* for the years ended December 31, 2013 and 2012 were \$34,286 and \$21,084, respectively. The \$13,202 increase is primarily attributable to a \$9,296 increase in compensation and related expenses of which \$7,183 relates to an increase in stock-based compensation and cash bonus expense. The remaining increase of \$3,906 relates to charitable contributions of \$1,066 and other administrative costs, which include a variety of professional service fees, corporate insurances, information system expense, and other general expenses of \$2,840. As of December 31, 2013, we had 177 employees located at our offices in Florida compared with 145 employees as of December 31, 2012. We also had 67 employees located in Noida, India at December 31, 2013 versus 62 at December 31, 2012.

*Income Tax Expense* for the years ended December 31, 2013 and 2012 were \$40,891 and \$19,423, respectively, for state, federal and foreign income taxes resulting in an effective tax rate of 38.4% for 2013 and 39.2% for 2012.

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**Ratios:**

The loss ratio applicable to the year ended December 31, 2013 (losses and loss adjustment expenses related to net premiums earned) was 27.8% compared with 42.1% for the year ended December 31, 2012. Our loss ratio was positively impacted by a significant increase in our net premiums earned during 2013 combined with favorable development in claim trends for frequency and severity and favorable development of reserves for prior accident years (see *Gross Premiums Earned* and *Losses and Loss Adjustment Expenses* above).

The expense ratio applicable to the year ended December 31, 2013 (defined as underwriting expenses, interest and other operating expenses related to net premiums earned) was 29.7% compared with 29.9% for the year ended December 31, 2012.

The combined loss and expense ratio (total of all expenses related to net premiums earned) is the key measure of underwriting performance traditionally used in the property and casualty industry. A combined ratio under 100% generally reflects profitable underwriting results. A combined ratio over 100% generally reflects unprofitable underwriting results. Our combined ratio for the year ended December 31, 2013 was 57.5% compared with 72.0% for the year ended December 31, 2012. Our combined ratio was positively impacted by a significant increase in our net premiums earned during 2013 (see *Gross Premiums Earned* above) and, also, by continued favorable trends in 2013 related to our losses and loss adjustment expenses.

Due to the impact our reinsurance costs have on net premiums earned from period to period, our management believes the combined loss and expense ratio measured to gross premiums earned is more relevant in assessing overall performance. The combined loss and expense ratio to gross premiums earned for the year ended December 31, 2013 was 39.9% compared with 48.6% for the year ended December 31, 2012.

***Comparison of the Year Ended December 31, 2012 to the Year Ended December 31, 2011***

Our results of operations for the year ended December 31, 2012 reflect income available to common stockholders of \$29,835, or \$3.02 earnings per diluted common share, compared with income available to common stockholders of \$9,149, or \$1.34 earnings per diluted common share, for the year ended December 31, 2011. Our results for the years ended December 31, 2012 and 2011 include bargain purchase gains on acquisitions of \$179 (\$110 net of tax) and \$936 (\$575 net of tax), respectively, or \$0.01 and \$0.08 diluted earnings per common share, respectively.

**Revenue**

*Gross Premiums Earned* for the year ended December 31, 2012 were \$233,607 and reflect the revenue from policies acquired from HomeWise in November 2011 and policies originally assumed from Citizens and subsequent renewals, including approximately 60,000 policies assumed in November 2012. Gross premiums earned for the year ended December 31, 2011 were \$143,606 and principally reflect the revenue from policies assumed from Citizens and subsequent renewals.

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*Premiums Ceded* for the years ended December 31, 2012 and 2011 were \$75,939 and \$55,525, respectively. Our premiums ceded represent amounts paid to reinsurers to cover losses from catastrophes that exceed the thresholds defined by our catastrophe excess of loss reinsurance treaties. Our reinsurance rates are based primarily on policy exposures reflected in gross premiums earned. Premiums ceded were 32.5% and 38.7% of gross premiums earned during the years ended December 31, 2012 and 2011, respectively. The percentage decrease in 2012 is primarily due to lower costs during the first five months of 2012 related to policies assumed from HomeWise, which were subject to minimal reinsurance premiums. In addition, we had approximately two months of earned premium in 2012 related to the November 2012 Citizens assumption with no associated increase in reinsurance premium.

*Net Premiums Earned* for the years ended December 31, 2012 and 2011 were \$157,668 and \$88,081, respectively, and reflect the gross premiums earned less reinsurance costs as described above.

*Net Premiums Written* during the years ended December 31, 2012 and 2011 totaled \$203,240 and \$131,724, respectively. Net premiums written represent the premiums charged on policies issued during a fiscal period less reinsurance costs.

The following is a reconciliation of our total Net Premiums Written to Net Premiums Earned for the years ended December 31, 2012 and 2011:

|                               | <b>Years Ended<br/>December 31,</b> |                  |
|-------------------------------|-------------------------------------|------------------|
|                               | <b>2012</b>                         | <b>2011</b>      |
| Net Premiums Written          | \$ 203,240                          | \$ 131,724       |
| Increase in Unearned Premiums | (45,572)                            | (43,643)         |
| <b>Net Premiums Earned</b>    | <b>\$ 157,668</b>                   | <b>\$ 88,081</b> |

*Net Investment Income* for the years ended December 31, 2012 and 2011 was \$980 and \$2,061, respectively. The decline in 2012 is primarily due to operating losses incurred with respect to certain operations of our real estate investments.

*Policy Fee Income* for the years ended December 31, 2012 and 2011 was \$2,538 and \$1,438, respectively, and reflects the policy fee income we earn with respect to our issuance of renewal policies.

*Gain on Bargain Purchase* was \$179 (\$110 net of tax), or \$0.01 diluted earnings per common share, and \$936 (\$575 net of tax), or \$0.08 diluted earnings per common share, for the years ended December 31, 2012 and 2011, respectively. The bargain purchase gains relate to our business acquisitions completed in April 2012 and in April 2011. See Note 6 Business Acquisitions to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

*Other Income* for the years ended December 31, 2012 and 2011 was \$1,424 and \$1,003, respectively. The increase in other income in 2012 is primarily due to policy payment plan fees, which are the fees paid by policyholders who elect to pay premiums in installments.



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**Table of Contents****Expenses**

Our *Losses and Loss Adjustment Expenses* amounted to \$66,310 and \$48,243, respectively, during the years ended December 31, 2012 and 2011. Our losses for the year ended December 31, 2012 include approximately \$1,417 and \$2,090 related to case reported claims from Tropical Storm Debby and Tropical Storm Isaac, respectively, which occurred in June and August 2012. See *Reserves for Losses and Loss Adjustment Expenses* under *Critical Accounting Policies and Estimates*.

*Policy Acquisition and Other Underwriting Expenses* for the years ended December 31, 2012 and 2011 were \$25,930 and \$18,129, respectively, and primarily reflect the amortization of deferred acquisition costs, commissions payable to agents for production and renewal of policies, and premium taxes and policy fees. The \$7,801 increase in 2012 is primarily attributable to an increase in our commissions and premium taxes for policy renewals combined with the one-time, \$1,210 adjustment specific to our adoption in January 2012 of the accounting standard update related to deferred acquisition costs.

*Other Operating Expenses* for the years ended December 31, 2012 and 2011 were \$21,084 and \$11,032, respectively. The \$10,052 increase is primarily attributable to a \$7,412 increase in compensation and related expenses of which \$2,378 relates to an increase in stock-based compensation and cash bonus expense. The remaining increase of \$2,640 relates to our other administrative costs, which include a variety of professional service fees, license fees, corporate insurances, lease expense, information system expense, and other general expenses. Our 2012 compensation and related expenses include a full year of payroll expense related to our India operations (acquired in November 2011) and to the employees hired in late 2011 to service policies acquired from HomeWise. As of December 31, 2012, we had 145 employees located at our headquarters in Tampa, Florida compared with 119 employees as of December 31, 2011. We also had 62 employees located in Noida, India at December 31, 2012 versus 68 at December 31, 2011.

*Income Tax Expense* for the years ended December 31, 2012 and 2011 were \$19,423 and \$6,441, respectively, for state, federal and foreign income taxes resulting in an effective tax rate of 39.2% for 2012 and 39.3% for 2011.

**Ratios:**

The loss ratio applicable to the year ended December 31, 2012 was 42.1% compared with 54.8% for the year ended December 31, 2011. Our loss ratio was positively impacted by a significant increase in our gross premiums earned during 2012 (see *Gross Premiums Earned above*).

The expense ratio applicable to the year ended December 31, 2012 was 29.9% compared with 33.1% for the year ended December 31, 2011. The decrease in our expense ratio is attributable to the significant increase in our gross premiums earned as we experienced an increase in other operating expenses during 2012 (see *Other Operating Expenses above*).

Our combined ratio for the year ended December 31, 2012 was 72.0% compared with 87.9% for the year ended December 31, 2011.



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Our combined loss and expense ratio to gross premiums earned for the year ended December 31, 2012 was 48.6% compared with 53.9% for the year ended December 31, 2011.

### ***Seasonality of Our Business***

Our insurance business is seasonal as hurricanes and tropical storms typically occur during the period from June 1 through November 30 each year. With our reinsurance treaty year effective on June 1 each year, any variation in the cost of our reinsurance, whether due to changes in 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 each year.

## **LIQUIDITY AND CAPITAL RESOURCES**

Over the years, our liquidity requirements have been met through issuance of our common and preferred stock, debt offerings and funds from operations. We expect our future liquidity requirements will be met by funds from operations, primarily the cash received by insurance subsidiaries from premiums written and investment income. We may consider raising additional capital through debt and equity offerings to support our growth and future investment opportunities.

HCPCI requires liquidity and adequate capital to meet ongoing obligations to policyholders and claimants and to fund operating expenses. In addition, we attempt to maintain adequate levels of liquidity and surplus to manage any differences between the duration of our liabilities and invested assets. In the insurance industry, cash collected for premiums from policies written is invested, interest and dividends are earned thereon, and losses and loss adjustment expenses are paid out over a period of years. This period of time varies by the circumstances surrounding each claim. A substantial portion of our losses and loss adjustment expenses are fully settled and paid within 90 days of the claim receipt date. Additional cash outflow occurs through payments of underwriting costs such as commissions, taxes, payroll, and general overhead expenses.

We believe that we maintain sufficient liquidity to pay HCPCI's claims and expenses, as well as to satisfy commitments in the event of unforeseen events such as reinsurer insolvencies, 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.

In the future, we anticipate our primary use of funds will be to pay claims, reinsurance premiums and interest, and also to fund operating expenses.

### ***Common Stock***

In 2012, we sold an aggregate of 1,840,000 shares of our common stock for net proceeds of \$20,082 after underwriting commissions and offering expenses. See Note 15 Stockholders' Equity to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

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***Preferred Stock***

In 2011, a total of 1,247,700 shares of our Series A cumulative convertible preferred stock were sold for net proceeds of \$11,307 after offering costs. See Note 15 Stockholders Equity to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

***Senior Notes***

In January 2013, we completed the sale of an aggregate of approximately \$40,250 of our 8.00% Senior Notes due 2020. In December 2013, we completed the sale of an aggregate of \$103,000 of our 3.875% senior convertible notes due 2019. See Note 10 Long-term debt to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

***Cash Flows***

Our cash flows from operating, investing and financing activities for the years ended December 31, 2013, 2012 and 2011 are summarized below.

*Cash Flows for the Year ended December 31, 2013*

Net cash provided by operating activities for the year ended December 31, 2013 was \$55,472, which consisted primarily of cash received from net written premiums less cash disbursed for operating expenses, reinsurance premiums and losses and loss adjustment expenses. Net cash used in investing activities of \$90,040 was primarily due to the purchases of available-for-sale securities of \$94,215, the purchase of \$3,433 in property and equipment and the purchase of \$565 in other investments offset by redemptions and repayments of fixed-maturity securities of \$3,607, and the proceeds from sales of available-for-sale securities of \$4,558. Net cash provided by financing activities totaled \$97,752, which was primarily due to \$143,250 from the issuance of long-term debt offset by \$4,770 of related underwriting and issuance costs, \$10,902 of cash dividend payments, and \$30,886 of payments to repurchase common stock.

*Cash Flows for the Year ended December 31, 2012*

Net cash provided by operating activities for the year ended December 31, 2012 was \$106,266, which consisted primarily of cash received from net written premiums less cash disbursed for operating expenses and losses and loss adjustment expenses. Net cash used in investing activities amounted to \$1,211 and was primarily due to \$8,157 used to complete our business acquisitions in 2012, \$16,538 used for the purchases of fixed-maturity and equity securities, and \$2,796 used for the purchases of property, equipment and other investments offset by \$10,726 from the proceeds from sales of fixed-maturity and equity securities, \$3,127 of proceeds from calls, repayments, and maturities of fixed-maturity securities and \$12,427 from time deposit redemptions. Net cash provided by financing activities totaled \$24,799, which was primarily due to \$20,082 from the issuance of common stock, \$12,152 related to the exercise of stock options and warrants and \$1,161 excess tax benefit from stock options exercised offset by \$8,561 in cash dividends paid.

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*Cash Flows for the Year ended December 31, 2011*

Net cash provided by operating activities for the year ended December 31, 2011 was \$56,033, which consisted primarily of cash received from net written premiums less cash disbursed for operating expenses and losses and loss adjustment expenses. Net cash used in investing activities of \$16,951 was primarily due to \$5,309 used for our business acquisitions completed in 2011, \$3,349 used for the purchase of property and equipment, and \$37,795 used for the purchases of fixed-maturity and equity securities offset by \$26,569 from the proceeds from sales of fixed-maturity and equity securities, \$1,327 from the proceeds from calls, repayments, maturities of fixed-maturity securities, and \$1,606 from time deposit redemptions. Net cash provided by financing activities totaled \$6,424, which was primarily due to \$11,307 from the issuance of preferred stock and \$829 related to the exercise of stock options offset by \$3,825 in cash dividends paid and \$1,887 used to repurchase our common shares.

***Investments***

The main objective of our investment policy is to maximize our after-tax investment income with a minimum of risk given the current financial market. Our excess cash is invested primarily in money market accounts and available-for-sale investments.

At December 31, 2013, we had \$129,800 of available-for-sale investments, which are carried at fair value. Changes in the general interest rate environment affect the returns available on new fixed-maturity investments. While a rising interest rate environment enhances the returns available on new investments, it reduces the market value of existing fixed-maturity investments and thus the availability of gains on disposition. A decline in interest rates reduces the returns available on new fixed-maturity investments but increases the market value of existing fixed-maturity investments, creating the opportunity for realized investment gains on disposition.

With the exception of large national banks, it is our current practice not to maintain cash deposits of more than an aggregate of \$5,500 in any one bank at any time. From time to time, we may have in excess of \$5,500 of cash designated for investment and on deposit at a single national brokerage firm. In the future, we may alter our investment policy to include or increase investments in federal, state and municipal obligations, preferred and common equity securities, real estate and real estate mortgages. The types of investments held by HCPCI and HCA are limited by insurance law and regulations.

**OFF-BALANCE SHEET ARRANGEMENTS**

As of December 31, 2013 and 2012, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of SEC Regulation S-K.

**Table of Contents****CONTRACTUAL OBLIGATIONS**

The following table summarizes our contractual obligations as of December 31, 2013:

|                                | Payment Due by Period (in thousands) |                     |           |           |                      |
|--------------------------------|--------------------------------------|---------------------|-----------|-----------|----------------------|
|                                | Total                                | Less than<br>1 Year | 1-3 Years | 3-5 Years | More than<br>5 Years |
| Operating lease (1)            | \$ 1,093                             | \$ 114              | \$ 246    | \$ 272    | \$ 461               |
| Service agreement (1)          | 197                                  | 21                  | 44        | 49        | 83                   |
| Long-term debt obligations (2) | 184,385                              | 6,269               | 14,423    | 14,422    | 149,271              |
| Total                          | \$ 185,675                           | \$ 6,404            | \$ 14,713 | \$ 14,743 | \$ 149,815           |

(1) Represents the lease and maintenance service agreement for office space in Noida, India. Liabilities were converted from India Rupee to U.S. dollars using the December 31, 2013 exchange rate.

(2) Amounts represent principal and interest payments over the life of the debts. See Note 10 Long-Term Debt to our consolidated financial statements under Item 8 of this Annual Report on Form 10-K.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

We have prepared our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and judgments to develop amounts reflected and disclosed in our financial statements. Material estimates that are particularly susceptible to significant change in the near term are related to our losses and loss adjustment expenses, which include amounts estimated for claims incurred but not yet reported. We base our estimates on various assumptions and actuarial data we believe to be reasonable under the circumstances. Actual results may differ materially from these estimates.

We believe our accounting policies specific to losses and loss adjustment expenses, reinsurance with retrospective provisions, deferred income taxes, and stock-based compensation expense involve our most significant judgments and estimates material to our consolidated financial statements.

**Reserves for Losses and Loss Adjustment Expenses.** We establish Reserves for the estimated total unpaid costs of losses including LAE. Reserves reflect management's best estimate of the total cost of (i) claims that have been incurred, but not yet paid, and (ii) claims that have been incurred but not yet reported. Reserves established by us are not an exact calculation of our liability. Rather, loss reserves represent management's best estimate of our company's liability based on the application of actuarial techniques and other projection methodology and taking into consideration other facts and circumstances known at the balance sheet date. The process of establishing loss reserves is complex and inherently imprecise, as it involves using judgment that is affected by many variables such as past loss experience, current claim trends and the prevailing social, economic and legal environments. The impact of both internal and external variables on ultimate losses and LAE costs is difficult to estimate. Our exposure is impacted by both the risk characteristics of the physical locations where we write policies, such as hurricane and tropical storm-related risks, as well as risks associated with varying social, judicial and legislative characteristics in the states in which we operate. In determining loss reserves, we give careful consideration to all available data and actuarial analyses, and this process involves significant judgment.



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Reserves represent estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported to our insurance company. The amount of loss reserves for reported claims is based primarily upon a case-by-case evaluation of the kind of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amounts of Reserves for unreported claims and LAE are determined using historical homeowners insurance information as adjusted to current conditions. Inflation is ordinarily implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results over multiple years.

Reserves are closely monitored and are recalculated periodically using the most recent information on reported claims and a variety of actuarial techniques. Specifically, claims management personnel complete weekly and ongoing reviews of existing case reserves, new claims, changes to existing case reserves, and paid losses with respect to the current and prior years. As we develop historical data regarding paid and incurred losses, we use this data to develop expected ultimate loss and loss adjustment expense ratios. We then apply these expected loss and loss adjustment expense ratios to earned premium to derive a reserve level for our homeowners line of business. In connection with the determination of these reserves, we will also consider other specific factors such as recent weather-related losses, trends in historical paid losses, and legal and judicial trends regarding liability. Most of our business was assumed from Citizens and HomeWise. Therefore, we use the loss ratio method, among other methods, to project an ultimate loss expectation, and then the related loss history must be regularly evaluated and loss expectations updated, with the possibility of variability from the initial estimate of ultimate losses.

When a claim is reported to us, our claims personnel establish a case reserve for the estimated amount of the ultimate payment. This estimate reflects an informed judgment based upon general insurance reserving practices and on the experience and knowledge of the estimator. The individual estimating the reserve considers the nature and value of the specific claim, the severity of injury or damage, location, and the policy provisions relating to the type of loss. Case reserves are adjusted by us as more information becomes available. It is our policy to settle each claim as expeditiously as possible.

We maintain IBNR Reserves to provide for claims that have been incurred but have not been reported and subsequent development on reported claims. The IBNR reserve is determined by estimating our insurance company's ultimate net liability for both reported and unreported claims and then subtracting the case reserves and payments made to date for reported claims.

Loss Reserve Estimation Methods. We apply the following general methods in projecting loss and LAE reserves:

Reported loss development;

Paid loss development;

Loss ratio method; and

Average outstanding and open claims.

The results of the reserve calculations using these methods were similar, and therefore, we relied on an average of the four methods.



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*Description of Ultimate Loss Estimation Methods.* The reported loss development method relies on the assumption that, at any given state of maturity, ultimate losses can be predicted by multiplying cumulative reported losses (paid losses plus case reserves) by a cumulative development factor. The validity of the results of this method depends on the stability of claim reporting and settlement rates, as well as the consistency of case reserve levels. Case reserves do not have to be adequately stated for this method to be effective; they only need to have a fairly consistent level of adequacy at all stages of maturity. Because of our limited loss experience, we select loss development factors based on industry data found in current A.M. Best's *Aggregates and Averages - Property/Casualty - United States & Canada*. We assume that our loss development patterns will be reasonably consistent with industry averages, and use the selected factors to assist in the projection of the ultimate losses.

The paid loss development method is mechanically identical to the reported loss development method described above. The paid method does not rely on case reserves or claim reporting patterns in making projections.

The validity of the results from using a loss development approach can be affected by many conditions, such as internal claim department processing changes, a shift between single and multiple claim payments, legal changes, or variations in our mix of business from year to year. Also, since the percentage of losses paid for immature years is often low, development factors are volatile. A small variation in the number of claims paid can have a leveraging effect that can lead to significant changes in estimated ultimate losses. Therefore, ultimate values for immature loss years are often based on alternative estimation techniques.

The loss ratio method used by us relies on the assumption that remaining unreported losses are a function of the total expected losses rather than a function of currently reported losses. The expected loss ratio is multiplied by earned premium to produce ultimate losses. Reported incurred losses are then subtracted from this estimate to produce expected unreported losses.

The loss ratio method is most useful as an alternative to other models for immature loss years. For these immature years, the amounts reported or paid may be small and unstable, and therefore, not predictive of future development. Therefore, future development is assumed to follow an expected pattern that is supported by more stable historical data or by emerging trends. This method is also useful when changing reporting patterns or payment patterns distort the historical development of losses.

Finally, we employ the average outstanding and open claims method. We segregate our claims according to when they were incurred and conduct a detailed review in order to estimate average future development of open claims and average projected loss on IBNR claims. We combine this estimate with our open claims in order to derive an estimate of expected unreported losses. Paid losses are added to this estimate in order to derive an estimate of ultimate losses. This method is based on the assumption that future unreported claims and the average severity of open claims and unreported claims can be reasonably estimated from the experience available.



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While the property and casualty industry has incurred substantial aggregate losses from claims related to asbestos-related illnesses, environmental remediation, product and mold, and other uncertain or environmental exposures, we have not experienced significant losses from these types of claims.

Currently, our estimated ultimate liability is calculated monthly using these principles and procedures applicable to the lines of business written. However, because the establishment of loss reserves is an inherently uncertain process, we cannot be certain that ultimate losses will not exceed the established loss reserves and have a material, adverse effect on our results of operations and financial condition. Changes in estimates, or differences between estimates and amounts ultimately paid, are reflected in the operating results of the period during which such adjustments are made.

Our reported results, financial position and liquidity would be affected by likely changes in key assumptions that determine our net loss reserves. Management does not believe that any reasonably likely changes in the frequency of claims would affect our loss reserves. However, management believes that a reasonably likely increase or decrease in the severity of claims could impact our net loss reserves. The table below summarizes the effect on net loss reserves and equity in the event of reasonably likely changes in the severity of claims considered in establishing loss and loss adjustment expense reserves. The range of reasonably likely changes in the severity of our claims was established based on a review of changes in loss year development and applied to loss reserves as a whole. The selected range of changes does not indicate what could be the potential best or worst case or likely scenarios:

| Year Ended December 31, 2013 |               |   |
|------------------------------|---------------|---|
| Change in Reserves           | Reserves      | Percentage change in equity, net of tax |
| -10.0%                       | 39,317        | 1.66%                                   |
| -7.5%                        | 40,410        | 1.25%                                   |
| -5.0%                        | 41,502        | 0.83%                                   |
| -2.5%                        | 42,594        | 0.42%                                   |
| <b>Base</b>                  | <b>43,686</b> |   |
| 2.5%                         | 44,778        | -0.42%                                  |
| 5.0%                         | 45,870        | -0.83%                                  |
| 7.5%                         | 46,962        | -1.25%                                  |
| 10.0%                        | 48,055        | -1.66%                                  |

**Economic Impact of Reinsurance Contracts with Retrospective Provisions.** For the reinsurance treaty year June 1, 2013 through May 31, 2014, the total premium cost of the program to HCI is approximately \$142,000 before broker fees. Certain of the reinsurance agreements include retrospective provisions that adjust premiums, increase the amount of future coverage, or result in profit commissions in the event losses are minimal or zero. As a result, we expect to recognize net reinsurance premiums ceded of approximately \$121,000 assuming no losses occur during that period. In accordance with generally accepted accounting principles, we will recognize an asset in the period in which the absence of loss experience gives rise to an increase in future coverage or obligates the reinsurer to pay cash or other consideration under the contract. In the event that a loss arises, we will derecognize such asset in the period in which a loss arises. Such adjustments to the asset, which accrue throughout the contract term, will negatively impact our operating results when a catastrophic loss event occurs.

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There were no benefits recognized prior to 2013. For the year ended December 31, 2013, we have accrued a benefit of \$8,815 and deferred recognition of \$3,706 in ceded premiums for a total reduction in 2013 ceded premiums of \$12,521 in connection with these agreements, an amount that would be charged to earnings in the event we experience a catastrophic loss that exceeds the coverage retention limits provided under such agreements.

***Income Taxes.*** We account for income taxes in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ), resulting in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. We determine deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. Valuation allowances are provided against assets that are not likely to be realized, if any. We have elected to classify interest and penalties, if any, as income tax expense as permitted by current accounting standards.

***Stock-Based Compensation.*** We account for our stock option and incentive plan under the fair value recognition provisions of U.S. GAAP, which requires the measurement, and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock issuances based on estimated fair values. We recognize stock-based compensation in the consolidated statements of income on a straight-line basis over the vesting period. We use the Black-Scholes option-pricing model, which requires the following variables for input to calculate the fair value of each stock award on the option grant date: 1) expected volatility of our stock price, 2) the risk-free interest rate, 3) expected term of each award, 4) expected dividends, and 5) an expected forfeiture rate. For restricted stock awards with market-based conditions, we estimate their fair values by using a Monte Carlo simulation model, which requires for input the following variables: 1) expected dividends per share, 2) expected volatility, 3) risk-free interest rate, 4) estimated cost of capital, and 5) expected term of each award.

**ITEM 7A *Quantitative and Qualitative Disclosures About Market Risk***

Our investment portfolios at December 31, 2013 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 investment companies and are overseen by the investment committee appointed by our board of directors.

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Our investment portfolios are primarily exposed to interest rate risk, credit risk and equity price risk. Fiscal and economic uncertainties caused by any government shutdown, as well as debt ceiling and spending cut debates in Washington may exacerbate these risks and potentially have adverse impacts on the securities markets as well as the value of our investment portfolios.

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 their fair value 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 December 31, 2013 (in thousands):

| <b>Hypothetical Change in Interest Rates</b> | <b>Estimated Fair Value</b> | <b>Change in Estimated Fair Value</b> | <b>Percentage Increase (Decrease) in Estimated Fair Value</b> |
|--|-----------------------------|---------------------------------------|---|
| 300 basis point increase                     | \$ 94,968                   | \$ (17,183)                           | (15.32)%  |
| 200 basis point increase                     | 100,694                     | (11,457)                              | (10.22)%  |
| 100 basis point increase                     | 106,422                     | (5,729)                               | (5.11)%   |
| 100 basis point decrease                     | 117,806                     | 5,655                                 | 5.04%   |
| 200 basis point decrease                     | 123,261                     | 11,110                                | 9.91%   |
| 300 basis point decrease                     | 127,953                     | 15,802                                | 14.09%  |

*Credit Risk*

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

The following table presents the composition of our fixed-maturity securities, by rating, at December 31, 2013 (in thousands):

| <b>Comparable Rating</b> | <b>Amortized Cost</b> | <b>% of Total Amortized Cost</b> | <b>Estimated Fair Value</b> | <b>% of Total Estimated Fair Value</b> |
|--------------------------|-----------------------|----------------------------------|-----------------------------|--|
| AAA                      | \$ 12,812             | 12                               | \$ 13,187                   | 12                                     |

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|                  |            |     |            |     |
|------------------|------------|-----|------------|-----|
| AA1, AA2, AA3    | 22,583     | 20  | 22,857     | 20  |
| A1, A2, A3       | 44,394     | 40  | 44,777     | 40  |
| BBB1, BBB2, BBB3 | 27,131     | 25  | 27,480     | 25  |
| BB1, BB2         | 3,818      | 3   | 3,850      | 3   |
| Total            | \$ 110,738 | 100 | \$ 112,151 | 100 |

**Table of Contents***Equity Price Risk*

Our equity investment portfolio at December 31, 2013 included common stocks, perpetual preferred stocks, mutual funds and exchange traded funds ( ETF ). We may incur potential losses due to adverse changes in equity security prices. We manage the risk primarily through industry and issuer diversification and asset allocation techniques.

The following table illustrates the composition of our equity securities at December 31, 2013 (in thousands):

|                                      | <b>Estimated<br/>Fair Value</b> | <b>% of Total<br/>Estimated<br/>Fair<br/>Value</b> |
|--------------------------------------|---------------------------------|--|
| <b>Stocks by sector:</b>             |                                 |  |
| Financial                            | \$ 7,950                        | 45   |
| Energy                               | 1,506                           | 9  |
| Consumer                             | 1,042                           | 6  |
| Other (1)                            | 522                             | 2  |
|                                      | 11,020                          | 62   |
| <b>Mutual funds and ETF by type:</b> |                                 |  |
| Debt                                 | 6,262                           | 35   |
| Equity                               | 367                             | 3  |
|                                      | 6,629                           | 38   |
| <b>Total</b>                         | <b>\$ 17,649</b>                | <b>100</b>   |

(1) Represents an aggregate of less than 5% sectors.

*Foreign Currency Exchange Risk*

At December 31, 2013, we did not have any material exposure to foreign currency related risk.

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**ITEM 8 *Financial Statements and Supplementary Data***

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders of

HCI Group, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheet of HCI Group, Inc. and Subsidiaries (the Company) as of December 31, 2013, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for the year ended December 31, 2013. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HCI Group, Inc. and Subsidiaries as of December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control-Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 12, 2014 expressed an unqualified opinion.

/s/ Dixon Hughes Goodman LLP

Clearwater, Florida

March 12, 2014

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**Report of Independent Registered Public Accounting Firm on Internal Control**

To the Board of Directors and Stockholders

HCI Group, Inc. and Subsidiaries

We have audited HCI Group, Inc. and Subsidiaries (the Company) internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, HCI Group, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of HCI Group, Inc. and Subsidiaries as of and for the year ended December 31, 2013, and our report dated March 12, 2014, expressed an unqualified opinion on those consolidated financial statements.

/s/ Dixon Hughes Goodman LLP



Clearwater, Florida

March 12, 2014

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

HCI Group, Inc.

Tampa, Florida:

We have audited the accompanying consolidated balance sheet of HCI Group, Inc. and Subsidiaries (the Company) as of December 31, 2012, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for each of the years in the two-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2012, and the consolidated results of its operations, its comprehensive income and its cash flows for each of the years in the two-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

/s/ Hacker, Johnson & Smith PA

HACKER, JOHNSON & SMITH PA

Tampa, Florida

March 12, 2014

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Balance Sheets****(Amounts in thousands, except share amounts)**

|  | <b>December 31,</b> |                   |
|--|---------------------|-------------------|
|  | <b>2013</b>         | <b>2012</b>       |
| <b>Assets</b>  |                     |                   |
| Fixed-maturity securities, available for sale, at fair value (amortized cost: \$110,738 and \$33,436, respectively)  | \$ 112,151          | \$ 35,953         |
| Equity securities, available for sale, at fair value (cost: \$17,248 and \$8,756, respectively)  | 17,649              | 8,876             |
| Other investments  | 16,228              | 16,087            |
| <b>Total investments</b>   | <b>146,028</b>      | <b>60,916</b>     |
| Cash and cash equivalents  | 293,398             | 230,214           |
| Accrued interest and dividends receivable  | 1,133               | 375               |
| Premiums receivable  | 14,674              | 10,642            |
| Prepaid reinsurance premiums   | 28,066              | 9,112             |
| Deferred policy acquisition costs  | 14,071              | 10,032            |
| Property and equipment, net  | 13,132              | 10,853            |
| Deferred income taxes, net   |                     | 3,848             |
| Other assets   | 15,814              | 2,296             |
| <b>Total assets</b>  | <b>\$ 526,316</b>   | <b>\$ 338,288</b> |
| <b>Liabilities and Stockholders Equity</b>   |                     |                   |
| Losses and loss adjustment expenses  | \$ 43,686           | \$ 41,168         |
| Unearned premiums  | 171,907             | 154,249           |
| Advance premiums   | 4,504               | 4,029             |
| Assumed reinsurance balances payable   | 4,660               | 1,377             |
| Accrued expenses   | 4,032               | 3,041             |
| Dividends payable  | 19                  | 42                |
| Income taxes payable   | 543                 | 8,813             |
| Deferred income taxes, net   | 2,740               |                   |
| Long-term debt   | 126,932             |                   |
| Other liabilities  | 6,772               | 4,316             |
| <b>Total liabilities</b>   | <b>365,795</b>      | <b>217,035</b>    |
| <b>Commitments and contingencies (Note 18)</b>   |                     |                   |
| <b>Stockholders equity:</b>  |                     |                   |
| 7% Series A cumulative convertible preferred stock (liquidation preference \$10.00 per share), no par value, 1,500,000 shares authorized, 110,684 and 241,182 shares issued and outstanding in 2013 and 2012, respectively |                     |                   |

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Series B junior participating preferred stock (no par value, 400,000 shares authorized, no shares issued or outstanding)

Preferred stock (no par value, 18,100,000 shares authorized, no shares issued or outstanding)

Common stock (no par value, 40,000,000 shares authorized, 10,939,268 and 10,877,537 shares issued and outstanding in 2013 and 2012, respectively)

|  |            |            |
|--|------------|------------|
| Additional paid-in capital                           | 48,966     | 63,875     |
| Retained income                                      | 110,441    | 55,758     |
| Accumulated other comprehensive income, net of taxes | 1,114      | 1,620      |
| Total stockholders' equity                           | 160,521    | 121,253    |
| Total liabilities and stockholders' equity           | \$ 526,316 | \$ 338,288 |

See accompanying Notes to Consolidated Financial Statements.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Income****(Amounts in thousands, except per share amounts)**

|  | <b>Years Ended December 31,</b> |             |             |
|--|---------------------------------|-------------|-------------|
|  | <b>2013</b>                     | <b>2012</b> | <b>2011</b> |
| <b>Revenue</b>                                     |                                 |             |             |
| Gross premiums earned                              | \$ 337,113                      | \$ 233,607  | \$ 143,606  |
| Premiums ceded                                     | (102,865)                       | (75,939)    | (55,525)    |
| Net premiums earned                                | 234,248                         | 157,668     | 88,081      |
| Net investment income                              | 1,469                           | 980         | 2,061       |
| Policy fee income                                  | 3,098                           | 2,538       | 1,438       |
| Net realized investment gains                      | 80                              | 276         | 290         |
| Gain on bargain purchase                           |                                 | 179         | 936         |
| Other  | 2,193                           | 1,424       | 1,003       |
| Total revenue                                      | 241,088                         | 163,065     | 93,809      |
| <b>Expenses</b>                                    |                                 |             |             |
| Losses and loss adjustment expenses                | 65,123                          | 66,310      | 48,243      |
| Policy acquisition and other underwriting expenses | 31,619                          | 25,930      | 18,129      |
| Interest expense                                   | 3,607                           |             |             |
| Goodwill impairment loss                           |                                 | 161         |             |
| Other operating expenses                           | 34,286                          | 21,084      | 11,032      |
| Total expenses                                     | 134,635                         | 113,485     | 77,404      |
| Income before income taxes                         | 106,453                         | 49,580      | 16,405      |
| Income tax expense                                 | 40,891                          | 19,423      | 6,441       |
| Net income   | \$ 65,562                       | \$ 30,157   | \$ 9,964    |
| Preferred stock dividends                          | (104)                           | (322)       | (815)       |
| Income available to common stockholders            | \$ 65,458                       | \$ 29,835   | \$ 9,149    |
| Basic earnings per common share                    | \$ 5.82                         | \$ 3.45     | \$ 1.49     |
| Diluted earnings per common share                  | \$ 5.63                         | \$ 3.02     | \$ 1.34     |
| Dividends per common share                         | \$ 0.95                         | \$ 0.88     | \$ 0.53     |

See accompanying Notes to Consolidated Financial Statements.



Table of Contents**HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income**

(Amounts in thousands)

|  | <b>Years Ended December 31,</b> |             |             |
|--|---------------------------------|-------------|-------------|
|  | <b>2013</b>                     | <b>2012</b> | <b>2011</b> |
| Net income   | \$ 65,562                       | \$ 30,157   | \$ 9,964    |
| Other comprehensive (loss) income:                           |                                 |             |             |
| Change in unrealized (loss) gain on investments:             |                                 |             |             |
| Unrealized (loss) gain arising during the period             | (767)                           | 2,571       | 674         |
| Call and repayment losses charged to investment income       | 24                              | 3           | 23          |
| Reclassification adjustment for realized (loss) gain         | (80)                            | (276)       | (290)       |
| Net change in unrealized (loss) gain                         | (823)                           | 2,298       | 407         |
| Deferred income taxes on above change                        | 317                             | (886)       | (157)       |
| Total other comprehensive (loss) income, net of income taxes | (506)                           | 1,412       | 250         |
| Comprehensive income   | \$ 65,056                       | \$ 31,569   | \$ 10,214   |

See accompanying Notes to Consolidated Financial Statements.

Table of Contents**HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders Equity****For the Year Ended December 31, 2013****(Amounts in thousands, except share amounts)**

|  | Series A Preferred Stock |        | Common Stock |        | Additional         | Retained  | Accumulated<br>Other<br>Comprehensive<br>Income,<br>Net<br>of Tax | Total<br>Stockholders<br>Equity |
|--|--------------------------|--------|--------------|--------|--------------------|-----------|---|---------------------------------|
|  | Shares                   | Amount | Shares       | Amount | Paid-In<br>Capital | Income    |   |                                 |
| Balance at<br>December 31, 2012  | 241,182                  | \$     | 10,877,537   | \$     | \$ 63,875          | \$ 55,758 | \$ 1,620  | \$ 121,253                      |
| Net income   |                          |        |              |        |                    | 65,562    |   | 65,562                          |
| Total other<br>comprehensive loss,<br>net of income taxes  |                          |        |              |        |                    |           | (506)   | (506)                           |
| Conversion of<br>preferred stock to<br>common stock  | (130,498)                |        | 130,498      |        |                    |           |   |                                 |
| Issuance of restricted<br>stock  |                          |        | 612,000      |        |                    |           |   |                                 |
| Forfeiture of<br>restricted stock  |                          |        | (29,670)     |        |                    |           |   |                                 |
| Repurchase and<br>retirement of<br>common stock  |                          |        | (28,346)     |        | (963)              |           |   | (963)                           |
| Repurchase of<br>common stock under<br>prepaid forward<br>contract                               |                          |        | (622,751)    |        | (29,923)           |           |   | (29,923)                        |
| Equity component on<br>3.875% convertible<br>senior notes (net of<br>offering costs of<br>\$557) |                          |        |              |        | 15,900             |           |   | 15,900                          |
| Deferred taxes on<br>debt discount   |                          |        |              |        | (6,348)            |           |   | (6,348)                         |
| Common stock<br>dividends  |                          |        |              |        |                    | (10,775)  |   | (10,775)                        |
| Preferred stock<br>dividends   |                          |        |              |        |                    | (104)     |   | (104)                           |
|  |                          |        |              |        | 1,060              |           |   | 1,060                           |



|  |         |    |            |    |           |            |          |            |
|--|---------|----|------------|----|-----------|------------|----------|------------|
| Tax benefits on stock-based compensation |         |    |            |    |           |            |          |            |
| Stock-based compensation                 |         |    |            |    | 5,365     |            |          | 5,365      |
| Balance at December 31, 2013             | 110,684 | \$ | 10,939,268 | \$ | \$ 48,966 | \$ 110,441 | \$ 1,114 | \$ 160,521 |

Table of Contents**HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders Equity (Continued)****For the Year Ended December 31, 2012****(Amounts in thousands, except share amounts)**

|  | Series A Preferred Stock |        | Common Stock |        | Additional         | Retained  | Accumulated<br>Other<br>Comprehensive, Net of | Total                  |
|--|--------------------------|--------|--------------|--------|--------------------|-----------|---|------------------------|
|  | Shares                   | Amount | Shares       | Amount | Paid-In<br>Capital | Income    | Tax   | Stockholders<br>Equity |
| Balance at<br>December 31, 2011                                  | 1,247,700                | \$     | 6,202,485    | \$     | \$ 29,636          | \$ 33,986 | \$ 208  | \$ 63,830              |
| Net income   |                          |        |              |        |                    | 30,157    |   | 30,157                 |
| Total other<br>comprehensive<br>income, net of<br>income taxes   |                          |        |              |        |                    |           | 1,412   | 1,412                  |
| Exercise of common<br>stock options                              |                          |        | 340,000      |        | 283                |           |   | 283                    |
| Shares surrendered<br>upon exercising<br>common stock<br>options |                          |        | (72,592)     |        |                    |           |   |                        |
| Exercise of common<br>stock warrants                             |                          |        | 1,314,806    |        | 11,869             |           |   | 11,869                 |
| Excess tax benefit<br>from stock options<br>exercised            |                          |        |              |        | 1,161              |           |   | 1,161                  |
| Conversion of<br>preferred stock to<br>common stock              | (1,006,518)              |        | 1,006,518    |        |                    |           |   |                        |
| Issuance of restricted<br>stock                                  |                          |        | 246,320      |        |                    |           |   |                        |
| Issuance of common<br>stock (net of offering<br>costs of \$220)  |                          |        | 1,840,000    |        | 20,082             |           |   | 20,082                 |
| Common stock<br>dividends  |                          |        |              |        |                    | (8,063)   |   | (8,063)                |
| Preferred stock<br>dividends                                     |                          |        |              |        |                    | (322)     |   | (322)                  |
|  |                          |        |              |        | 844                |           |   | 844                    |

Stock-based  
compensation

|                                 |         |    |            |    |           |           |    |       |    |         |
|---------------------------------|---------|----|------------|----|-----------|-----------|----|-------|----|---------|
| Balance at<br>December 31, 2012 | 241,182 | \$ | 10,877,537 | \$ | \$ 63,875 | \$ 55,758 | \$ | 1,620 | \$ | 121,253 |
|---------------------------------|---------|----|------------|----|-----------|-----------|----|-------|----|---------|

Table of Contents**HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders Equity (Continued)****For the Year Ended December 31, 2011****(Amounts in thousands, except share amounts)**

|   | Series A Preferred Stock |        | Common Stock |        | Additional         | Retained  | Accumulated<br>Other<br>Comprehensive<br>Income,<br>Net<br>of Tax | Total<br>Stockholders<br>Equity |
|---|--------------------------|--------|--------------|--------|--------------------|-----------|---|---------------------------------|
|   | Shares                   | Amount | Shares       | Amount | Paid-In<br>Capital | Income    |   |                                 |
| Balance at<br>December 31, 2010   |                          | \$     | 6,205,396    | \$     | \$ 18,606          | \$ 28,065 | \$ (42)   | \$ 46,629                       |
| Net income  |                          |        |              |        |                    | 9,964     |   | 9,964                           |
| Total other<br>comprehensive income,<br>net of income taxes                       |                          |        |              |        |                    |           | 250   | 250                             |
| Proceeds from sale of<br>preferred stock (net of<br>offering costs of<br>\$1,170) | 1,247,700                |        |              |        | 11,307             |           |   | 11,307                          |
| Exercise of common<br>stock options   |                          |        | 255,200      |        | 564                |           |   | 564                             |
| Shares surrendered<br>upon exercising<br>common stock options                     |                          |        | (9,317)      |        |                    |           |   |                                 |
| Excess tax benefit from<br>stock options exercised                                |                          |        |              |        | 265                |           |   | 265                             |
| Common stock<br>dividends   |                          |        |              |        |                    | (3,229)   |   | (3,229)                         |
| Preferred stock<br>dividends  |                          |        |              |        |                    | (814)     |   | (814)                           |
| Repurchase and<br>retirement of common<br>stock                                   |                          |        | (248,794)    |        | (1,887)            |           |   | (1,887)                         |
| Warrants issued in<br>connection with<br>assumption transaction                   |                          |        |              |        | 754                |           |   | 754                             |
| Stock-based<br>compensation   |                          |        |              |        | 27                 |           |   | 27                              |

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|                                 |           |    |           |    |           |           |    |     |           |
|---------------------------------|-----------|----|-----------|----|-----------|-----------|----|-----|-----------|
| Balance at<br>December 31, 2011 | 1,247,700 | \$ | 6,202,485 | \$ | \$ 29,636 | \$ 33,986 | \$ | 208 | \$ 63,830 |
|---------------------------------|-----------|----|-----------|----|-----------|-----------|----|-----|-----------|

See accompanying Notes to Consolidated Financial Statements.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

(Amounts in thousands)

|  | <b>Years Ended December 31,</b> |                |               |
|--|---------------------------------|----------------|---------------|
|  | <b>2013</b>                     | <b>2012</b>    | <b>2011</b>   |
| <b>Cash flows from operating activities:</b>   |                                 |                |               |
| Net income   | \$ 65,562                       | \$ 30,157      | \$ 9,964      |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                                 |                |               |
| Stock-based compensation   | 5,365                           | 844            | 27            |
| Net amortization of discounts and premiums on investments in fixed-maturity securities   | 336                             | 279            | 195           |
| Depreciation and amortization  | 2,103                           | 1,591          | 576           |
| Deferred income tax expense (benefit)  | 557                             | (2,366)        | (1,984)       |
| Net realized investment gains  | (80)                            | (276)          | (290)         |
| Gain on bargain purchase   |                                 | (179)          | (936)         |
| Goodwill impairment loss   |                                 | 161            |               |
| Loss on sale of other investment   | 20                              |                |               |
| Loss on disposal of other investment   | 6                               |                |               |
| Foreign currency remeasurement loss  | 69                              | 23             |               |
| <b>Changes in operating assets and liabilities:</b>                                      |                                 |                |               |
| Premiums and reinsurance receivable  | (4,032)                         | 3,267          | (8,061)       |
| Advance premiums   | 475                             | 1,897          | 1,018         |
| Prepaid reinsurance premiums   | (18,954)                        | 5,057          | 3,618         |
| Accrued interest and dividends receivable  | (758)                           | 33             | (228)         |
| Other assets   | (9,728)                         | (803)          | 82            |
| Assumed reinsurance balances payable   | 3,283                           | 1,377          |               |
| Deferred policy acquisition costs  | (4,039)                         | 2,289          | (2,914)       |
| Losses and loss adjustment expenses  | 2,518                           | 13,744         | 5,278         |
| Unearned premiums  | 17,658                          | 45,572         | 43,643        |
| Income taxes payable   | (8,270)                         | 3,857          | 4,646         |
| Accrued expenses and other liabilities   | 3,381                           | (258)          | 1,399         |
| <b>Net cash provided by operating activities</b>   | <b>55,472</b>                   | <b>106,266</b> | <b>56,033</b> |
| <b>Cash flows from investing activities:</b>   |                                 |                |               |
| Cash consideration paid for acquired business, net of cash acquired                      |                                 | (8,157)        | (5,309)       |
| Purchase of property and equipment, net  | (3,433)                         | (1,196)        | (3,144)       |
| Purchase of other investments  | (565)                           | (1,600)        | (205)         |
| Purchase of fixed-maturity securities  | (82,907)                        | (10,128)       | (31,170)      |
| Purchase of equity securities  | (11,308)                        | (6,410)        | (6,625)       |
| Proceeds from sales of fixed-maturity securities   | 1,749                           | 8,991          | 24,904        |
| Proceeds from calls, repayments and maturities of fixed-maturity securities              | 3,607                           | 3,127          | 1,327         |

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|   |          |         |          |
|---|----------|---------|----------|
| Proceeds from sales of equity securities      | 2,809    | 1,735   | 1,665    |
| Proceeds from sales of property and equipment | 1        |         |          |
| Proceeds from sales of other investment       | 7        |         |          |
| Time deposits, net                            |          | 12,427  | 1,606    |
| Net cash used in investing activities         | (90,040) | (1,211) | (16,951) |

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Continued)****(Amounts in thousands)**

|  | <b>Years Ended December 31,</b> |                   |                   |
|--|---------------------------------|-------------------|-------------------|
|  | <b>2013</b>                     | <b>2012</b>       | <b>2011</b>       |
| <b>Cash flows from financing activities:</b>                                       |                                 |                   |                   |
| Net proceeds from the issuance of common stock                                     |                                 | 20,082            |                   |
| Net proceeds from the issuance of preferred stock                                  |                                 |                   | 11,307            |
| Proceeds from the exercise of common stock options                                 |                                 | 283               | 564               |
| Proceeds from the exercise of common stock warrants                                |                                 | 11,869            |                   |
| Proceeds from the issuance of long-term debt                                       | 143,250                         |                   |                   |
| Cash dividends paid  | (10,902)                        | (8,561)           | (3,825)           |
| Repurchases of common stock  | (30,886)                        |                   | (1,887)           |
| Debt issuance costs  | (4,770)                         | (35)              |                   |
| Tax benefits on stock-based compensation   | 1,060                           | 1,161             | 265               |
| <b>Net cash provided by financing activities</b>                                   | <b>97,752</b>                   | <b>24,799</b>     | <b>6,424</b>      |
| Effect of exchange rate changes on cash  |                                 | 5                 |                   |
| <b>Net increase in cash and cash equivalents</b>                                   | <b>63,184</b>                   | <b>129,859</b>    | <b>45,506</b>     |
| Cash and cash equivalents at beginning of year                                     | 230,214                         | 100,355           | 54,849            |
| <b>Cash and cash equivalents at end of year</b>                                    | <b>\$ 293,398</b>               | <b>\$ 230,214</b> | <b>\$ 100,355</b> |
| <b>Supplemental disclosure of cash flow information:</b>                           |                                 |                   |                   |
| Cash paid for income taxes   | \$ 47,435                       | \$ 16,710         | \$ 3,451          |
| Cash paid for interest   | \$ 2,531                        | \$                | \$                |
| <b>Non-cash investing and financing activities:</b>                                |                                 |                   |                   |
| Unrealized (loss) gain on investments in available-for-sale securities, net of tax | \$ (506)                        | \$ 1,412          | \$ 250            |
| Common stock warrants issued for outside services                                  | \$                              | \$                | \$ 754            |
| Conversion of Series A preferred stock to common stock                             | \$ 1,170                        | \$ 9,121          | \$                |

See accompanying Notes to Consolidated Financial Statements.



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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

**Note 1 Nature of Operations**

The accompanying consolidated financial statements of HCI Group, Inc. ( HCI or the Company ), formerly known as Homeowners Choice, Inc., include the accounts of HCI, Homeowners Choice Property & Casualty Insurance Company, Inc. ( HCPCI ), HCI s principal operating subsidiary, and certain other insurance and non-insurance subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Through its subsidiaries, the Company is primarily engaged in the property and casualty insurance business. HCPCI is authorized to underwrite various homeowners property and casualty insurance products in the state of Florida. HCPCI s operations are supported by the following HCI subsidiaries:

Homeowners Choice Managers, Inc. ( HCM ) acts as managing general agent and provides marketing, underwriting, claims settlement, accounting and financial services to HCPCI;

Southern Administration, Inc. provides policy administration services to HCPCI; and

Claddaugh Casualty Insurance Company, Ltd. participates in the reinsurance program to HCPCI. As part of geographical expansion into other states, Homeowners Choice Assurance Company, Inc. ( HCA ) was organized to enter the Alabama property and casualty insurance market. HCA was approved and licensed by the Alabama Department of Insurance in August 2013. HCA did not commence underwriting during 2013.

In addition, while not material to the consolidated financial statements, HCI has various subsidiaries primarily engaged in the businesses of owning and leasing real estate, operating marina facilities and one restaurant and developing software.

The Company reports its operations under one business segment.

The Company obtained a majority of its policies through participation in a take-out program with Citizens Property Insurance Corporation ( Citizens ), a Florida state supported insurer. Policies were obtained in ten separate assumption transactions with Citizens that took place from July 2007 through November 2013. The Company is required to offer renewals on the policies acquired for a period of three years subsequent to the initial expiration of the assumed policies. During the first full year after assumption, such renewals are required to have rates that are equivalent to or less than the rates charged by Citizens. The Company s premium revenue since inception comes from these assumptions and one additional assumption from HomeWise Insurance Company ( HomeWise ) in November 2011 through which the Company acquired the Florida policies of HomeWise.



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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

**Note 2 Summary of Significant Accounting Policies**

***Basis of Presentation.*** The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ( U.S. GAAP ).

***Acquisition Accounting.*** The Company accounts for business combinations using the acquisition method, which requires an allocation of the purchase price of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. Goodwill represents the excess of the purchase price over the net tangible and intangible assets acquired. In the event the net assets acquired exceed the purchase price, the Company will recognize a gain on bargain purchase.

***Use of Estimates.*** The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as well as the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ materially from these estimates. Material estimates that are particularly susceptible to significant change in the near term are primarily related to losses and loss adjustment expenses, reinsurance with retrospective provisions, deferred income taxes, and stock-based compensation expense.

***Cash and Cash Equivalents.*** The Company considers all short-term highly liquid investments with original maturities of less than three months to be cash and cash equivalents. At December 31, 2013 and 2012, cash and cash equivalents consist of cash on deposit with financial institutions and securities brokerage firms and also includes a \$300 statutory deposit held by the State of Florida for the benefit of all policyholders.

***Investments.*** Investments consist of fixed-maturity and equity securities. Fixed-maturity securities include debt securities and redeemable preferred stock. Securities may be classified as either trading, held to maturity or available-for-sale. The Company's available-for-sale securities are carried at fair value. Temporary changes in the fair value of available-for-sale securities are excluded from net investment income and reported in stockholders' equity as a component of accumulated other comprehensive income, net of deferred income taxes. Realized investment gains and losses from sales are recorded on the trade date and are determined using the first-in first-out (FIFO) method. Investment income is recognized as earned and discounts or premiums arising from the purchase of debt securities are recognized in investment income using the interest method over the estimated remaining term of the security. Gains and losses from call redemptions and repayments are charged to investment income.

The Company reviews all securities for other-than-temporary impairment ( OTTI ) on a quarterly basis and more frequently when economic or market conditions warrant such review. When the fair value of any investment is lower than its cost, an assessment is made to determine whether the decline is temporary or other-than-temporary. If the decline is determined to be other-than-temporary, the investment is written down to fair value and an impairment charge is recognized in income in the period in which the Company makes such determination. For a debt security that the Company does not



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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

intend to sell nor is it more likely than not that the Company will be required to sell before recovery of its amortized cost, only the credit loss component of the impairment is recognized in income, while the impairment related to all other factors is recognized in other comprehensive income. The Company considers various factors in determining whether an individual security is other-than-temporarily impaired (see Note 4 Investments ).

Other investments consist primarily of real estate and the related assets purchased for investment purposes (see Note 4 Investments and Note 6 Business Acquisitions ). Real estate and the related depreciable assets are carried at cost, net of accumulated depreciation, which is included in net investment income and allocated over the estimated useful life of the asset using the straight-line method of depreciation. Real estate is evaluated for impairment when events or circumstances indicate the carrying value of the real estate may not be recoverable.

**Deferred policy acquisition costs.** Deferred policy acquisition costs ( DAC ) primarily represent commissions paid to outside agents at the time of collection of the policy premium and premium taxes and are amortized over the life of the related policy in relation to the amount of gross premiums earned.

The method followed in computing DAC limits the amount of such deferred costs to their estimated realizable value, which gives effect to the gross premium earned, related investment income, unpaid losses and LAE and certain other costs expected to be incurred as the premium is earned.

DAC is reviewed to determine if it is recoverable from future income, including investment income. If such costs are determined to be unrecoverable, they are expensed at the time of determination. The amount of DAC considered recoverable could be reduced in the near term if the estimates of total revenues discussed above are reduced or permanently impaired as a result of the disposition of a line of business. The amount of amortization of DAC could be revised in the near term if any of the estimates discussed above are revised.

**Property and Equipment.** Property and equipment is stated at cost less accumulated depreciation and amortization, which is included in other operating expenses. Depreciation is calculated on a straight-line basis over the estimated useful lives as follows: building 39 years; computer hardware and software 3 years; office and furniture equipment 3 to 7 years. Leasehold improvements are amortized over the shorter of the lease term or the asset s useful life. Expenditures for improvements are capitalized to the property accounts. Replacements and maintenance and repairs that do not improve or extend the life of the respective assets are expensed as incurred.

**Impairment of Long-Lived Assets.** Long-lived assets, such as property and equipment, are reviewed for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. The Company assesses the recoverability of long-lived assets by determining whether the assets can be recovered from undiscounted future cash flows. Recoverability of long-lived assets is dependent upon, among other things, the Company s ability to maintain profitability, so as to be able to meet its obligations when they become due. In the opinion of management, based upon current information and projections, long-lived assets will be recovered over the period of benefit.



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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

**Long-Term Debt.** Long-term debt is generally classified as a liability and carried at amortized cost, net of any discount. At issuance, a debt instrument with embedded features such as conversion and redemption options is evaluated to determine whether bifurcation and derivative accounting is applicable. If such instrument is not subject to derivative accounting, it is further evaluated to determine if the Company is required to separately account for the liability and equity components.

To determine the carrying values of the liability and equity components at issuance, the Company measures the fair value of a similar liability, including any embedded features other than the conversion option, and assigns such value to the liability component. The liability component's fair value is then subtracted from the initial proceeds to determine the carrying value of the debt instrument's equity component, which is included in additional paid-in capital.

Any embedded feature other than the conversion option is evaluated at issuance to determine if it is probable that such embedded feature will be exercised. If the Company concludes that the exercisability of that embedded feature is not probable, the embedded feature is considered to be nonsubstantive and would not impact the initial measurement and expected life of the debt instrument's liability component.

Transaction costs related to issuing a debt instrument that embodies both liability and equity components are allocated to the liability and equity components in proportion to the allocation of the proceeds and accounted for as debt issuance costs and equity issuance costs, respectively. Debt issuance costs are recognized in other assets. Both debt discount and deferred debt issuance costs are amortized to interest expense over the expected life of the debt instrument using the effective interest method. Equity issuance costs are a reduction to the proceeds allocated to the equity component.

**Prepaid Share Repurchase Forward Contract.** A prepaid share repurchase forward contract is generally a contract that allows the Company to buy from the counterparty a specified number of common shares at a specific time at a given forward price. The Company entered into such a contract in December 2013 and evaluated the characteristics of the forward contract to determine whether it met the definition of a derivative financial instrument pursuant to U.S. GAAP. The Company determined the forward contract is an equity contract on the Company's common shares requiring physical settlement in common shares of the Company. As such, the transaction is recognized as a component of stockholders' equity with a charge to additional paid-in capital equal to the prepayment amount, which represents the cash paid to the counterparty. There will be no recognition in earnings for changes in fair value in subsequent periods.

**Losses and Loss Adjustment Expenses.** Reserves for losses and loss adjustment expenses (LAE) are determined by establishing liabilities in amounts estimated to cover incurred losses and LAE. Such reserves are determined based on the assessment of claims reported and the development of pending claims. These reserves are based on individual case estimates for the reported losses and LAE and estimates of such amounts that are incurred but not reported. Changes in the estimated liability are charged or credited to income as the losses and LAE are settled.

The estimates of unpaid losses and LAE are subject to trends in claim severity and frequency and are continually reviewed. As part of the process, the Company reviews historical data and considers various factors, including known and anticipated regulatory and legal developments, changes in social attitudes, inflation and economic conditions. As experience develops and other data becomes available, these estimates are revised, as required, resulting in increases or decreases to the existing unpaid losses and LAE. Adjustments are reflected in the results of operations in the period in which they are made and the liabilities may deviate substantially from prior estimates.



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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

**Advance Premiums.** Premium payments received prior to the policy effective date are recorded as advance premiums. Once the policy is in force, the premiums are recorded as described under *Premium Revenue* below.

**Reinsurance.** In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. The Company contracts with a number of reinsurers to secure its annual reinsurance coverage, which generally becomes effective June 1<sup>st</sup> each year. The Company purchases reinsurance each year taking into consideration probable maximum losses and reinsurance market conditions. Amounts recoverable from reinsurers would be estimated in a manner consistent with the applicable reinsurance contract(s). Reinsurance premiums and reserves related to reinsured business are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums ceded to other companies have been reported as a reduction of gross premiums earned. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers.

Certain of the Company's current contracts contain retrospective provisions including terms and conditions that adjust premiums, increase the amount of future coverage, or result in profit commissions based on the loss experience under the contracts. In such cases, a with-and-without method is used to estimate the asset or liability amount to be recognized at each reporting date. The amount of the estimate is the difference between the net contract costs before and after the loss experience under the contract. Estimates related to premium adjustments, profit commissions and coverage changes are recognized in ceded premiums earned. These estimates are reviewed monthly based on the loss experience to date and as adjustments become necessary. Such adjustments are reflected in the Company's current operations.

**Premium Revenue.** Premium revenue is earned on a daily pro-rata basis over the term of the policies and is included in gross premiums earned. Unearned premiums represent the portion of the premium related to the unexpired policy term. The Company reviews its policy detail and establishes an allowance for any amount outstanding for more than 90 days. As of December 31, 2013 and 2012, there was no allowance required.

**Policy Fees.** Policy fees represent nonrefundable fees for insurance coverage, which are intended to reimburse a portion of the costs incurred to underwrite the policy. Effective October 1, 2013 on a prospective basis, policy fees are recognized ratably over the policy coverage period. Prior to October 1, 2013, the fees were recognized in income when the policy was written on the basis that the revenues were appropriately matched to the Company's incremental direct costs related to policy underwriting.

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**HCI GROUP, INC. AND SUBSIDIARIES**

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*(Amounts in thousands, except per share data, unless otherwise stated)*

**Florida Insurance Guaranty Association Assessments.** The Company may be assessed by the state guaranty association. The assessments are intended to be used for the payment of covered claims of insolvent insurance entities. The assessments are generally based on a percentage of premiums written during or following the year of insolvency. Liabilities are recognized when the assessments are probable to be imposed on the premiums on which they are expected to be based and the amounts can be reasonably estimated. The Company is permitted by Florida statutes to recover the entire amount of assessments from in-force and future policyholders through policy surcharges. U.S. GAAP provides that the Company should record an asset based on the amount of written or obligated-to-write premiums and limited to the amounts recoverable over the life of the in-force policies.

**Foreign Currency.** The functional currency of the Company's Indian subsidiary is the U.S. dollar. As such, the monetary assets and liabilities of this subsidiary are remeasured into U.S. dollars at the exchange rate in effect on the balance sheet date. Non-monetary assets and liabilities are remeasured using historical rates. Expenses recorded in the local currency are remeasured at the prevailing exchange rate. Exchange gains and losses resulting from these remeasurements are included in other operating expenses.

**Income Taxes.** The Company files consolidated federal and state income tax returns and allocates taxes among its wholly-owned subsidiaries in accordance with a written tax-allocation agreement approved by the Company's Board of Directors.

The Company accounts for income taxes in accordance with U.S. GAAP, resulting in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term "more likely than not" means a likelihood of more than fifty percent; the terms "examined" and "upon examination" also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than fifty percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. As of December 31, 2013, management is not aware of any uncertain tax positions that would have a material effect on the Company's consolidated financial statements.



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***Fair Value of Financial Instruments.*** The carrying amounts for the Company's cash and cash equivalents approximate their fair values at December 31, 2013 and 2012. Fair values for securities are based on the framework for measuring fair value established by U.S. GAAP (see Note 5 – Fair Value Measurements ).

***Stock-Based Compensation.*** The Company accounts for stock-based compensation under the fair value recognition provisions of U.S. GAAP which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock issuances based on estimated fair values. In accordance with U.S. GAAP, the fair value of stock-based awards is generally recognized as compensation expense over the requisite service period, which is defined as the period during which an employee is required to provide service in exchange for an award. The Company uses a straight-line attribution method for all grants that include only a service condition. The Company's restricted stock awards include service, market and performance conditions. As a result, restricted stock grants with market condition are expensed over the derived service period for each separately vesting tranche. For awards with performance conditions, the Company recognizes compensation expense over the requisite service period when it is probable that the performance condition will be achieved. Compensation expense related to all awards is included in other operating expense.

***Basic and diluted earnings per common share.*** Basic earnings per common share is computed by dividing net income attributable to common stockholders by the weighted-average number of common shares outstanding for the period. U.S. GAAP requires the inclusion of restricted stock as participating securities since holders of the Company's restricted stock have the right to share in dividends, if declared, equally with common stockholders. During periods of net income, participating securities are allocated a proportional share of net income determined by dividing total weighted-average participating securities by the sum of total weighted-average common shares and participating securities (the two-class method ). Diluted earnings per common share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted as well as participating equities. Potentially dilutive securities at December 31, 2013 consisted of stock options, the 7.0% Series A cumulative convertible preferred stock (see Note 15 – Stockholders' Equity ) and the 3.875% convertible senior notes (see Note 10 – Long-term debt ).

***Reclassifications.*** Certain reclassifications of prior year amounts have been made to conform to the current year presentation.

**Note 3 – Recent Accounting Pronouncements**

***Accounting Standards Update No. 2013-02.*** In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update No. 2013-02 ( ASU 2013-02 ), Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other

comprehensive income by the respective line items of net income but only if the amount reclassified is

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required to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required that provide additional detail about those amounts. ASU 2013-02 is effective prospectively for public entities for reporting periods beginning after December 15, 2012. Early adoption is permitted. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

**Note 4 Investments**

The Company holds investments in fixed-maturity securities as well as equity securities, which are classified as available-for-sale. At December 31, 2013 and 2012, the cost or amortized cost, gross unrealized gains and losses, and estimated fair value of the Company's available-for-sale securities by security type were as follows:

|   | <b>Cost or<br/>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gain</b> | <b>Gross<br/>Unrealized<br/>Loss</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---|---------------------------------------|--------------------------------------|--------------------------------------|-------------------------------------|
| <b><u>As of December 31, 2013</u></b>             |                                       |                                      |                                      |                                     |
| <i>Fixed-maturity securities</i>                  |                                       |                                      |                                      |                                     |
| U.S. Treasury and U.S. government agencies        | \$ 4,549                              | \$ 37                                | \$ (22)                              | \$ 4,564                            |
| Corporate bonds                                   | 25,139                                | 484                                  | (219)                                | 25,404                              |
| Commercial mortgage-backed securities             | 10,929                                | 499                                  | (96)                                 | 11,332                              |
| State, municipalities, and political subdivisions | 69,715                                | 917                                  | (181)                                | 70,451                              |
| Redeemable preferred stock                        | 406                                   | 5                                    | (11)                                 | 400                                 |
| Total   | 110,738                               | 1,942                                | (529)                                | 112,151                             |
| <i>Equity securities</i>                          | 17,248                                | 920                                  | (519)                                | 17,649                              |
| Total available-for-sale securities               | \$ 127,986                            | \$ 2,862                             | \$ (1,048)                           | \$ 129,800                          |
| <b><u>As of December 31, 2012</u></b>             |                                       |                                      |                                      |                                     |
| <i>Fixed-maturity securities</i>                  |                                       |                                      |                                      |                                     |
| U.S. Treasury and U.S. government agencies        | \$ 1,359                              | \$ 88                                | \$                                   | \$ 1,447                            |
| Corporate bonds                                   | 10,298                                | 572                                  | (10)                                 | 10,860                              |
| Commercial mortgage-backed securities             | 10,708                                | 936                                  |                                      | 11,644                              |
| State, municipalities, and political subdivisions | 10,152                                | 914                                  |                                      | 11,066                              |
| Redeemable preferred stock                        | 919                                   | 18                                   | (1)                                  | 936                                 |
| Total   | 33,436                                | 2,528                                | (11)                                 | 35,953                              |
| <i>Equity securities</i>                          | 8,756                                 | 303                                  | (183)                                | 8,876                               |

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|                                     |           |          |          |           |
|-------------------------------------|-----------|----------|----------|-----------|
| Total available-for-sale securities | \$ 42,192 | \$ 2,831 | \$ (194) | \$ 44,829 |
|-------------------------------------|-----------|----------|----------|-----------|

At December 31, 2013, fixed-maturity securities included \$105 of U.S. Treasury securities, which represents a statutory deposit held in trust with the Treasurer of Alabama.

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Expected maturities will differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without penalties. The scheduled contractual maturities of fixed-maturity securities at December 31, 2013 and 2012 are as follows:

|  | December 31,      |                            |                   |                            |
|--|-------------------|----------------------------|-------------------|----------------------------|
|  | 2013              | 2012                       | 2013              | 2012                       |
|  | Amortized<br>Cost | Estimated<br>Fair<br>Value | Amortized<br>Cost | Estimated<br>Fair<br>Value |
| <b>Available-for-sale</b>              |                   |                            |                   |                            |
| Due in one year or less                | \$ 2,366          | \$ 2,381                   | \$ 1,258          | \$ 1,264                   |
| Due after one year through five years  | 24,829            | 25,145                     | 8,387             | 8,728                      |
| Due after five years through ten years | 59,083            | 59,582                     | 8,045             | 8,612                      |
| Due after ten years                    | 13,531            | 13,711                     | 5,038             | 5,705                      |
| Commercial mortgage-backed securities  | 10,929            | 11,332                     | 10,708            | 11,644                     |
|  | \$ 110,738        | \$ 112,151                 | \$ 33,436         | \$ 35,953                  |

Proceeds received, and the gross realized gains and losses from sales of available-for-sale securities, for the years ended December 31, 2013, 2012 and 2011 were as follows:

|                                     | Proceeds  | Gross<br>Realized<br>Gains | Gross<br>Realized<br>Losses |
|-------------------------------------|-----------|----------------------------|-----------------------------|
| <u>Year ended December 31, 2013</u> |           |                            |                             |
| Fixed-maturity securities           | \$ 1,749  | \$ 92                      | \$ (4)                      |
| Equity securities                   | \$ 2,809  | \$ 155                     | \$ (163)                    |
| <u>Year ended December 31, 2012</u> |           |                            |                             |
| Fixed-maturity securities           | \$ 8,991  | \$ 421                     | \$ (6)                      |
| Equity securities                   | \$ 1,735  | \$ 91                      | \$ (230)                    |
| <u>Year ended December 31, 2011</u> |           |                            |                             |
| Fixed-maturity securities           | \$ 24,904 | \$ 545                     | \$ (96)                     |



|                    |          |        |          |
|--------------------|----------|--------|----------|
| Equity securities* | \$ 1,665 | \$ 121 | \$ (280) |
|--------------------|----------|--------|----------|

- \* Amounts reported for the year ended December 31, 2011 include the gross realized gains and losses from equity option contracts. During the year ended December 31, 2011, the Company entered into equity contracts for exchange-traded call and put options to meet certain investment objectives. With respect to these option contracts, the Company received net proceeds of \$89 and realized gains of \$49 during the year ended December 31, 2011. Such gains are included in the realized investment gains in the Consolidated Statements of Income. There were no open option contracts at December 31, 2011 or in subsequent years.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)****Other-than-temporary Impairment ( OTTI )***

The Company regularly reviews its individual investment securities for OTTI. The Company considers various factors in determining whether each individual security is other-than-temporarily impaired, including:

the financial condition and near-term prospects of the issuer, including any specific events that may affect its operations or income;

the length of time and the extent to which the market value of the security has been below its cost or amortized cost;

general market conditions and industry or sector specific factors;

nonpayment by the issuer of its contractually obligated interest and principal payments; and

the Company's intent and ability to hold the investment for a period of time sufficient to allow for the recovery of costs.

Securities with gross unrealized loss positions at December 31, 2013 and 2012, aggregated by investment category and length of time the individual securities have been in a continuous loss position, are as follows:

|   | Less Than Twelve Months     |                            | Twelve Months<br>or<br>Greater |                            | Total                       |                            |
|---|-----------------------------|----------------------------|--------------------------------|----------------------------|-----------------------------|----------------------------|
|   | Gross<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Loss    | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <b>As of December 31, 2013</b>                    |                             |                            |                                |                            |                             |                            |
| <i>Fixed-maturity securities</i>                  |                             |                            |                                |                            |                             |                            |
| U.S. treasury and U.S. government agencies        | \$ (22)                     | \$ 3,291                   | \$                             | \$                         | \$ (22)                     | \$ 3,291                   |
| Corporate bonds                                   | (212)                       | 9,502                      | (7)                            | 230                        | (219)                       | 9,732                      |
| Commercial mortgage-backed securities             | (96)                        | 2,179                      |                                |                            | (96)                        | 2,179                      |
| State, municipalities, and political subdivisions | (181)                       | 20,233                     |                                |                            | (181)                       | 20,233                     |

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|                                     |          |           |          |          |            |           |
|-------------------------------------|----------|-----------|----------|----------|------------|-----------|
| Redeemable preferred stock          | (11)     | 239       |          |          | (11)       | 239       |
| Total fixed-maturity securities     | (522)    | 35,444    | (7)      | 230      | (529)      | 35,674    |
| <i>Equity securities</i>            | (273)    | 10,742    | (246)    | 1,069    | (519)      | 11,811    |
| Total available-for-sale securities | \$ (795) | \$ 46,186 | \$ (253) | \$ 1,299 | \$ (1,048) | \$ 47,485 |

| As of December 31, 2012             | Twelve Months<br>or         |                            |                             |                            |                             |                            |
|-------------------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|----------------------------|
|                                     | Less Than Twelve Months     |                            | Greater                     |                            | Total                       |                            |
|                                     | Gross<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Loss | Estimated<br>Fair<br>Value |
| <i>Fixed-maturity securities</i>    |                             |                            |                             |                            |                             |                            |
| Corporate bonds                     | \$ (2)                      | \$ 444                     | \$ (8)                      | \$ 981                     | \$ (10)                     | \$ 1,425                   |
| Redeemable preferred stock          | (1)                         | 66                         |                             |                            | (1)                         | 66                         |
| Total fixed-maturity securities     | (3)                         | 510                        | (8)                         | 981                        | (11)                        | 1,491                      |
| <i>Equity securities</i>            | (136)                       | 3,019                      | (47)                        | 201                        | (183)                       | 3,220                      |
| Total available-for-sale securities | \$ (139)                    | \$ 3,529                   | \$ (55)                     | \$ 1,182                   | \$ (194)                    | \$ 4,711                   |

The Company believes there were no fundamental issues such as credit losses or other factors with respect to any of its available-for-sale securities. The unrealized losses on investments in fixed-maturity securities were caused by interest rate changes. It is expected that the securities would not be settled at a price less than the par value of the investments. In determining whether equity securities are

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other than temporarily impaired, the Company considers its intent and ability to hold a security for a period of time sufficient to allow for the recovery of cost. Because the decline in fair value is attributable to changes in interest rates or market conditions and not credit quality, and because the Company has the ability and intent to hold its available-for-sale investments until a market price recovery or maturity, the Company does not consider any of its investments to be other-than-temporarily impaired at December 31, 2013 and 2012.

**Other Investments**

Other investments consist primarily of the Company's real estate portfolio and the related assets of the marina and restaurant facilities acquired in 2012 and 2011. Operating activities related to the Company's real estate investments include leasing of office and retail space to tenants, wet and dry boat storage, a restaurant, and fuel services with respect to marina clients and recreational boaters.

Other investments consist of the following as of December 31, 2013 and 2012:

|   | <b>December 31,</b> |                  |
|---|---------------------|------------------|
|   | <b>2013</b>         | <b>2012</b>      |
| Land  | \$ 11,299           | \$ 10,993        |
| Land improvements                               | 1,351               | 1,326            |
| Building  | 3,022               | 2,869            |
| Other   | 1,262               | 1,238            |
| <b>Total, at cost</b>                           | <b>16,934</b>       | <b>16,426</b>    |
| Less: accumulated depreciation and amortization | (706)               | (339)            |
| <b>Other investments</b>                        | <b>\$ 16,228</b>    | <b>\$ 16,087</b> |

Depreciation and amortization expense for other investments was \$388 and \$279, respectively, for the years ended December 31, 2013 and 2012.

Net investment income (loss), by source, is summarized as follows:

|                                | <b>Years Ended December 31,</b> |             |             |
|--------------------------------|---------------------------------|-------------|-------------|
|                                | <b>2013</b>                     | <b>2012</b> | <b>2011</b> |
| Available-for-sale securities: |                                 |             |             |
| Fixed-maturity securities      | \$ 1,868                        | \$ 1,464    | \$ 1,339    |

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|                           |          |         |          |
|---------------------------|----------|---------|----------|
| Equity securities         | 499      | 492     | 247      |
| Investment expense        | (210)    | (150)   | (92)     |
| Time deposits             |          | 357     | 538      |
| Other investments         | (1,045)  | (1,334) | (96)     |
| Cash and cash equivalents | 357      | 151     | 125      |
|                           | \$ 1,469 | \$ 980  | \$ 2,061 |

At December 31, 2013, \$241,378 or 82.3% of the Company's cash and cash equivalents were deposited at three national banks and included \$22,252 in two custodial accounts. At December 31, 2012, deposits at two national banks totaled \$208,890, representing 90.7% of the Company's cash and cash equivalents and included \$22,957 in two custodial accounts.

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**Note 5 Fair Value Measurements**

The Company records and discloses certain financial assets at their estimated fair value but does not elect the fair value option for its long-term debt. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows:

Level 1 Unadjusted quoted prices in active markets for identical assets.

Level 2 Other inputs that are observable for the asset, either directly or indirectly.

Level 3 Inputs that are unobservable.

*Cash and cash equivalents:*

Cash and cash equivalents primarily consist of money-market funds. Their carrying value approximates fair value due to the short maturity and high liquidity of these funds.

*Available-for-sale securities:*

Estimated fair values of the Company's available-for-sale securities are determined in accordance with U.S. GAAP, using valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Fair values are generally measured using quoted prices in active markets for identical securities or other inputs that are observable either directly or indirectly, such as quoted prices for similar securities. In those instances where observable inputs are not available, fair values are measured using unobservable inputs. Unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use in pricing the security and are developed based on the best information available in the circumstances. Fair value estimates derived from unobservable inputs are significantly affected by the assumptions used, including the discount rates and the estimated amounts and timing of future cash flows. The derived fair value estimates cannot be substantiated by comparison to independent markets and are not necessarily indicative of the amounts that would be realized in a current market exchange.

The estimated fair values for securities that do not trade on a daily basis are determined by management, utilizing prices obtained from an independent pricing service and information provided by brokers. Management reviews the assumptions and methods utilized by the pricing service and then compares the relevant data and pricing to broker-provided data. The Company gains assurance of the overall reasonableness and consistent application of the assumptions and methodologies and compliance with accounting standards for fair value determination through ongoing monitoring of the reported fair values.

*Long-term debt:*

Long-term debt includes the Company's 8% senior notes due 2020 and 3.875% convertible senior notes due 2019. The 8% senior notes were initially sold to the public in January 2013 and trade on the New York Stock Exchange. The estimated fair value of the 8% senior notes is based on the closing market price on December 31, 2013. The 3.875% convertible senior notes were sold in a private offering completed December 30, 2013. The fair value of the 3.875% convertible senior notes is estimated using a discounted cash flow method that relies on Level 3 inputs.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)**Assets Measured at Estimated Fair Value on a Recurring Basis:*

The following table presents information about the Company's financial assets measured at estimated fair value on a recurring basis and the estimated fair value of its long-term debt that is reflected in the financial statements at carrying value. The table indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value as of December 31, 2013 and 2012:

|   | <b>Fair Value Measurements Using</b> |                  |                  |                   |
|---|--------------------------------------|------------------|------------------|-------------------|
|   | <b>(Level 1)</b>                     | <b>(Level 2)</b> | <b>(Level 3)</b> | <b>Total</b>      |
| <b><i>As of December 31, 2013</i></b>             |                                      |                  |                  |                   |
| <b>Financial Assets:</b>                          |                                      |                  |                  |                   |
| <i>Cash and cash equivalents</i>                  | \$ 293,398                           | \$               | \$               | \$ 293,398        |
| <i>Fixed-maturity securities:</i>                 |                                      |                  |                  |                   |
| U.S. Treasury and U.S. government agencies        | 3,520                                | 1,044            |                  | 4,564             |
| Corporate bonds                                   | 24,476                               | 928              |                  | 25,404            |
| Commercial mortgage-backed securities             |                                      | 11,332           |                  | 11,332            |
| State, municipalities, and political subdivisions |                                      | 70,451           |                  | 70,451            |
| Redeemable preferred stock                        | 400                                  |                  |                  | 400               |
| Total fixed-maturity securities                   | 28,396                               | 83,755           |                  | 112,151           |
| <i>Equity securities</i>                          | 17,649                               |                  |                  | 17,649            |
| Total available-for-sale securities               | 46,045                               | 83,755           |                  | 129,800           |
| <b>Total</b>                                      | <b>\$ 339,443</b>                    | <b>\$ 83,755</b> | <b>\$</b>        | <b>\$ 423,198</b> |
| <b>Financial Liabilities:</b>                     |                                      |                  |                  |                   |
| <i>Long-term debt:</i>                            |                                      |                  |                  |                   |
| 8% Senior notes                                   | \$                                   | \$ 43,390        | \$               | \$ 43,390         |
| 3.875% Convertible senior notes                   |                                      |                  | 86,630           | 86,630            |
| Total long-term debt                              | \$                                   | \$ 43,390        | \$ 86,630        | \$ 130,020        |

**Fair Value Measurements Using**



|   | (Level 1)         | (Level 2)        | (Level 3) | Total             |
|---|-------------------|------------------|-----------|-------------------|
| <b><u>As of December 31, 2012</u></b>             |                   |                  |           |                   |
| Financial Assets:                                 |                   |                  |           |                   |
| <i>Cash and cash equivalents</i>                  | \$ 230,214        | \$               | \$        | \$ 230,214        |
| <i>Fixed-maturity securities:</i>                 |                   |                  |           |                   |
| U.S. Treasury and U.S. government agencies        | 583               | 864              |           | 1,447             |
| Corporate bonds                                   | 10,860            |                  |           | 10,860            |
| Commercial mortgage-backed securities             |                   | 11,644           |           | 11,644            |
| State, municipalities, and political subdivisions | 11,066            |                  |           | 11,066            |
| Redeemable preferred stock                        | 936               |                  |           | 936               |
| Total fixed-maturity securities                   | 23,445            | 12,508           |           | 35,953            |
| <i>Equity securities</i>                          | 8,876             |                  |           | 8,876             |
| Total available-for-sale securities               | 32,321            | 12,508           |           | 44,829            |
| <b>Total</b>                                      | <b>\$ 262,535</b> | <b>\$ 12,508</b> | <b>\$</b> | <b>\$ 275,043</b> |

During the second quarter of 2013, the Company analyzed its investment portfolio and determined the municipal bonds, which were previously classified as Level 1, should be classified as Level 2 based on the inputs used to measure fair value and the level of market activity in those instruments. As such, transfers into Level 2 from Level 1 were \$10,684 during the year ended December 31, 2013. In addition, \$11,066 related to municipal bonds included in the table related to December 31, 2012 was transferred from Level 1 to Level 2. There were no transfers between Level 1, 2 or 3 during the year ended December 31, 2012.

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*(Amounts in thousands, except per share data, unless otherwise stated)*

*Assets Measured at Estimated Fair Value on a Nonrecurring Basis:*

The Company used a discounted cash flow method, which relies on Level 3 inputs in valuing goodwill at November 30, 2012. The Company did not identify the existence of goodwill and, as a result, goodwill was eliminated resulting in an impairment loss of \$161 for the year ended December 31, 2012.

With respect to the Company's business acquisition completed in 2012 (see Note 6 Business Acquisitions), all assets acquired, aside from cash which was valued based on Level 1 measurements, and liabilities assumed were valued based on Level 3 measurements. Property, plant and equipment acquired in April 2012 was valued based on an external appraisal using the sales comparison approach and other unobservable inputs. The carrying amounts of all other acquired assets and assumed liabilities approximated their fair values at the acquisition date.

**Note 6 Business Acquisitions**

Effective April 2, 2012, the Company, through its subsidiary, Greenleaf Capital LLP (formerly known as HCI Holdings LLC), acquired the assets and operations of John's Pass Marina, Inc. and Rice Family Holdings LLLP. The real estate consists primarily of ten acres of waterfront property and land improvements, which include a waterfront restaurant and a marina facility purchased for approximately \$8,157. Operating activities at acquisition include the restaurant as well as wet boat storage and fuel services with respect to marina clients and recreational boaters. The Treasure Island, Florida real estate and operations were acquired to further strengthen and diversify the Company's investment portfolio.

The fair value of the net assets acquired was approximately \$8,285, which exceeded the \$8,157 purchase price. As a result, the Company recognized a gain on bargain purchase in the amount of \$179 (\$119 net of tax), which is included in operations for the year ended December 31, 2012. The following table summarizes the Company's preliminary allocation of the net consideration paid to the fair value of the assets acquired, identifiable intangible assets acquired and liabilities assumed at April 2, 2012:

|  |          |
|--|----------|
| Property, plant and equipment                | \$ 8,280 |
| Other assets                                 | 56       |
| Cash   | 9        |
| Deferred tax liability                       | (60)     |
| Fair value of net assets acquired            | 8,285    |
| Gain on bargain purchase, net of tax of \$60 | (119)    |
| Cash consideration paid                      | \$ 8,166 |

For the year ended December 31, 2012, the effect of the acquisition was not material to the Company's consolidated financial statements and basic and diluted earnings per share and, as such, pro forma information has not been presented. The acquired assets are included in other investments of the consolidated balance sheet. For the year ended December 31, 2012, the acquired business contributed approximately \$4,553 in revenues and \$698 of net loss inclusive of the net gain on bargain purchase.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)***Note 7 Deferred Policy Acquisition Costs**

The following table summarizes the activity with respect to deferred policy acquisition costs:

|                                   | <b>December 31,</b> |             |
|-----------------------------------|---------------------|-------------|
|                                   | <b>2013</b>         | <b>2012</b> |
| Beginning balance                 | \$ 10,032           | \$ 12,321   |
| Policy acquisition costs deferred | 31,097              | 15,984      |
| Amortization                      | (27,058)            | (18,273)    |
| Ending balance                    | \$ 14,071           | \$ 10,032   |

Effective January 1, 2012, the Company adopted, on a prospective basis, the accounting standards update related to DAC. As such, the Company recognized additional amortization expense of \$1,210 with a corresponding decrease in deferred acquisition costs as of the date of adoption. This one-time adjustment reduced our net income for the year ended December 31, 2012 by approximately \$741, or \$0.08 earnings per diluted common share. In addition, certain direct marketing, compensation, and other administrative costs are no longer deferred. Rather, such costs are expensed as incurred beginning January 1, 2012.

The amount of policy acquisition costs amortized and included in policy acquisition and other underwriting expenses for the years ended December 31, 2013, 2012 and 2011 was \$27,058, \$18,273, and \$19,450, respectively.

**Note 8 Property and Equipment, net**

Property and equipment, net consists of the following:

|                                   | <b>December 31,</b> |             |
|-----------------------------------|---------------------|-------------|
|                                   | <b>2013</b>         | <b>2012</b> |
| Land                              | \$ 1,642            | \$ 1,241    |
| Building                          | 7,596               | 5,955       |
| Computer hardware and software    | 1,486               | 1,089       |
| Office furniture and equipment    | 1,407               | 1,131       |
| Tenant and leasehold improvements | 3,093               | 2,767       |
| Other                             | 629                 | 251         |
| Total, at cost                    | 15,853              | 12,434      |

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|   |           |           |
|---|-----------|-----------|
| Less: accumulated depreciation and amortization | (2,721)   | (1,581)   |
| Property and equipment, net                     | \$ 13,132 | \$ 10,853 |

On February 28, 2013, the Company purchased real estate in Ocala, Florida for a total purchase price of \$2,002. At acquisition, the real estate consisted of 1.6 acres of land and a vacant office building with rentable area of approximately 16,000 square feet. The facility is currently used by the Company's insurance operations and, also, as an alternative location in the event a catastrophic event impacts the Company's home office and other support operations.

Depreciation and amortization expense under property and equipment was \$1,151, \$848 and \$466, respectively, for the years ended December 31, 2013, 2012 and 2011.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)***Note 9 Other Assets**

The following table summarizes the Company's other assets:

|  | <b>December 31,</b> |                 |
|--|---------------------|-----------------|
|  | <b>2013</b>         | <b>2012</b>     |
| Benefits receivable related to retrospective reinsurance contracts | \$ 8,815            | \$              |
| Deferred costs related to retrospective reinsurance contracts      | 194                 |                 |
| Deferred offering costs on senior notes issued in 2013             | 4,305               | 127             |
| Prepaid expenses   | 771                 | 582             |
| Guarantee fund assessment recoverable                              |                     | 482             |
| Other  | 1,729               | 1,105           |
| <b>Total other assets</b>  | <b>\$ 15,814</b>    | <b>\$ 2,296</b> |

Other assets include a \$757 receivable related to the settlement of a 2009 revenue sharing agreement. The full settlement amount was received in January 2014.

**Note 10 Long-Term Debt**

The following table summarizes the Company's long-term debt:

|  | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2013</b>         | <b>2012</b> |
| 8% Senior Notes, due January 30, 2020                | \$ 40,250           | \$          |
| 3.875% Convertible Senior Notes, due March 15, 2019* | 86,682              |             |
| <b>Total long-term debt</b>                          | <b>\$ 126,932</b>   | <b>\$</b>   |

\* net carrying value

**8% Senior Notes**

On January 17, 2013, the Company completed the sale of unsecured senior notes in a public offering for an aggregate principal amount of \$35,000. In addition, effective January 25, 2013, the Company received an aggregate principal

amount of \$5,250 pursuant to the underwriters' exercise of the over-allotment option. The offering was made pursuant to the Company's effective registration statement on Form S-3, as amended (Registration Statement No. 333-185228) and the prospectus supplement dated January 10, 2013. The combined net proceeds were \$38,690 after underwriting and issuance costs of approximately \$1,560, \$1,525 of which was paid during the year ended December 31, 2013. The notes will mature on January 30, 2020 and bear interest at a fixed annual rate of 8% payable quarterly on January 30, April 30, July 30 and October 30, commencing on April 30, 2013. The notes may be redeemed, in whole or in part, at any time on and after January 30, 2016 upon not less than 30 or more than 60 days' notice. The redemption price will be equal to 100% of the principal amount redeemed plus accrued and unpaid interest. Additionally, the Company may, at any time, repurchase the senior notes at any price in the open market and may hold, resell or surrender the notes for cancellation.

The senior notes rank on parity with all of the Company's other existing and future senior unsecured obligations. In addition, to the extent the senior notes are unsecured, they also rank junior in right of payment to any secured debt that the Company may have outstanding to the extent of the value of the assets securing such debt.

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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

The senior notes contain customary restrictive covenants relating to merger, modification of the indenture, subordination, issuance of debt securities and sale of assets, the most significant of which include limitations with respect to certain designated subsidiaries on the incurrence of additional indebtedness or guarantees secured by any security interest on any shares of their capital stock. The senior note covenants also limit the Company's ability to sell or otherwise dispose of any shares of capital stock of such designated subsidiaries. The senior note covenants do not contain any restrictions on the Company's payment or declaration of dividends nor require a sinking fund to be established for the purpose of redemption.

Interest expense with respect to the senior notes was approximately \$3,228 for the year ended December 31, 2013 and included amortization of debt issuance costs of approximately \$159. The effective interest rate, taking into account the stated interest expense and amortization of debt issuance costs, approximates 8.7%.

**3.875% Convertible Senior Notes**

On December 11, 2013, the Company issued 3.875% Convertible Senior Notes (the "Convertible Notes") in a private offering for an aggregate principal amount of \$100,000. In addition, pursuant to the over-allotment option exercised by the underwriters, the Company received an aggregate principal amount of \$3,000 on December 30, 2013. The aggregate net proceeds of the Convertible Notes were \$99,514, after \$3,486 in related issuance and transaction costs of which \$3,245 had been paid as of December 31, 2013. The Convertible Notes rank equally in right of payment to the Company's existing and future unsecured and unsubordinated obligations. The Convertible Notes bear interest at a rate of 3.875% per year, payable semiannually in arrears on March 15 and September 15 of each year. The Convertible Notes will mature on March 15, 2019 unless repurchased or converted prior to such date. The Company may not redeem the Convertible Notes prior to maturity unless requested by the note holders under certain events specified in the indenture.

The Convertible Notes do not contain any financial or operating covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. The Convertible Notes provide no protection to the note holders in the event of a fundamental change or other corporate transaction involving the Company except those described in the indenture to the Convertible Notes. The Convertible Notes do not require a sinking fund to be established for the purpose of redemption.

In conjunction with the issuance of the Convertible Notes, the Company entered into a prepaid stock repurchase forward contract and used \$29,923 of the net proceeds from the Convertible Notes offering to repurchase the Company's common stock. See Note 15 "Stockholders' Equity" for the effect of the repurchase forward contract on earnings per share.

For the year ended December 31, 2013, interest expense applicable to the Convertible Notes included the contractual interest coupon, discount amortization and amortization of allocated issuance costs aggregating \$379, the amount of which included non-cash interest expense of \$164. The effective interest rate, taking into account both cash and non-cash components, approximates 8.3%. As of December 31, 2013, the remaining amortization period of the debt



discount was expected to be 5.2 years.

Table of Contents**HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)*

The following table summarizes information regarding the equity and liability components of the Convertible Notes:

|  | <b>December 31,</b> |             |
|--|---------------------|-------------|
|  | <b>2013</b>         | <b>2012</b> |
| Principal amount                                   | \$ 103,000          | \$          |
| Unamortized discount                               | (16,318)            |             |
| <b>Liability component net carrying value</b>      | <b>\$ 86,682</b>    | <b>\$</b>   |
| Equity component conversion, net of offering costs | \$ 15,900           | \$          |

*Embedded Conversion Feature*

Each \$1 of principal of the Convertible Notes will initially be convertible into 16.0090 shares of common stock, which is the equivalent of approximately \$62.47 per share, subject to adjustment upon the occurrence of specified events but will not be adjusted for any accrued and unpaid interest. The note holders may convert all or a portion of their Convertible Notes during specified periods as follows: (1) during any calendar quarter commencing after the calendar quarter ending on March 31, 2014, if the last reported sale price of the Company's common stock for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than 130% of the conversion price on each applicable trading day; (2) during the five business-day period after any ten consecutive trading-day period in which the trading price per \$1 principal amount of the Convertible Notes is less than 98% of the product of the last reported sale price and the conversion rate on each such trading day; (3) if specified corporate events, including a change in control, occur; or (4) at any time on or after January 1, 2019.

The note holders who elect to convert their Convertible Notes in connection with a fundamental change as described in the indenture will be entitled to a "make-whole" adjustment in the form of an increase in the conversion rate. Upon conversion, the Company has options to satisfy its conversion obligation by paying or delivering cash, shares of its common stock or a combination of cash and shares of its common stock. As of December 31, 2013, none of the conditions allowing the note holders to convert had been met.

The Company determined that the embedded conversion feature is not a derivative financial instrument but rather is required to be separately accounted for in equity because the Company may elect to settle the conversion option entirely or partially in cash. At issuance, the Company accounted for the equity component of the embedded conversion feature, which amounted to \$16,457, as a reduction in the carrying amount of the debt and an increase in additional paid-in capital. The increase in additional paid-in capital was offset in part by \$557 in related transaction costs.



**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)**Embedded Redemption Feature*

The note holders also have the right to require the Company to repurchase for cash all or any portion of the Convertible Notes at par prior to the maturity date should any of the fundamental change events described in the indenture occur. The Company concluded that the embedded redemption feature is not a derivative financial instrument and that it is not probable at issuance that any of the specified fundamental change events will occur. Therefore, the embedded redemption feature is not substantive and will not affect the expected life of the liability component.

**Note 11 Reinsurance**

The Company cedes a portion of its homeowners insurance exposure to other entities under catastrophe excess of loss reinsurance treaties. The Company remains liable with respect to claims payments in the event that any of the reinsurers are unable to meet their obligations under the reinsurance agreements. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. The Company contracts with a number of reinsurers to secure its annual reinsurance coverage, which generally becomes effective June 1<sup>st</sup> each year. The Company purchases reinsurance each year taking into consideration maximum projected losses and reinsurance market conditions.

The impact of the catastrophe excess of loss reinsurance treaties on premiums written and earned is as follows:

|                          | <b>Years Ended December 31,</b> |             |             |
|--------------------------|---------------------------------|-------------|-------------|
|                          | <b>2013</b>                     | <b>2012</b> | <b>2011</b> |
| <b>Premiums Written:</b> |                                 |             |             |
| Direct                   | \$ 315,695                      | \$ 205,839  | \$ 125,145  |
| Assumed                  | 39,076                          | 73,340      | 62,104      |
| Gross written            | 354,771                         | 279,179     | 187,249     |
| Ceded                    | (102,865)                       | (75,939)    | (55,525)    |
| Net premiums written     | \$ 251,906                      | \$ 203,240  | \$ 131,724  |
| <b>Premiums Earned:</b>  |                                 |             |             |
| Direct                   | \$ 273,037                      | \$ 168,937  | \$ 119,756  |
| Assumed                  | 64,076                          | 64,670      | 23,850      |

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|                     |            |            |           |
|---------------------|------------|------------|-----------|
| Gross earned        | 337,113    | 233,607    | 143,606   |
| Ceded               | (102,865)  | (75,939)   | (55,525)  |
| Net premiums earned | \$ 234,248 | \$ 157,668 | \$ 88,081 |

During the years ended December 31, 2013, 2012 and 2011, there were no recoveries pertaining to reinsurance contracts that were deducted from losses incurred. Prepaid reinsurance premiums related to 27 reinsurers at December 31, 2013 and 31 reinsurers at December 31, 2012, respectively. There were no amounts receivable with respect to reinsurers at December 31, 2013 and 2012. Thus, there were no concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums as of December 31, 2013 and 2012. The ratio of assumed premiums earned to net premiums earned for the years ended December 31, 2013, 2012 and 2011 were 27.4%, 41.0%, and 27.1%, respectively.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)*

Certain of the reinsurance contracts include retrospective provisions that adjust premiums, increase the amount of future coverage, or result in profit commissions in the event losses are minimal or zero. As a result, the Company's reported revenue for the year ended December 31, 2013 includes a net reduction in ceded premiums of \$12,521 comprised of various components of these adjustments, with \$9,009 and \$3,512 included in other assets and prepaid reinsurance premiums, respectively. See Reinsurance under Note 2 Summary of Significant Accounting Policies.

**Note 12 Losses and Loss Adjustment Expenses**

The liability for losses and loss adjustment expenses (LAE) is determined on an individual case basis for all claims reported. The liability also includes amounts for unallocated expenses, anticipated future claim development and losses incurred, but not reported.

Activity in the liability for losses and LAE is summarized as follows:

|                            | <b>Years Ended December 31,</b> |                 |                 |
|----------------------------|---------------------------------|-----------------|-----------------|
|                            | <b>2013</b>                     | <b>2012</b>     | <b>2011</b>     |
| Balance, beginning of year | \$ 41,168                       | \$ 27,424       | \$ 22,146       |
| Incurred related to:       |                                 |                 |                 |
| Current year               | 67,579                          | 66,425          | 43,613          |
| Prior years                | (2,456)                         | (115)           | 4,630           |
| <b>Total incurred</b>      | <b>65,123</b>                   | <b>66,310</b>   | <b>48,243</b>   |
| Paid related to:           |                                 |                 |                 |
| Current year               | (40,240)                        | (36,914)        | (26,132)        |
| Prior years                | (22,365)                        | (15,652)        | (16,833)        |
| <b>Total paid</b>          | <b>(62,605)</b>                 | <b>(52,566)</b> | <b>(42,965)</b> |
| Balance, end of year       | \$ 43,686                       | \$ 41,168       | \$ 27,424       |

The significant increase in the Company's liability for unpaid losses and LAE from 2011 to 2012 is primarily due to the increase in policy base as a result of the HomeWise assumption in November 2011 and the Citizens assumption in November 2012.

The establishment of loss reserves is an inherently uncertain process and changes in loss reserve estimates are expected as such estimates are subject to the outcome of future events. Changes in estimates, or differences between

estimates and amounts ultimately paid, are reflected in the operating results of the period during which such adjustments are made. During the year ended December 31, 2013, the Company experienced favorable development of \$2,456 with respect to its net unpaid losses and loss adjustment expenses established for the year ended December 31, 2012. Factors attributable to this favorable development include a lower severity of claims and reduced frequency of reported claims.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)*

The Company writes insurance in the state of Florida, which could be exposed to hurricanes or other natural catastrophes. The occurrence of a major catastrophe could have a significant effect on the Company's yearly results and cause a temporary disruption of the normal operations of the Company. However, the Company is unable to predict the frequency or severity of any such events that may occur in the near term or thereafter.

**Note 13 Income Taxes**

A summary of income tax expense is as follows:

|                             | <b>Years Ended December 31,</b> |                  |                 |
|-----------------------------|---------------------------------|------------------|-----------------|
|                             | <b>2013</b>                     | <b>2012</b>      | <b>2011</b>     |
| Current:                    |                                 |                  |                 |
| Federal                     | \$ 34,372                       | \$ 18,484        | \$ 7,220        |
| State                       | 5,844                           | 3,168            | 1,196           |
| Foreign                     | 118                             | 137              | 9               |
| <b>Total current taxes</b>  | <b>40,334</b>                   | <b>21,789</b>    | <b>8,425</b>    |
| Deferred:                   |                                 |                  |                 |
| Federal                     | 514                             | (1,986)          | (1,715)         |
| State                       | 43                              | (380)            | (269)           |
| <b>Total deferred taxes</b> | <b>557</b>                      | <b>(2,366)</b>   | <b>(1,984)</b>  |
| <b>Income tax expense</b>   | <b>\$ 40,891</b>                | <b>\$ 19,423</b> | <b>\$ 6,441</b> |

The reasons for the differences between the statutory Federal income tax rate and the effective tax rate are summarized as follows:

|  | <b>Years Ended December 31,</b> |          |               |          |               |          |
|--|---------------------------------|----------|---------------|----------|---------------|----------|
|  | <b>2013</b>                     |          | <b>2012</b>   |          | <b>2011</b>   |          |
|  | <b>Amount</b>                   | <b>%</b> | <b>Amount</b> | <b>%</b> | <b>Amount</b> | <b>%</b> |
| Income taxes at statutory rate                       | \$ 37,258                       | 35.0     | \$ 17,353     | 35.0     | \$ 5,785      | 35.0     |
| Increase (decrease) in income taxes resulting from : |                                 |          |               |          |               |          |
| State income taxes, net of federal tax benefits      | 3,802                           | 3.6      | 1,799         | 3.6      | 599           | 3.6      |
| Other  | (169)                           | (0.2)    | 271           | 0.6      | 57            | 0.7      |



|                    |           |      |           |      |          |      |
|--------------------|-----------|------|-----------|------|----------|------|
| Income tax expense | \$ 40,891 | 38.4 | \$ 19,423 | 39.2 | \$ 6,441 | 39.3 |
|--------------------|-----------|------|-----------|------|----------|------|

The Company has no uncertain tax positions or unrecognized tax benefits that, if recognized, would impact the effective income tax rate. The tax years ending December 31, 2012, 2011, and 2010 remain subject to examination by the Company's major taxing jurisdictions. The Company elected to classify, if any, interest and penalties arising from uncertain tax positions as income tax expense as permitted by current accounting standards. There have been no such interest or penalties during the three years ended December 31, 2013. In January 2014, the Company received notice from the Internal Revenue Service with respect to an examination of the Company's 2011 federal income tax return. The examination commenced in the first quarter of 2014. In February 2014, the Company received notice from the Florida Department of Revenue with respect to an examination of the Company's 2010, 2011 and 2012 state income tax returns. The examination commenced in the first quarter of 2014.

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Significant components of the Company's net deferred income tax (liabilities) assets are as follows:

|  | <b>December 31,</b> |              |
|--|---------------------|--------------|
|  | <b>2013</b>         | <b>2012</b>  |
| Deferred tax assets:                                 |                     |              |
| Unearned premiums                                    | \$ 8,829            | \$ 9,149     |
| Losses and loss adjustment expenses                  | 885                 | 1,116        |
| Organizational costs                                 | 95                  | 106          |
| Stock-based compensation                             | 2,026               | 394          |
| Accrued expenses                                     | 163                 | 40           |
| Deferred expenses                                    |                     | 72           |
| Unearned revenue                                     | 52                  |              |
| Bad debt reserve                                     | 5                   |              |
| <br>Total deferred tax assets                        | <br>12,055          | <br>10,877   |
| Deferred tax liabilities:                            |                     |              |
| Property and equipment                               | (1,748)             | (1,519)      |
| Deferred policy acquisition costs                    | (5,600)             | (4,027)      |
| Unrealized net gain on securities available-for-sale | (700)               | (1,017)      |
| Basis difference related to convertible senior notes | (6,295)             |              |
| Prepaid expenses                                     | (296)               | (225)        |
| Unearned brokerage income                            |                     | (105)        |
| Other  | (156)               | (136)        |
| <br>Total deferred tax liabilities                   | <br>(14,795)        | <br>(7,029)  |
| <br>Net deferred tax (liabilities) assets            | <br>\$ (2,740)      | <br>\$ 3,848 |

A valuation allowance is established if, based upon the relevant facts and circumstances, management believes any portion of the deferred tax assets will not be realized. Although realization of deferred income tax assets is not certain, management believes it is more likely than not that deferred tax assets will be realized. As a result, the Company did not have a valuation allowance established as of December 31, 2013 or 2012.

**Note 14 Earnings Per Share**

U.S. GAAP requires the Company to use the two-class method in computing basic earnings per share since holders of the Company's restricted stock have the right to share in dividends, if declared, equally with common stockholders. These participating securities effect the computation of both basic and diluted earnings per share during periods of net income.

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A summary of the numerator and denominator of the basic and fully diluted earnings per common share is presented below:

|   | <b>Income<br/>(Numerator)</b> | <b>Shares<br/>(Denominator)</b> | <b>Per Share<br/>Amount</b> |
|---|-------------------------------|---------------------------------|-----------------------------|
| <b>Year Ended December 31, 2013</b>                             |                               |                                 |                             |
| Net income  | \$ 65,562                     |                                 |                             |
| Less: Preferred stock dividends                                 | (104)                         |                                 |                             |
| Less: Income attributable to participating securities           | (3,213)                       |                                 |                             |
| <b>Basic Earnings Per Share:</b>                                |                               |                                 |                             |
| Income allocated to common stockholders                         | 62,245                        | 10,691                          | \$ 5.82                     |
| <b>Effect of Dilutive Securities:</b>                           |                               |                                 |                             |
| Stock options   |                               | 163                             |                             |
| Convertible preferred stock                                     | 104                           | 178                             |                             |
| Convertible senior notes  | 237                           | 90                              |                             |
| <b>Diluted Earnings Per Share:</b>                              |                               |                                 |                             |
| Income available to common stockholders and assumed conversions | \$ 62,586                     | 11,122                          | \$ 5.63                     |
| <b>Year Ended December 31, 2012</b>                             |                               |                                 |                             |
| Net income  | \$ 30,157                     |                                 |                             |
| Less: Preferred stock dividends                                 | (322)                         |                                 |                             |
| Less: Income attributable to participating securities           | (488)                         |                                 |                             |
| <b>Basic Earnings Per Share:</b>                                |                               |                                 |                             |
| Income available to common stockholders                         | 29,347                        | 8,497                           | \$ 3.45                     |
| <b>Effect of Dilutive Securities:</b>                           |                               |                                 |                             |
| Stock options   |                               | 220                             |                             |
| Convertible preferred stock                                     | 322                           | 655                             |                             |
| Warrants  |                               | 441                             |                             |
| <b>Diluted Earnings Per Share:</b>                              |                               |                                 |                             |
| Income available to common stockholders and assumed conversions | \$ 29,669                     | 9,813                           | \$ 3.02                     |

**Year Ended December 31, 2011**

|                                 |    |       |  |  |
|---------------------------------|----|-------|--|--|
| Net income                      | \$ | 9,964 |  |  |
| Less: Preferred stock dividends |    | (815) |  |  |

**Basic Earnings Per Share:**

|   |  |       |       |    |      |
|---|--|-------|-------|----|------|
| Income available to common stockholders |  | 9,149 | 6,132 | \$ | 1.49 |
|---|--|-------|-------|----|------|

**Effect of Dilutive Securities:**

|                             |  |     |     |  |  |
|-----------------------------|--|-----|-----|--|--|
| Stock options               |  |     | 352 |  |  |
| Convertible preferred stock |  | 815 | 961 |  |  |

**Diluted Earnings Per Share:**

|   |    |       |       |    |      |
|---|----|-------|-------|----|------|
| Income available to common stockholders and assumed conversions | \$ | 9,964 | 7,445 | \$ | 1.34 |
|---|----|-------|-------|----|------|

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*(Amounts in thousands, except per share data, unless otherwise stated)*

For the year ended December 31, 2011, 2,738,335 warrants to purchase 1,405,001 shares of common stock were excluded from the computation of diluted earnings per share because the exercise price of \$9.10 exceeded the average market price of the Company's common stock. On September 26, 2012, the Company's Board of Directors fixed October 27, 2012 as the cancellation date for the IPO warrants. As such, the record holders of the IPO warrants had no further rights under the warrants on and after October 27, 2012.

**Note 15 Stockholders' Equity**

***Common Stock***

In April 2012, the Company completed an underwritten public offering of its common stock, in which the Company sold an aggregate of 1,840,000 shares of its common stock at \$11.75 per share. The offering resulted in aggregate gross proceeds to the Company of \$21,620 and net proceeds of approximately \$20,082 after underwriting commissions and offering expenses.

***Series B Junior Participating Preferred Share Purchase Right***

On October 17, 2013, the Company's Board of Directors declared a dividend of one preferred share purchase right (Right) for each outstanding share of its common stock to shareholders of record at the close of business on November 15, 2013. Each Right entitles the common shareholder to purchase from the Company one one-hundredth of a share of Series B Junior Participating Preferred Stock, no par value, at a price of \$125.00 per one one-hundredth of such preferred share, subject to adjustment for certain events. The Right is intended to prevent any unsolicited takeover attempt that is unfair and unfavorable to the Company's shareholders. The Right will not interfere with any merger approved by the Company's Board of Directors.

The Right will not be exercisable until ten days following a public announcement that a person or group has acquired beneficial ownership of 10% or more of the Company's common stock or until ten business days after a person or group begins a tender or exchange offer that would result in beneficial ownership of 10% or more of the Company's common stock. The Right may be redeemed or exchanged by the Company for \$0.001 per Right at any time until the Right's expiration date on October 18, 2018.

***Prepaid Share Repurchase Forward Contract***

Effective December 11, 2013, in conjunction with the issuance of the Convertible Notes, the Company entered into a prepaid share repurchase forward contract (the forward contract) with Deutsche Bank AG, London Branch (the forward counterparty). Pursuant to the forward contract, the Company prepaid \$29,923 of the net proceeds of the offering to repurchase 622,751 shares of the Company's common stock under which the shares will be delivered over a settlement period in 2019. The forward contract is subject to early settlement, in whole or in part, at any time prior to the final settlement date at the option of the forward counterparty, as well as early settlement or settlement with alternative consideration in the event of certain corporate transactions. In the event the Company pays any cash

dividends on its common shares, the forward counterparty will pay an equivalent amount to the Company. The shares to be purchased under the prepaid forward contract will be treated as retired as of the effective date of the forward contract, but will remain outstanding for corporate law purposes, including for purposes of any future stockholders votes.

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The Company determined that the forward contract does not meet the characteristic of a derivative instrument and, as such, the transaction resulted in an immediate reduction of the outstanding shares used to calculate the weighted-average common shares outstanding for both basic and diluted earnings per share.

***Common Stock Warrants***

On September 26, 2012, the Company's Board of Directors fixed October 27, 2012 as the cancellation date for the warrants that were issued in 2008 in connection with the Company's initial public offering ( IPO ). As such, the record holders of the IPO warrants had no further rights under the warrants on and after October 27, 2012.

Effective December 31, 2012, 500,000 shares of common stock were issued upon the exercise of 1,000,000 warrants that were issued in 2011 in connection with the HomeWise assumption transaction. The fair value of the warrants issued in 2011 was estimated on the date of issuance using the following assumptions and the Black-Scholes option pricing model:

|  |         |
|--|---------|
| Expected dividend yield                            | 5.0%    |
| Expected volatility                                | 52%     |
| Risk-free interest rate                            | 0.23%   |
| Expected life (in years)                           | 1.75    |
| Per share grant date fair value of warrants issued | \$0.754 |

The \$754 aggregate value of the warrants was deferred and amortized over the expected policy term of the policies assumed in the transaction. During the years ended December 31, 2013, 2012 and 2011, the Company recognized \$241, \$463, and \$50 of expense, respectively, which is included in other operating expenses.

As of December 31, 2012, there were no warrants outstanding.

***Preferred Stock******Series A Cumulative Convertible Preferred Stock ( Series A Preferred )***

As of December 31, 2013, 110,684 shares of Series A Preferred remain outstanding. Dividends on the Series A Preferred are cumulative and accrue on the last day of each month, at an annual rate of 7.0% of the \$10 liquidation preference per share, equivalent to a fixed annual amount of \$0.70 per share. Accrued but unpaid dividends accumulate and earn additional dividends at 7.0%, compounded monthly.

Shareholders of Series A Preferred may convert all or any portion of their shares, at their option, at any time, into shares of the Company's common stock at an initial conversion rate of one share of common stock for each share of Series A Preferred, which is equivalent to an initial conversion price of \$10 per share; provided, however, that the



Company may terminate this conversion right on or after

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March 31, 2014, if for at least twenty trading days within any period of thirty consecutive trading days, the market price of the Company's common stock exceeds the conversion price of the Series A Preferred by more than 20% and the Company's common stock is then traded on specified exchange markets. Under certain circumstances, the Company will be required to adjust the conversion rate. The initial conversion price of \$10 per share is subject to proportionate adjustment in the event of stock splits, reverse stock splits, stock dividends, or similar changes with respect to the Company's common stock. On February 4, 2014, the Company announced its Board of Directors fixed April 1, 2014 as the cancellation date for the conversion rights on its 7% Series A Preferred. As such, the record holders of the Series A Preferred will no longer have conversion rights on and after April 1, 2014.

During the years ended December 31, 2013 and 2012, holders of 130,498 and 1,006,518 shares of Series A Preferred converted their Series A Preferred shares to 130,498 and 1,006,518 shares of common stock, respectively.

Shareholders of the Company's Series A Preferred at the close of business on the record date will be entitled to receive the dividends payable on their Series A Preferred shares on the corresponding dividend payment date notwithstanding the conversion of such Series A Preferred shares before the dividend payment date. The Series A Preferred terms include a provision requiring such shareholders to pay an amount equal to the amount of the dividend payable. That requirement has been permanently waived by the Company.

Holders of the Series A Preferred shares generally have no voting rights, except under limited circumstances, and holders are entitled to receive cumulative preferential dividends when and as declared by the Company's Board of Directors.

On December 24, 2013, the Company's Board of Directors declared a cash dividend on its Series A Preferred shares in the amount of \$0.05833 per share for each of the months of December 2013, January 2014, and February 2014. The December 2013 dividend was paid on January 27, 2014 to shareholders of record at the close of business on January 2, 2014. The January 2014 dividend was paid on February 27, 2014 to shareholders of record at the close of business on February 3, 2014. The February 2014 dividend is payable on March 27, 2014 to shareholders of record at the close of business on March 3, 2014.

*Series B Junior Participating Preferred Stock ( Series B Preferred )*

On October 17, 2013, in connection with the declaration of the Right dividends, the Company's Board of Directors established and fixed the rights and preferences of the Series B Preferred. Of the authorized shares, the Company designated 400,000 shares as Series B Preferred. Each Series B Preferred will be entitled to a minimum preferential quarterly dividend payment of \$1.00 per share but will be entitled to an aggregate dividend of 100 times the dividend declared per common share of the Company. In the event of liquidation, the holders of the Series B Preferred will be entitled to a minimum preferential liquidation payment of \$100 per share but will be entitled to an aggregate payment of 100 times the payment made per common share. Each Series B Preferred will have 100 votes per share, voting together as one class on all matters submitted to a vote of shareholders of the Company. Finally, in the event of any merger, consolidation or other transaction in which common shares are exchanged, each Series B Preferred will be

entitled to receive 100 times the amount received per common share. The aforementioned rights of Series B Preferred are protected by customary anti-dilution provisions. As of December 31, 2013, there were no Series B Preferred issued or outstanding.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)**Undesignated Preferred Stock*

The Company is authorized to issue up to an additional 18,100,000 shares of preferred stock, no par value. The authorized but unissued and undesignated preferred stock may be issued in one or more series and the shares of each series shall have such rights as determined by the Company's Board of Directors subject to the rights of the holders of the Series A Preferred and Series B Preferred.

**Note 16 Stock-Based Compensation***Incentive Plan*

The Company has outstanding stock-based awards granted under the 2007 Stock Option and Incentive Plan ( 2007 Plan ) and its 2012 Omnibus Incentive Plan (the 2012 Plan ) which are collectively called the Incentive Plan. The Company terminated the 2007 Plan in 2012 and thus there were no shares available for future grant under the 2007 Plan. With respect to the Incentive Plan which permits the granting of stock-based awards to employees, directors, consultants, and advisors of the Company, the aggregate number of shares of common stock reserved and available for issuance is 5,000,000. At December 31, 2013, there were 4,344,350 shares available for grant under the Incentive Plan.

*Stock Options*

Stock options granted and outstanding under the Incentive Plan vest over periods ranging from immediately vested to five years and are exercisable over the contractual term of ten years.

A summary of the stock option activity for the years ended December 31, 2013, 2012 and 2011 is as follows:

|                                  | Number of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|----------------------|--|---|---------------------------------|
| Outstanding at January 1, 2011   | 870,000              | \$ 2.71                                  | 6.5 years   | \$ 4,675                        |
| Issued                           | 30,000               | \$ 6.30                                  |   |                                 |
| Forfeited                        | (24,800)             | \$ 2.50                                  |   |                                 |
| Exercised                        | (255,200)            | \$ 2.50                                  |   |                                 |
| Outstanding at December 31, 2011 | 620,000              | \$ 2.97                                  | 5.7 years   | \$ 3,122                        |

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|                                  |           |    |      |           |           |
|----------------------------------|-----------|----|------|-----------|-----------|
| Exercised                        | (340,000) | \$ | 3.03 |           |           |
| Outstanding at December 31, 2012 | 280,000   | \$ | 2.91 | 4.9 years | \$ 5,007  |
| Outstanding at December 31, 2013 | 280,000   | \$ | 2.91 | 3.9 years | \$ 14,166 |
| Exercisable at December 31, 2013 | 270,000   | \$ | 2.78 | 3.8 years | \$ 13,694 |

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The following table summarizes information about options exercised, and the fair value of vested options for the years ended December 31, 2013, 2012 and 2011:

|                                      | <b>2013</b> | <b>2012</b> | <b>2011</b> |
|--------------------------------------|-------------|-------------|-------------|
| Options exercised                    |             | 340,000     | 255,200     |
| Intrinsic value of exercised options |             | \$ 3,648    | \$ 1,184    |
| Tax benefits realized                |             | \$ 1,161    | \$ 265      |
| Fair value of vested options         | \$ 17       | \$ 22       | \$ 76       |

During the year ended December 31, 2012, a total of 340,000 options were exercised of which 227,003 options were net settled by surrender of 72,592 shares. During the year ended December 31, 2011, a total of 255,200 options were exercised, which includes 30,000 options exercised and net settled by surrender of 9,317 shares. Compensation expense recognized for the years ended December 31, 2013, 2012 and 2011 totaled approximately \$19, \$68 and \$27, respectively, and is included in other operating expenses. At December 31, 2013 and 2012, there was approximately \$6 and \$25, respectively, of unrecognized compensation expense related to nonvested stock options granted under the plan. The Company expects to recognize the remaining compensation expense over a weighted-average period of 4 months. Deferred tax benefits related to stock options for the years ended December 31, 2013, 2012 and 2011 were immaterial.

No options were granted during the years ended December 31, 2013 and 2012. In 2011, 30,000 options were granted with fair value estimated on the date of grant using the following assumptions and the Black-Scholes option-pricing model:

|                          |       |
|--------------------------|-------|
| Expected dividend yield  | 6.3%  |
| Expected volatility      | 53.3% |
| Risk-free interest rate  | 0.97% |
| Expected life (in years) | 5.00  |

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)****Restricted Stock Awards***

From time to time, the Company has granted and may grant restricted stock awards to certain executive officers, other employees and nonemployee directors in connection with their service to the Company. The terms of the Company's outstanding restricted stock grants may include service, performance and market-based conditions. The fair value of the awards with market-based conditions is determined using a Monte Carlo simulation method, which calculates many potential outcomes for an award and then establishes fair value based on the most likely outcome. The determination of fair value with respect to the awards with only performance or service-based conditions is based on the value of the Company's stock on the grant date.

Information with respect to the activity of unvested restricted stock awards during the years ended December 31, 2013 and 2012 is as follows:

|                                | <b>Number of<br/>Restricted<br/>Stock<br/>Awards</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair<br/>Value</b> |
|--------------------------------|--|---|
| Nonvested at January 1, 2012   |  |   |
| Granted                        | 246,320  | \$ 14.54  |
| Nonvested at December 31, 2012 | 246,320  | \$ 14.54  |
| Granted                        | 612,000  | \$ 27.36  |
| Vested                         | (93,000)   |   |
| Forfeited                      | (29,670)   |   |
| Nonvested at December 31, 2013 | 735,650  | \$ 25.48  |

The Company recognized compensation expense, which is included in other operating expenses, of \$5,346 and \$776, respectively, for the years ended December 31, 2013 and 2012. At December 31, 2013 and 2012, there was approximately \$13,757 and \$2,805, respectively, of total unrecognized compensation expense related to nonvested restricted stock arrangements. The Company expects to recognize the remaining compensation expense over a weighted-average period of 27 months. The following table summarizes information about deferred tax benefits recognized related to restricted stock awards and the fair value of vested restricted stock for the years ended December 31, 2013 and 2012.

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|                                       | <b>2013</b> | <b>2012</b> |
|---------------------------------------|-------------|-------------|
| Deferred tax benefits recognized      | \$ 2,062    | \$ 299      |
| Fair value of vested restricted stock | \$ 1,133    | \$          |



**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)*

For the year ended December 31, 2013, the Company realized tax benefits of approximately \$277 related to cash dividends paid on restricted stock. The following presents assumptions used in a Monte Carlo simulation model to determine the fair value of the awards with market-based conditions:

|                              | <b>2013</b> |       | <b>2012</b> |       |
|------------------------------|-------------|-------|-------------|-------|
| Expected dividends per share | \$          | 0.90  | \$          | 0.80  |
| Expected volatility          | 41.5        | 51.6% | 36.7        | 50.0% |
| Risk-free interest rate      | 0.0         | 1.9%  | 0.1         | 1.2%  |
| Estimated cost of capital    | 9.3         | 10.3% | 11.9        | 12.1% |
| Expected life (in years)     | 4.00        | 6.00  |             | 6.00  |

**Note 17 Employee Benefit Plan**

Effective July 1, 2013, the Company implemented a 401(k) Safe Harbor Profit Sharing Plan ( 401(k) Plan ) that qualifies as a defined contribution plan under Section 401(k) of the Internal Revenue Code. Under the 401(k) Plan, participating employees are eligible for company matching and discretionary profit sharing contributions. Plan participants may elect to defer up to one hundred percent of their pre-tax gross wages, subject to annual limitations. The company matching contribution is limited to a maximum of four percent of the employee's annual salary or wage and is fully vested when contributed. Eligibility and vesting of the Company's discretionary profit sharing contribution is subject to the plan participant's years of service. During the year ended December 31, 2013, the Company contributed approximately \$183 in matching contributions, which is included in other operating expenses. There was no discretionary profit sharing contribution in 2013.

The Company also maintains benefit plans for its employees in India including a statutory post-employment benefit plan, or gratuity plan, providing defined, lump-sum benefits. The Company's liability for the gratuity plan reflects the undiscounted benefit obligation payable as of the balance sheet date, which was based upon the employees' salary and years of service. As of December 31, 2013, the amount accrued under the gratuity plan was \$6. In addition, the Company provides matching contributions with respect to two defined contribution plans; the Provident Fund and the Employees State Insurance Fund, both of which are available to qualifying employees in India. Expense recognized by the Company for all benefit plans in India was \$7 for the year ended December 31, 2013. No expense was recognized for any benefit plan in India for the years ended December 31, 2012 and 2011.

**Note 18 Commitments and Contingencies****Lease Commitments**

The Company currently leases 15,000 square feet of office space in Noida, India. The lease has an initial term of nine years commencing January 15, 2013 with monthly rental payments of approximately \$10 plus applicable service tax for the first year. Thereafter the monthly rental payment will increase by five percent every year. The Company is

entitled to terminate the lease 36 months after the commencement date by providing 3 months written notice to the landlord.

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Provided the lease is not early terminated, minimum future rental payments under operating leases after December 31, 2013 are as follows:

| <b>Year</b>                          | <b>Amount</b>   |
|--------------------------------------|-----------------|
| 2014                                 | \$ 114          |
| 2015                                 | 120             |
| 2016                                 | 126             |
| 2017                                 | 133             |
| 2018                                 | 139             |
| Thereafter                           | 461             |
| <b>Total minimum future payments</b> | <b>\$ 1,093</b> |

Rental expense under all facility leases was \$248, \$527 and \$239, respectively, during the years ended December 31, 2013, 2012 and 2011. Expense in 2012 and 2011 include amounts related to the Company's former corporate headquarters.

**Service Agreement**

In connection with the lease for new office space in India as described in the lease commitments above, the Company signed a long-term contract with the landlord to receive maintenance and facility services. The agreement has the same initial term of nine years with monthly payments of approximately \$2 plus applicable service tax for the first year. Thereafter the monthly payment will increase by five percent every year. The Company is also entitled to terminate the agreement 36 months after the commencement date by providing 3 months' written notice to the landlord.

Provided the agreement is not early terminated, minimum future payments under the service agreement after December 31, 2013 are as follows:

| <b>Year</b> | <b>Amount</b> |
|-------------|---------------|
| 2014        | \$ 21         |
| 2015        | 21            |
| 2016        | 23            |
| 2017        | 24            |
| 2018        | 25            |
| Thereafter  | 83            |

|                               |        |
|-------------------------------|--------|
| Total minimum future payments | \$ 197 |
|-------------------------------|--------|

Rental Income

The Company owns real estate that consists of 3.5 acres of land, a building with gross area of 122,000 square feet, and a four-level parking garage. This facility is used by the Company and its subsidiaries. In addition, the Company leases space to non-affiliates.

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Expected annual rental income due under non-cancellable operating leases for all properties and other investments owned at December 31, 2013 are as follows:

| <b>Year</b>  | <b>Amount</b>   |
|--------------|-----------------|
| 2014         | \$ 894          |
| 2015         | 618             |
| 2016         | 307             |
| 2017         | 27              |
| <b>Total</b> | <b>\$ 1,846</b> |

**Regulatory Assessments***a) Regular Insurance Assessments and Surcharges*

As a direct premium writer in the state of Florida, the Company is subject to mandatory assessments by Citizens and the Florida Hurricane Catastrophe Fund ( FHCF ). These assessments are paid based on a percentage of the Company's direct written premium by line of business. For the years ended December 31, 2013, 2012 and 2011, HCPCI paid assessments to FHCF amounting to \$4,103, \$2,517 and \$1,592, respectively. Additionally, HCPCI paid assessments to Citizens of \$3,156, \$1,936 and \$1,604, respectively, for the years ended December 31, 2013, 2012 and 2011. As of December 31, 2013, the Company's other liabilities included \$341 and \$444 payable to Citizens and FHCF, respectively. These assessments are recorded as a surcharge in premium billings to insureds. As of December 31, 2013, 2012 and 2011, the surcharge rates in effect for FHCF and Citizens were 1.3% and 1.0%, respectively, for each of these years.

*b) Guaranty Fund*

The Florida Insurance Guaranty Association may assess the Company to provide for the payment of covered claims of insolvent insurance entities. The assessments are generally based on a percentage of premiums written as of the end of the prior year in which the assessment is levied. Although the Company is permitted by Florida statutes to recover the entire amount of assessments from existing and future policyholders through policy surcharges, liabilities are recognized when the assessments are probable to be imposed on the premiums on which they are expected to be based and the amounts can be reasonably estimated. During 2012, the Company paid \$1,139 of guaranty fund assessments, \$482 of which was recognized as an asset recoverable from policyholders. The balance of \$657 was charged to expense in 2012. As approved by the Florida Office of Insurance Regulation, the Company had recovered a total of \$1,030 during 2013, \$434 of which was credited to the asset recoverable from policyholders. The amount recovered in excess of \$434 reduced the Company's 2013 policy acquisition and other underwriting expenses and was offset by a \$48 expense for the amount unrecovered from policyholders. At December 31, 2013, the Company has no liability

related to guaranty fund assessments.

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**Environmental Matters**

In connection with the acquisition of one of the Company's properties located in Pinellas County, Florida, the Company assumed the liability to complete a site assessment and remediation of environmental contamination that resulted from a petroleum release at the marina site in late 2009. At acquisition, the Company recorded a liability of \$150 with respect to the planned remedial action. Such liability was determined based on reasonably estimable costs of completing the actions defined in the work plan. As of December 31, 2013, a total of \$117 has been expended with respect to the site assessment and remediation and the remaining \$33 accrued at acquisition is included in other liabilities in the accompanying consolidated balance sheets. Even with the Company's best effort in estimating the costs, it is possible that additional testing and additional environmental monitoring and remediation will be required as part of the Company's ongoing discussions with the Florida Department of Health, the agency contracted by the Florida Department of Environmental Protection to administer cases of petroleum contamination in Pinellas County, in which case additional expenses could exceed the current estimated liability. However, based on information known at December 31, 2013, the Company does not expect that such additional expenses would have a material, adverse effect on the liquidity or financial condition of the Company.

**Premium Tax**

In September 2013, the Company received a notice of intent to make audit adjustments from the Pittsburgh Service Center of the Florida Department of Revenue ( FDR ) in connection with the FDR's audit of the Company's premium tax returns for the three-year period ended December 31, 2012. The auditor's proposed adjustments primarily relate to the disallowance of the entire amount of \$1,754 in Florida salary credits applicable to that period. The proposed adjustment, which includes interest through September 10, 2013, approximates \$1,913. Management has held discussions with the FDR staff and will continue working with the FDR to resolve this matter. The Company is confident in the merits of its position in claiming the Florida salary credits and intends to vigorously defend its position. As such, and based on the current status of and likelihood of final resolution, the Company has no amount accrued as of December 31, 2013 related to this contingency.

**Litigation**

The Company is party to claims and legal actions arising routinely in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material, adverse effect on the consolidated financial position or liquidity.

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The tables below summarize unaudited quarterly results of operations for 2013, 2012 and 2011.

|  | <b>Three Months Ended</b> |                 |                 |                 |
|--|---------------------------|-----------------|-----------------|-----------------|
|  | <b>03/31/13</b>           | <b>06/30/13</b> | <b>09/30/13</b> | <b>12/31/13</b> |
| Net premiums earned                                | \$ 60,551                 | \$ 57,335       | \$ 52,934       | \$ 63,428       |
| Total revenue                                      | 61,811                    | 59,333          | 54,692          | 65,252          |
| Losses and loss adjustment expenses                | 15,872                    | 17,414          | 14,489          | 17,348          |
| Policy acquisition and other underwriting expenses | 5,968                     | 7,308           | 8,887           | 9,456           |
| Interest expense                                   | 686                       | 846             | 847             | 1,228           |
| Total expenses                                     | 28,641                    | 32,926          | 33,048          | 40,020          |
| Income before income taxes                         | 33,170                    | 26,407          | 21,644          | 25,232          |
| Net income   | 20,387                    | 16,235          | 13,378          | 15,562          |
| Net income available to common stockholders        | 20,353                    | 16,203          | 13,356          | 15,546          |
| Earnings per share:                                |                           |                 |                 |                 |
| Basic  | \$ 1.87                   | \$ 1.44         | \$ 1.17         | \$ 1.36         |
| Diluted  | \$ 1.81                   | \$ 1.40         | \$ 1.13         | \$ 1.31         |

|  | <b>Three Months Ended</b> |                 |                 |                 |
|--|---------------------------|-----------------|-----------------|-----------------|
|  | <b>03/31/12</b>           | <b>06/30/12</b> | <b>09/30/12</b> | <b>12/31/12</b> |
| Net premiums earned                                | \$ 40,431                 | \$ 37,070       | \$ 30,603       | \$ 49,564       |
| Total revenue                                      | 41,652                    | 38,855          | 31,481          | 51,077          |
| Losses and loss adjustment expenses                | 19,168                    | 16,197          | 15,017          | 15,928          |
| Policy acquisition and other underwriting expenses | 6,836                     | 6,243           | 6,611           | 6,240           |
| Total expenses                                     | 30,271                    | 26,846          | 26,356          | 30,012          |
| Income before income taxes                         | 11,381                    | 12,009          | 5,125           | 21,065          |
| Net income   | 6,968                     | 7,262           | 2,826           | 13,101          |
| Net income available to common stockholders        | 6,787                     | 7,199           | 2,784           | 13,065          |
| Earnings per share:                                |                           |                 |                 |                 |
| Basic  | \$ 1.07                   | \$ 0.85         | \$ 0.30         | \$ 1.27         |
| Diluted  | \$ 0.88                   | \$ 0.74         | \$ 0.27         | \$ 1.19         |

|                                     | <b>Three Months Ended</b> |                 |                 |                 |
|-------------------------------------|---------------------------|-----------------|-----------------|-----------------|
|                                     | <b>03/31/11</b>           | <b>06/30/11</b> | <b>09/30/11</b> | <b>12/31/11</b> |
| Net premiums earned                 | \$ 16,674                 | \$ 17,044       | \$ 18,530       | \$ 35,833       |
| Total revenue                       | 18,049                    | 19,481          | 19,713          | 36,566          |
| Losses and loss adjustment expenses | 10,403                    | 10,523          | 10,431          | 16,886          |



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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Policy acquisition and other underwriting expenses | 4,263   | 2,780   | 3,529   | 7,557   |
| Total expenses                                     | 16,794  | 15,660  | 16,407  | 28,543  |
| Income before income taxes                         | 1,255   | 3,821   | 3,306   | 8,023   |
| Net income   | 793     | 2,301   | 2,074   | 4,796   |
| Net income available to common stockholders        | 776     | 1,940   | 1,856   | 4,578   |
| Earnings per share:                                |         |         |         |         |
| Basic  | \$ 0.13 | \$ 0.32 | \$ 0.30 | \$ 0.74 |
| Diluted  | \$ 0.12 | \$ 0.30 | \$ 0.27 | \$ 0.62 |

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**Note 20 Regulatory Requirements and Restrictions**

The following briefly describes certain requirements and restrictions regulated by the states or jurisdiction in which the Company's insurance subsidiaries are incorporated.

**Florida**

HCPCI, which is domiciled in Florida, prepares its statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the Florida Department of Financial Services, Office of Insurance Regulation (the FLOIR), which Florida utilizes for determining solvency under the Florida Insurance Code (the Code). The commissioner of the FLOIR has the right to permit other practices that may deviate from prescribed practices. Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in Florida. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from entity to entity within a state, and may change in the future.

The Code requires HCPCI to maintain capital and surplus equal to the greater of 10% of its liabilities or a statutory minimum as defined in the Code. At December 31, 2013, HCPCI is required to maintain a minimum capital and surplus of \$20,435.

U.S. GAAP differs in certain respects from the accounting practices prescribed or permitted by insurance regulatory authorities (statutory-basis). HCPCI's statutory-basis financial statements are presented on the basis of accounting practices prescribed or permitted by the FLOIR. The FLOIR has adopted the National Association of Insurance Commissioner's (NAIC) *Accounting Practices and Procedures Manual* as the basis of its statutory accounting practices. At December 31, 2013, 2012 and 2011, HCPCI's statutory-basis capital and surplus was \$116,900, \$69,800 and \$46,500, respectively. HCPCI had a statutory-basis net income of \$45,700 and \$13,200, respectively, for the years ended December 31, 2013 and 2012 and a statutory net loss of \$4,300 for the year ended December 31, 2011. Statutory-basis surplus differs from stockholders' equity reported in accordance with U.S. GAAP primarily because policy acquisition costs are expensed when incurred. In addition, the recognition of deferred tax assets is based on different recoverability assumptions.

Since inception, HCPCI has maintained a cash deposit with the Insurance Commissioner of the state of Florida, in the amount of \$300, to meet regulatory requirements.

Under Florida law, a domestic insurer may not pay any dividend or distribute cash or other property to its stockholders except out of that part of its available and accumulated capital and surplus funds which is derived from realized net operating profits on its business and net realized capital gains. A Florida domestic insurer may not make dividend payments or distributions to stockholders without prior approval of the FLOIR if the dividend or distribution would exceed the larger of (1) the lesser of (a) 10.0% of its capital surplus or (b) net income, not including realized capital gains, plus a two year carry forward, (2) 10.0% of capital surplus with dividends payable constrained to unassigned

funds minus 25% of unrealized capital gains or (3) the lesser of (a) 10.0% of capital surplus or (b) net investment income plus a three year carry forward with dividends payable constrained to unassigned funds minus 25% of unrealized capital gains.

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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

Alternatively, a Florida domestic insurer may pay a dividend or distribution without the prior written approval of the FLOIR (1) if the dividend is equal to or less than the greater of (a) 10.0% of the insurer's capital surplus as regards policyholders derived from realized net operating profits on its business and net realized capital gains or (b) the insurer's entire net operating profits and realized net capital gains derived during the immediately preceding calendar year, (2) the insurer will have policy holder capital surplus equal to or exceeding 115.0% of the minimum required statutory capital surplus after the dividend or distribution, (3) the insurer files a notice of the dividend or distribution with the FLOIR at least ten business days prior to the dividend payment or distribution and (4) the notice includes a certification by an officer of the insurer attesting that, after the payment of the dividend or distribution, the insurer will have at least 115% of required statutory capital surplus as to policyholders. Except as provided above, a Florida domiciled insurer may only pay a dividend or make a distribution (1) subject to prior approval by the FLOIR or (2) 30 days after the FLOIR has received notice of such dividend or distribution and has not disapproved it within such time.

HCPCI may make dividend payments for the year ended December 31, 2013. At December 31, 2012 and 2011, no dividends were available to be paid by HCPCI.

In addition, a Florida insurance company is required to adhere to prescribed premium-to-capital surplus ratios. Florida state law requires that the ratio of 90% of written premiums divided by surplus as to policyholders does not exceed 10 to 1 for gross written premiums or 4 to 1 for net written premiums. The ratio of gross and net written premium to surplus for the year ended December 31, 2013, was 2.76 to 1, and 1.68 to 1, respectively. The ratio of gross and net written premium to surplus for the year ended December 31, 2012, was 3.63 to 1, and 2.27 to 1, respectively. The ratio of gross and net written premium to surplus for the year ended December 31, 2011, was 3.65 to 1, and 2.44 to 1, respectively.

**Alabama**

Homeowners Choice Assurance Company, Inc. ( HCA ) is domiciled in Alabama and was organized in 2013. HCA is required to maintain minimum paid-in capital of \$500. In addition, HCA must maintain a minimum deposit in trust of \$100 with the Treasurer of Alabama. At December 31, 2013, HCA's statutory capital and surplus was \$1,969. Similar to HCPCI in Florida, HCA is required to file statutory-basis financial statements with the Alabama Department of Insurance, which has also adopted the NAIC *Accounting Practices and Procedures Manual* as the basis of its statutory accounting practices.

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**HCI GROUP, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

**Bermuda**

The Bermuda Monetary Authority requires Claddaugh to maintain minimum capital and surplus of \$2,000. At December 31, 2013, 2012 and 2011, Claddaugh's statutory capital and surplus was \$15,526, \$10,313 and \$8,801, respectively. Claddaugh's statutory net profit was \$4,164, \$4,818 and \$4,259, respectively, for the years ended December 31, 2013, 2012 and 2011. During the years ended December 31, 2013, 2012 and 2011, Claddaugh paid its parent, HCI, cash dividends of \$4,000, \$6,000 and \$0, respectively.

HCPCI and HCA are subject to risk-based capital ( RBC ) requirements as specified by the NAIC. Under those requirements, the amount of minimum capital and surplus maintained by a property and casualty insurance company is to be determined based on the various risks related to it. Pursuant to the RBC requirements, insurers having less statutory capital than required by the RBC calculation will be subject to varying degrees of regulatory action, depending on the level of capital inadequacy. At December 31, 2013, 2012 and 2011, the Company's insurance subsidiaries exceeded any applicable minimum risk-based capital requirements and no corrective actions have been required.

**Note 21 Related Party Transactions**

Claddaugh has one reinsurance treaty with Moksha Re SPC Ltd. and multiple capital partners ( Moksha ) whereby a portion of the business assumed from the Company's insurance subsidiary, HCPCI, is ceded by Claddaugh to Moksha. With respect to the period from June 1, 2013 through May 31, 2014, Moksha assumed approximately \$15,400 of the total covered exposure for approximately \$4,300 in premiums, a rate which management believes to be competitive with market rates available to Claddaugh. The \$4,300 premium was fully paid by Claddaugh on June 27, 2013. With respect to the 2012-2013 treaty year, which covers the period from June 1, 2012 through May 31, 2013, Moksha assumed \$13,800 of the total covered exposure for approximately \$4,000 in premiums. Moksha has deposited funds into a trust account to fully collateralize Moksha's exposure. Trust assets may be withdrawn by HCPCI, the trust beneficiary, in the event amounts are due under the 2013-2014 Moksha reinsurance agreement. Among the Moksha capital partner participants are the Company's chief executive officer, Paresh Patel, and certain of his immediate family members and Sanjay Madhu, one of the Company's non-employee directors.

Claddaugh also has reinsurance treaties with Oxbridge Reinsurance Limited ( Oxbridge ) whereby a portion of the business assumed from HCPCI is ceded by Claddaugh to Oxbridge. With respect to the period from June 1, 2013 through May 31, 2014, Oxbridge assumed \$10,100 of the total covered exposure for approximately \$4,900 in premiums, a rate which management believes to be competitive with market rates available to Claddaugh. The \$4,900 premium was fully paid by Claddaugh on July 9, 2013. Oxbridge has deposited funds into a trust account to fully collateralize Oxbridge's exposure. Trust assets may be withdrawn by HCPCI, the trust beneficiary, in the event amounts are due under the 2013-2014 Oxbridge reinsurance agreement. Among the Oxbridge capital partner participants are Paresh Patel, the Company's chief executive officer who is also chairman of the board of directors for Oxbridge, and members of his immediate family and Anthony Saravanos, president of Greenleaf Capital, the Company's real estate division. In addition, two of the Company's non-employee directors, including Sanjay Madhu

who serves as Oxbridge's president and chief executive officer, are investors in Oxbridge.

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**Notes to Consolidated Financial Statements**

*(Amounts in thousands, except per share data, unless otherwise stated)*

One of the Company's directors is a partner at a law firm that manages certain of the Company's corporate legal matters. Fees incurred with respect to this law firm for the years ended December 31, 2013, 2012 and 2011 were approximately \$450, \$335 and \$232, respectively.

During 2011 and 2012, the Company leased office space under an operating lease agreement with one director. The lease required annual base rental payments of approximately \$150. The lease was terminated in December 2012 and the total payments during 2012 and 2011 were \$179 and \$160, respectively.

Effective April 4, 2011, the Company repurchased and retired a total of 80,000 shares of the Company's common stock at a price of \$8.00 per share for a total cost of \$640. Such shares were repurchased under a stock purchase agreement with one of the Company's directors at a price below the \$8.20 market value of the Company's common stock on the date of the transaction. Such repurchases were not part of a publicly announced plan or program.

Effective June 27, 2011, the Company repurchased and retired a total of 85,200 shares of the Company's common stock at a price of \$6.50 per share for a total cost of \$554. Such shares were repurchased under a stock purchase agreement with the Company's former Chief Executive Officer at a price below the \$6.96 market value of the Company's common stock on the date of the transaction. Such repurchases were not part of a publicly announced plan or program.

One of the Company's directors received a consulting fee and software license fees for development and use of the Company's premium administration application software. Under this arrangement, the Company incurred a fee of \$181 for the year ended December 31, 2011. Effective June 30, 2011, all rights to the software license were assigned to the Company in exchange for a one-time payment of \$50. Such payment was made to the Company's director who developed and licensed the software to the Company. The related software license and consulting agreements were terminated coincident with this exchange.

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)***Note 22 Condensed Financial Information of HCI Group, Inc.**

Condensed financial information of HCI Group, Inc. is as follows:

**Balance Sheets**

|  | <b>December 31,</b> |                   |
|--|---------------------|-------------------|
|  | <b>2013</b>         | <b>2012</b>       |
| <b>Assets</b>  |                     |                   |
| Cash and cash equivalents                                    | \$ 87,715           | \$ 6,317          |
| Fixed-maturity securities, available for sale, at fair value | 56                  |                   |
| Equity securities, available for sale, at fair value         | 6,581               |                   |
| Investment in subsidiaries                                   | 214,958             | 140,563           |
| Property and equipment, net                                  | 1,119               | 1,293             |
| Income tax receivable  | 1,782               | 2,379             |
| Other assets   | 5,705               | 916               |
| <b>Total assets</b>  | <b>\$ 317,916</b>   | <b>\$ 151,468</b> |
| <b>Liabilities and Stockholders Equity</b>                   |                     |                   |
| Accrued expenses and other liabilities                       | \$ 1,863            | \$ 727            |
| Deferred income taxes, net                                   | 5,888               | 415               |
| Dividends payable  | 19                  | 42                |
| Long-term debt   | 126,932             |                   |
| Due to related parties                                       | 22,693              | 29,031            |
| <b>Total liabilities</b>                                     | <b>157,395</b>      | <b>30,215</b>     |
| <b>Total stockholders equity</b>                             | <b>160,521</b>      | <b>121,253</b>    |
| <b>Total liabilities and stockholders equity</b>             | <b>\$ 317,916</b>   | <b>\$ 151,468</b> |



**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)***Statements of Income**

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2013</b>                     | <b>2012</b> | <b>2011</b> |
| Net investment income   | \$ 84                           | \$ 8        | \$ 75       |
| Net realized loss on investments                                    | (2)                             |             |             |
| Other income  | 864                             | 144         | 66          |
| Interest expense  | (3,607)                         |             |             |
| Operating expenses  | (4,865)                         | (2,812)     | (2,428)     |
| Loss before income tax benefit and equity in income of subsidiaries | (7,526)                         | (2,660)     | (2,287)     |
| Income tax benefit  | 2,863                           | 750         | 846         |
| Net loss before equity in income of subsidiaries                    | (4,663)                         | (1,910)     | (1,441)     |
| Equity in income of subsidiaries                                    | 70,225                          | 32,067      | 11,405      |
| Net income  | \$ 65,562                       | \$ 30,157   | \$ 9,964    |

**Table of Contents****HCI GROUP, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements***(Amounts in thousands, except per share data, unless otherwise stated)***Statements of Cash Flows**

|   | <b>Years Ended December 31,</b> |                 |                 |
|---|---------------------------------|-----------------|-----------------|
|   | <b>2013</b>                     | <b>2012</b>     | <b>2011</b>     |
| <b>Cash flows from operating activities:</b>  |                                 |                 |                 |
| Net income  | \$ 65,562                       | \$ 30,157       | \$ 9,964        |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                                 |                 |                 |
| Stock-based compensation  | 2,362                           | 237             | 27              |
| Net realized investment loss  | 2                               |                 |                 |
| Depreciation and amortization   | 1,000                           | 788             | 214             |
| Equity in income of subsidiaries  | (70,225)                        | (32,067)        | (11,405)        |
| Deferred income taxes   | (914)                           | 763             | (83)            |
| Changes in operating assets and liabilities:  |                                 |                 |                 |
| Income taxes receivable   | 597                             | (2,379)         |                 |
| Other assets  | (1,001)                         | 84              | (348)           |
| Accrued expenses and other liabilities  | 1,136                           | (1,051)         | 1,488           |
| Income taxes payable  |                                 | (1,605)         | (1,957)         |
| Due to related parties  | (6,338)                         | 5,314           | 10,489          |
| <b>Net cash (used in) provided by operating activities</b>                                  | <b>(7,819)</b>                  | <b>241</b>      | <b>8,389</b>    |
| <b>Cash flows from investing activities:</b>  |                                 |                 |                 |
| Redemption of short-term investments  |                                 |                 | 2,074           |
| Purchase of fixed-maturity securities   | (64)                            |                 |                 |
| Purchase of equity securities   | (6,835)                         |                 |                 |
| Purchases of property and equipment   | (262)                           | (668)           | (900)           |
| Proceeds from sales of equity securities  | 361                             |                 |                 |
| Dividends received from subsidiary  | 4,000                           | 6,000           |                 |
| Investment in subsidiaries  | (5,735)                         | (24,056)        | (16,400)        |
| <b>Net cash used in investing activities</b>  | <b>(8,535)</b>                  | <b>(18,724)</b> | <b>(15,226)</b> |
| <b>Cash flows from financing activities:</b>  |                                 |                 |                 |
| Net proceeds from the issuance of common stock  |                                 | 20,082          |                 |
| Repurchases of common stock   | (30,886)                        |                 | (1,887)         |
| Dividends paid to stockholders  | (10,902)                        | (8,561)         | (3,827)         |
| Proceeds from exercise of stock options   |                                 | 283             | 564             |

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|  |           |          |        |
|--|-----------|----------|--------|
| Proceeds from exercise of stock warrants             |           | 11,869   |        |
| Proceeds from sale of preferred stock, net of costs  |           |          | 11,307 |
| Proceeds from issuance of long-term debt             | 143,250   |          |        |
| Debt issuance costs paid                             | (4,770)   | (35)     |        |
| Tax benefits on stock-based compensation             | 1,060     | 1,161    | 265    |
| Net cash provided by financing activities            | 97,752    | 24,799   | 6,422  |
| Net increase (decrease) in cash and cash equivalents | 81,398    | 6,316    | (415)  |
| Cash and cash equivalents at beginning of year       | 6,317     | 1        | 416    |
| Cash and cash equivalents at end of year             | \$ 87,715 | \$ 6,317 | \$ 1   |

