Palomar

First Quarter 2021 Earnings Call Transcript
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PRESENTATION

Operator

Good morning, and welcome to the Palomar Holdings, Inc. First Quarter 2021 Earnings Conference Call.

As a reminder, this conference call is being recorded.

I would now like to turn this call over to Mr. Chris Uchida, Chief Financial Officer. Please go ahead, sir. Thank you. You may begin.

Chris Uchida

Thank you Operator, and good morning everyone. We appreciate your participation in our First Quarter 2021 Earnings Call.

With me here today is Mac Armstrong, our Chairman, Chief Executive Officer and Founder. As a reminder, a telephonic replay of this call will be available on the Investor Relations section of our website through 11:59 p.m. Eastern Time on May 13, 2021.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about management's future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties, and other factors that could cause actual results to differ materially from those indicated or implied by such statements, including, but not limited to, risks and uncertainties relating to the COVID-19 pandemic. Such risks and other factors are set forth in our quarterly report on Form 10-Q filed with the Securities and Exchange Commission. We do not undertake any duty to update such forward looking statements.

Additionally, during today's call, we will discuss certain non-GAAP measures, which we believe are useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to their most comparable GAAP measure can be found in our earnings release.

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

Mac Armstrong

Thank you Chris, and good morning everyone.

Today, I will speak to our first quarter results at a high level and then discuss ongoing efforts to expand our business and drive profitable growth. From there I will turn the call back to Chris to discuss our financial results in more detail.

We had a strong first quarter. A quarter that generated solid financial results and a quarter that puts in position to reap the long-term benefits of several key initiatives. Highlights of Q1 I would like to emphasize are as follows:

First, our strong growth trajectory not only continued but actually accelerated as our gross written premium increased by 45% during the quarter. We grew broadly across both new and existing offerings, including Residential and Commercial Earthquake, Hawaii Hurricane and Inland Marine.

Second, our E&S carrier, PESIC, continues to be an important driver of growth for existing products and diversification into new lines of business. PESIC grew rapidly, approaching $100 million in annualized gross written premiums in just its second full quarter of operation.

Third, we continue to refine our underwriting and risk transfer strategy while benefiting from a sustained attractive pricing environment and dislocation in selected specialty insurance markets. We have spoken to this in great length on previous calls, but I would like to emphasize that we are committed to the ongoing improvement of Palomar across all dimensions of our business and believe that our actions and results this quarter reflect this commitment and capability.

Fourth, we remain focused on providing visibility into our earnings base and growth. I am very pleased that the $25 million of aggregate excess of loss reinsurance which we refer to as the Aggregate Cover what was secured in the first quarter will protect our balance sheet. Moreover, it establishes a floor for our earnings and return on equity. The Aggregate Cover is an actionable example of how we are proactively safeguarding our business and our results.

Finally, our business model and strategy are architected to support continued profitable growth by addressing several attractive tailwinds, and we remain confident that Palomar is still in the early stages of executing upon our long-term plan and the associated market opportunity. The launch of two new products and three carrier partnerships this quarter are prime examples of this dynamic.

Turning to our results in more detail, as previously mentioned, we delivered strong growth and premium growth of 45% in the first quarter. Overall, earthquake premium grew 44% while non-earthquake premium increased 46%. Our Commercial Earthquake products were up 96% in the quarter driven by rate and distribution partners accessing PESIC. Our residential earthquake products increased 25%. Other strong contributors were Inland Marine and Hawaii Hurricane with 315% and 128% year-over-year growth, respectively. We have seen very good conversion rates on the book of business in Hawaii we acquired in late 2020. Newer products like our Real Estate Errors and Omissions program continue to gain traction and scale.

Our commercial lines premium grew 58% year-over-year during the quarter, a function of PESIC's launch, new distribution sources, expanded geographic footprint, incremental product traction and sustained pricing increases. This growth is more impressive when factoring in the run-off off our admitted All Risk policies, nearly a 7% offset to our premium growth rate. The average rate increase on renewals during the first quarter for our Commercial Earthquake policies was 18% versus 15% in the fourth quarter of 2020, demonstrating an ongoing hard market. We are seeing the strongest rate increases in the small to mid-sized accounts, with larger accounts showing some deceleration after an earlier dislocation. Our other commercial lines of business are also seeing sustained rate increases; in certain cases like small account single-shot or Large TIV wood frame builders risk accounts increases are well north of 20%. We also continue to use terms and conditions as well as risk attachment points to optimize our risk adjusted returns. This has been most successful in our E&S All Risk program.

Our premium retention exceeded 90% across our book during the first quarter, excluding the run-off admitted All Risk business. Most notably, our Residential Earthquake, Commercial Earthquake and Hawaii Hurricane experienced retention rates above 93%. The continued high retention rates are a testament to the unique value our products offer insureds and distribution partners.

Turning to our E&S company, PESIC, our conviction remains as strong as ever about the added dimension it will provide our business. E&S premiums in the quarter were $23.8 million, which constitutes 16% sequential growth from the fourth quarter of 2020. This considerable growth was driven by a combination of existing property lines of business such as commercial earthquake and new lines such as layered and shared national property. In the quarter, we launched two new products Excess Liability and National Builder's Risk that, while not meaningful in gross written premium contribution in the quarter, had meaningful prospects. The Excess Liability program is PESIC's first casualty line of business; the Builder's Risk product follows our tested playbook of launching a line of business with an initial focus on regional, small commercial accounts and then extending into national, large account business with a well-respected partner. Both products are buttressed by strong quota share reinsurance programs to enable a successful and conservative launch. PESIC provides us with the flexibility to enter new market segments in an expedient fashion and serves as the logical extension of our commercial property franchise. Over the longer term, we can see our E&S carrier approaching the size of our admitted carrier as well as eventually housing the majority of our commercial business given its superior ability to address changing market conditions.

Insurance carrier partnerships continue to be a key growth driver for the Company. During the first quarter, we launched a partnership with Travelers involving the marketing of Palomar's Residential Earthquake products to Travelers' agency partners in Missouri, Indiana and Utah. This partnership further expands our retail distribution footprint in these states and will help diversify our earthquake business. Separately we consummated another earthquake partnership in the quarter that involved the assumption of an existing book of business via a reinsurance transaction. This new partnership provided a one-time transfer of $3.6 million of unearned premium at inception as we stepped into the risk. We believe these partnerships deliver sustainable long-term growth and serve as an important point of how Palomar can collaborate and add value to our partners.

As it pertains to reinsurance matters, there were two successful initiatives in the quarter worth highlighting: The Aggregate Cover and our Torrey Pines Re catastrophe bond. The aforementioned $25 million of aggregate excess of loss reinsurance limit, effective April 1st of this year, will provide supplemental coverage against losses from multiple severe catastrophe events including but not limited to earthquakes, hurricanes, convective storms and floods. The aggregate coverage triggers after $30 million of pre-tax losses from qualifying events, a threshold that could be reached through full retention losses or a number of smaller events. We believe this aggregate coverage further enhances visibility into our performance by providing a floor on our earnings and return on equity.

At the end of the quarter, we successfully issued a $400 million 144A catastrophe bond. Torrey Pines Re is a multi-year reinsurance arrangement, whereby Palomar is provided with indemnity-based reinsurance covering earthquake events. It fits seamlessly into our existing traditional CAT reinsurance program. We were pleased to upsize the offering from $300 million to $400 million at compelling pricing and believe the success of the issuance reflects investor confidence in our ability to underwrite Residential and Commercial Earthquake business effectively. The multi-year protection strengthens our robust reinsurance program, broadens our already extensive panel of reinsurance partners and benefits policyholders, distribution partners and investors by providing further transparency into our risk transfer program.

As we speak here today, we are essentially complete with our 6/1 reinsurance renewal. We are pleased with the outcome and greatly appreciate our reinsurers support and moreover their acceptance of the underwriting actions taken in 2020. We intend to release an 8-K with more detail once all allocations, terms and conditions are finalized. It is worth noting that the cost of the 6/1 reinsurance renewal is reflected in our revised 2021 guidance.

I want to take the opportunity to briefly touch on Winter Storm Uri. First, our thoughts remain with all of those impacted by the storm, and we'd like to reiterate our commitment to supporting our affected policyholders. While Chris will provide more detail regarding the event in his remarks, I will reiterate that due to our conservative and thoughtfully designed reinsurance structure for events of this nature, our net loss from the event is approximately $1 million, in line with what was signaled on our Q4 2020 earnings call. We are hyper-focused on protecting our balance sheet from both shock attritional losses and catastrophe losses. Uri proved to be the rare event where both risk transfer strategies were used simultaneously. I will also point out that Uri did not consume any of our aggregate cover.

Finally, in late March our Board approved a share repurchase program effective March 31, 2021. The plan authorizes the repurchase of up to $40 million of our outstanding shares over a two-year period. This program provides the Company with the flexibility to opportunistically deploy our capital in an accretive fashion when we believe our shares are underpriced and ultimately drive long-term value creation for our shareholders. That said, this program is opportunistic and does not diminish our growth strategy or our ambitions. We remain as energized as ever about the long-term opportunity ahead of us to bring unique products to market, to serve a growing footprint of customers, partners and team members, and to deliver attractive results to our investors for years to come.

With the strong start to the year, we are pleased to increase our adjusted net income guidance. For the full year 2021, we believe that our adjusted net income will be between $64 and $69 million. Additionally, we believe that with our Aggregate Cover in place, we have established a floor of approximately 10.5% for adjusted return on equity and $41 million for adjusted net income for the year.

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

Chris Uchida

Thank you, Mac.

Please note that during my portion, when referring to any "per share" figure, I am referring to "per diluted common share" as calculated using the treasury stock method. This methodology requires us to include common share equivalents, such as outstanding stock options during profitable periods and exclude them in periods when we incur a net loss. We have adjusted the calculations accordingly.

For the first quarter of 2021, our net income was $16.6 million, or $0.63 per share, compared to net income of $11.8 million, or $0.48 per share for the same quarter in 2020. Our adjusted net income was $19.3 million, or $0.73 per share, compared to adjusted net income of $12.3 million, or $0.50 per share for the same quarter of 2020.

Gross written premiums for the first quarter were $103.6 million, representing an increase of 44.9% compared to the prior year's first quarter. As Mac indicated, this growth was driven by a combination of new products, sustained rate increases, expansion of our E&S footprint, and extension of our distribution networks.

Ceded written premiums for the first quarter were $43.4 million, representing an increase of 47.0% compared to the prior year's first quarter. The increase was primarily due to increased XOL reinsurance related to exposure growth. Additionally, our XOL costs were impacted by the acceleration of expenses and charges related to the reinstatement of our reinsurance program. Separately, we had increased quota share cessions due to growth in the volume of written premiums subject to quota shares. Ceded written premiums as a percentage of gross written premiums increased to 41.9% for the three months ended March 31, 2021 from 41.3% for the three months ended March 31, 2020. This increase was primarily due to XOL charges and a higher proportion of our written premiums being subject to quota shares.

Net earned premiums for the first quarter were $47.1 million, an increase of 35.2% compared to the prior year's first quarter, due to the growth and earning of higher gross written premiums offset by the growth and earning of higher ceded written premiums that include the additional and accelerated reinsurance expense described earlier. For the first quarter of 2021, net earned premiums as a percentage of gross earned premiums were 51.5% compared to 53.6% in the first quarter of 2020.

We believe the ratio of net earned premiums to gross earned premiums is a better metric for assessing our business versus the ratio of net written premiums to gross written premiums. With the additional reinsurance expense impacting the first and second quarter of this year, we expect a similar gross earned premium ratio of 51.5% for the second quarter of 2021. After that, we expect this ratio to be around 52% to 54% on an annual basis, lower at the beginning of a new reinsurance placement and higher at the end with our expected growth in earned premium. The expected net earned premium ratio contemplates the new aggregate cover that provides increased protection and improved earnings visibility if we face multiple catastrophic events similar to what we saw in 2020.

Losses and loss adjustment expenses, or LAE, incurred in the first quarter were negative $4.4 million made up of $5.2 million of attritional losses offset by $2.4 million of favorable prior year development on 2020 catastrophe losses and Winter Storm Uri, which I will describe a little more later. The loss ratio for the quarter was negative 9.4%, including an attritional loss ratio of 11.1%, compared to a loss ratio of 5.4% during the same period last year comprised entirely of attritional losses. Non-catastrophe losses increased due to the growth of lines of business subject to attritional losses such as Specialty Homeowners, Flood and Inland Marine.

Due to Winter Storm Uri in the first quarter, we incurred additional reinsurance charges related to the reinstatement of our reinsurance program. For the first half of 2021, Uri will result in a net underwriting loss of approximately $1 million comprised of approximately $4 million of additional reinsurance expense in the first quarter of 2021 and a similar additional reinsurance expense in the second quarter of 2021 partially offset by the negative net loss in the first quarter of 2021.

Our expense ratio for the first quarter of 2021 was 69.8% compared to 58.2% in the first quarter of 2020. On an adjusted basis, our expense ratio was 62.7% for the quarter compared to 56.2% in the first quarter of 2021. The increased expense ratio was driven by additional reinsurance placements with increased ceded premiums and continued investments in PESIC.

Our acquisition expense as a percentage of gross earned premiums for the first quarter of 2021 was 21.2% compared to 20.1% in the first quarter of 2020. The ratio of other underwriting expenses, excluding adjustments, to gross earned premiums for the first quarter of 2021 was 11.9% compared to 11.2% in the first quarter of 2020.

Our combined ratio for the first quarter was 60.4% compared to 63.6% in the first quarter of 2020. Our adjusted combined ratio, which we believe is a better assessment of our efforts, was 53.3% during the first quarter compared to 61.6% in the prior year's first quarter.

Net investment income for the first quarter was $2.2 million, an increase of 9% compared to the prior year's first quarter. The year-over-year increase was primarily due to a higher average balance of investments held during the three months ended March 31, 2021, offset by lower yields on invested assets. We maintain a conservative investment strategy as our funds are generally invested in high quality securities, including government agency securities, asset and mortgage-backed securities, and municipal and corporate bonds with an average credit quality of A1/A.

Our fixed income investment portfolio book yield during the first quarter was 2.24% compared to 2.85% for the first quarter of 2020. The weighted average duration of our fixed-maturity investment portfolio, including cash equivalents, was 3.97 years at quarter end. Cash and invested assets totaled $436.7 million as compared to $320.4 million at March 31, 2020. For the first quarter, we recognized losses on investments in the consolidated statement of income of $739,000 compared to a $440,000 gain in the prior year's first quarter.

Our effective tax rate for the first quarter was 17.3% compared to 22.3% for the three months ended March 31, 2020. For the current quarter, our income tax rate differed from the statutory rate due to the tax impact of the permanent component of employee stock option exercises.

Our stockholders' equity was $376.4 million at March 31, 2021, compared to $363.7 at December 31, 2020. For the first quarter of 2021, annualized return on equity was 18.0% compared to 19.7% for the same period last year. Our annualized adjusted return on equity was 20.8% compared to 20.6% for the same period last year.

As Mac indicated, looking ahead to 2021, we are increasing our adjusted net income guidance to between $64 to $69 million. This adjusted net income guidance considers the impact of Winter Storm Uri in Texas. Additionally, with some of the moving pieces associated with Winter Storm Uri described earlier, we are providing adjusted net income guidance for the first half of 2021 of between $31.5 and $33 million. We believe the unique nature of Winter Storm Uri's impact to our financial results over multiple quarters necessitates this additional guidance. While we believe that this additional guidance is warranted in the current situation, we will only provide this type of information in the future if we believe the facts warrant such disclosure.

As of March 31, 2021, we had 26,198,960 diluted shares outstanding as calculated using the treasury stock method. We do not anticipate a material increase to this number during the year ahead.

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

Operator

Thank you.

Our first question comes from the line of Matt Carletti with JMP. You may proceed with your question.

Matt Carletti

Thanks. Good morning. Just a couple of numbers questions for me. First is on the current year attritional loss ratio. Is there anything to note in that in terms of one timers one way or the other, or is that a good starting point to think about where the business is today, and I presume as we go forward and some of the newer products grow at a faster rate than some of the earthquake products slow drift higher?

Mac Armstrong

Hey, Matt, this is Mac, good to hear from you. Chris will chime in and have some thoughts on this as well. But what I would provide is when you look at the attritional loss ratio there, a few things that I believe are worth highlighting. First is exactly what you touched upon in that it is a function of the growth in certain lines of business that have exposure to attritional loss. I'll pick on inland marine, for instance. It grew 315%. It has some attritional loss to it. Now mind you, it's performing in line with expectation. But as that grows at a disproportionate level or over-indexes the rest of the book, that will move the loss ratio up.

Similarly, that's what you would see even with the new E&S all risk line of business, which is one of the big drivers of the E&S growth. That does have attritional loss. That outpaces the growth of maybe a residential earthquake, for instance, or you're going to see that attritional loss tick up.

The other point that I would make, though, is we guided folks towards a slow increase of that attritional loss ratio. It was 11% in this quarter. That number is somewhat obfuscated by how Uri is being accounted for with reinstatement premiums, reinsurance expense, as opposed to being captured in the loss ratio that reduced our net premiums earned. If you normalize the 11% attritional loss ratio, it's closer to 10%, which is just a subtle increase from the fourth quarter.

That's what I would point out, but I'm sure Chris has a few things to offer.

Chris Uchida

Yes. Thanks, Mac. I think you described it well, obviously. When you look at it, compared what we've talked about before, we have indicated when you think about the end of 2020, the overall loss ratio for the year was about 8.5%. We had indicated that we do expect that to tick up. I think we indicated in probably about 2 to 3 points for 2021. When you think about that, that's right in line with that, especially when you think about the high ceded premium that makes the ratio a little bit higher. You could adjust that out and think of it as more as 10%.

I think seasonally also, the first quarter is a little bit of a higher loss ratio month for us just naturally because of some of the exposure that we have in Texas and other states that have some tour hail or even with events similar to Uri and some of our other lines had higher exposure with whether it'd be Motor Truck Cargo that was impacted by some of the icy roads that were out there. Just a little bit higher in nature, but overall, nothing that I would say is surprising and in line with what we would expect to see based on the growth of lines we talked about, and then also some of the indications we gave to the market after a following the year-end results.

Mac Armstrong

Yes, just to piggyback on that seasonality point. Even like you look at a line like flood for us, where we write flood states like California and even in Hawaii, there is some seasonality to it. We see a little bit higher loss in the first quarter of the year than we do the rest of the year, certainly in a state like California.

Matt Carletti

Okay, great. That's helpful. Then kind of a follow up there, just as you've got that extra 4 million of ceded premium that will also impact Q2. All else equal, that tend to look more like an 11 in Q2 as well, correct? Obviously, I understand the seasonality can be different and mix of business different and so forth. But all else equal, that will repeat itself in 2Q.

Mac Armstrong

Yes, that's correct. Yes, there will be incremental reinsurance expense associated with Uri in the second quarter. That's exactly right.

Matt Carletti

All right. Great. Wonderful. Thank you very much for the color. Appreciate it.

Operator

Our next question comes from the line of David Motemaden with Evercore ISI. You may proceed with your question.

David Motemaden

Hi. Thanks. Good morning. I just had a question. Good to see growth reaccelerate this quarter. I guess I'm wondering, was there anything one-off in the growth that you would call out, or is this a good indication of what we should expect to see from a growth standpoint over the course of the rest of the year?

Mac Armstrong

Hey, Dave. Great question. We were thrilled to see the growth, and we expected it. We touched upon it at the end of Q4 earnings call that we saw very good momentum in the business, and it did manifest itself in Q1 and we think it's going to manifest itself through the rest of the year.

To your question on one-off, as I mentioned in my remarks, there was $3.6 million of premium that was associated with the earthquake book, both commercial and residential, for the partnership that we stepped into that you could argue as one-off, but at the same time there also was around seven points, call it $7 million of premium that was wound down from the all risk book, so net-net it washes.

I guess the best way to describe it is, when it's all said and done in this quarter, there's nothing really one-off because there was one thing to the good and one thing that's probably 2X that to the bad. We feel very good about the growth in this quarter and how we're positioned for Q2 and beyond.

David Motemaden

Got it. Thanks for that. Just on the all risk book that's winding down the 7 million of headwind this quarter, the seven points, is that going to remain around that level over the course of the year? Is that book non-renewals, or are there some chunkier pieces that are rolling off in subsequent quarters?

Mac Armstrong

I think that should be a good rule of thumb for the year. It will probably be less pronounced in Q4 because that's when we started to non-renew. But the majority of the policies will be coming off to the October timeframe. But I think that is a good rule of thumb.

Now, the one thing that we have going for us is that the national account all risk business, the layered and shared all risk business that we're doing in concert with headwinds growing. It's growing nicely. It's getting great returns. It's hitting our metrics, if not exceeding them, from an average annual loss and a PML for premium standpoint. We're encouraged with that. So, that mitigates that decline, and we will continue to drive growth beyond 2021. But I do think that that seven points of headwind associated with the winddown of the admitted book that we'll see over the course of certainly the next Q2 and Q3 and might be a little bit less in Q4.

David Motemaden

Got it. That makes sense. I guess on the other side. Obviously, the E&S book continues to ramp up. I guess maybe could you just quantify, it sounds like 25 million this quarter of gross premiums. I believe it was 21 million last quarter, so ramping up on an annualized basis by a decent amount. I guess, have we reached—do you expect to see a continued sequential acceleration in that, or we kind of hit the capacity now of where you think you can? Obviously, still a very good year-over-year growth, but maybe it slows down a bit more sequentially.

Mac Armstrong

Yes, Dave, I don't want to give guidance on sequential growth, but what I would say is there's very good momentum in the E&S Company right now, and it's coming from commercial earthquake, it's coming from national property accounts. But there also new programs that we launched in the second quarter, as I said, that were not meaningful contributors. In particular, a builder's risk partnership for national builder's risk accounts, our excess liability program. All of those have great potential, terrific market conditions to be out participating in or capturing—taking advantage of rather. Great distribution partners that can drive production, some cases, an existing book of business that we can slot into.

I would say there's terrific momentum in the lines that we've launched in Q3 and Q4 of '20. There's a lot of terrific potential in products that are just getting off the ground in Q1, and then lastly, we're not done. There are several more that are in various stages of R&D, so to speak. I think you'll see more products in the E&S market come online from us this year, which gives us the conviction to say that, in time, the majority of our commercial business could be E&S, as well as it has the potential to be the same size as the admitted Company.

David Motemaden

Got it. Great. Thanks for the color.

Operator

Our next question comes from the line of Paul Newsome with Piper Sandler. You may proceed with your question.

Paul Newsome

Congratulations on the quarter. I just had one remaining question, and I apologize this may be just a little confused. But I know your loss ratio is an amazing thing. I think I see it once in my career. But the most interesting thing is this current year was a negative number, not just the property you talked about. Can you talk about how this likely works from an accounting perspective, how you have a—how you get to a negative number for the current period or is there something else going on there?

Chris Uchida

Hey, Paul, it's Chris. Let me respond to your question. Yes, it's a good thing. You pointed it out. Yes, it is a little bit of something that is unusual to see. I think usually it just naturally happen that way based on the way that our reinsurance is structured. Obviously, we've talked about this before. We use quota share reinsurance for a lot of our attritional lines of business, and then we buffer that with excess of loss. This just happened to be an attritional loss that went into our CAT tower as well. These contracts or these reinsurance relationships do not work to the benefit of each other. I think that's one thing to point out when we look at it. We think of the negative loss as being offset by the ceded premium that is related to reinstatement of the reinsurance layers.

I think when you look at it in Q4, that was about 4 million. It's going to be a similar amount in Q2 just because of the way the reinsurance is expensed through ceded premium. If we were to combine those numbers, I think we talked about it on the prepared remarks, we think that is a negative $1 million.

For us, it's really the accounting treatment shows it in two different lines, but we think of it as a combined loss. One example or maybe an analogy that we think of is, think of this as we use our reinsurance structure with a reinstatement premium function to it so that when the event happened, we were able to recover 100% of the loss and then offset that with reinstatement premium. We could have also structured this with a co-participation, where instead of recovering 100%, we only recovered the net amount.

In that scenario, our loss would've been about the same, a million-dollar loss. You just would have seen it all through the loss line versus us we use reinstatement premiums for our structure, and so you can see it in the ceded premium and in the loss number. That's the, I'll call it a little bit of a nuts and bolts about the accounting treatment and why it's in different lines and why it's showing up all over multiple quarters. That also reiterates the reason why on the call we gave half or a full—the first half year guidance because with the ups and downs caused by that reinsurance charge, we want to make sure the market had a better view of how we're thinking about the first half of 2021 impacted by those reinsurance charges.

Mac Armstrong

Yes, Chris described it well, Paul. Ultimately, it is a negative number in that loss, but it ultimately ends up collectively being, when you factor in reinstatements and the like, a loss of $1 million, a positive loss, so to speak.

Paul Newsome

That makes a ton of sense. Thank you. That was very helpful. I appreciate it.

Operator

Our next question comes from the line of Mark Hughes with Truist. You may proceed with your question.

Mark Hughes

Yes, thank you. Good afternoon or good morning. When you talk about capital, kind of where you said, obviously, PESIC is ramping up pretty quickly. How much more runway do you have with your current balance sheet?

Mac Armstrong

Yes, Mark, this is Mac. It's a very good question. What I would say is, we have ample capital to support the growth that we have in front of us. We right now are in and around a 0.5 net premiums earned to surplus ratio. Our long-term target on that is 0.9 to 1. In fact, that target could actually be moving up somewhat because of the complexion of the book, as we write some casualty business that has a longer tail to it. As a result, we think we are adequately capitalized and then some to go execute on the plan that we've put in place.

I also think it's the impetus behind why we authorized the stock buyback because we think that we can be opportunistic in how we deploy capital. We can be opportunistic to go out and do an acquisition like we did in Hawaii and acquire a book of business, which we're doing an excellent job of bringing onto our paper. We could go out and buy back our stock and acquire our currency at what we think is a very attractive valuation and get an ROE that's in the mid-teens, or we can continue to invest it in the business where we could bring on new teams or enter into new lines of business. Fortunately, the capital position that we are in right now really affords us the chance to do all of those. We think that we can be very effective in how we deploy capital over the next several quarters and generate attractive ROEs in several different fashions.

Mark Hughes

Well, thank you for that. Then the excess liability book, how are you approaching it from an underwriting perspective? What expertise have you brought in-house? What is informing your judgment about what pieces of business you should write?

Mac Armstrong

Yes, that's a very—it's a good question, Mark. What I will tell you is, we have brought in a leader in Jason Sears, who is overseeing all of our programs in business. He is a long-standing casualty underwriter, and we have selected a partner who he has a long-standing history with to help us build out the excess liability franchise. I think overarchingly, what we're doing in excess liability is very similar to what we've done with all lines of business that we've gone into that are not earthquake or not in line with hurricane, it might be viewed as a little further afield. That is be very deliberate in terms of how much we want to write in year one, very conservative in how much limit we're willing to write, and then also very conservative in how we use reinsurance to support it.

In this circumstance, we will write no more than a $5 million gross line, but we're taking around 22.5% of that. Our net position is around $1.1 million line, and we are attaching it in an excess position in a market that is very hard right now. We think we have the potential to build a nice book of business there. It's with a production plant that we have great history within the property arena, but what we're trying to do now is to get them familiar with our philosophy and strategy in this segment in casualty generally. But, I think there's great promise there, but it's not a circumstance where we're going to turn around and write $50 million of excess liability in year one. It's going to be modest, but it does have the potential maybe in year two, year three to be a sizable book.

Mark Hughes

Thank you.

Operator

Our next question comes from the line of Tracy Benguigui with Barclays. You may proceed with your question.

Tracy Benguigui

Thank you. I just want to follow up on some comments you made about the buyback authorization. I totally get that you're not trying to signal that you're not constructive about growth. But just help me think about how that may be attractive to you. Because usually, you tend to see companies want to buy back for stock when they are trading below or near book value, and you're well above that. If you could just help me understand the framework you have in mind.

Mac Armstrong

Yes. Sure, Tracy. This is Mac, and it's a fair question to ask. I think that our Board and us as a management team, we look at our earnings growth potential and all the steps that we've taken to provide consistency and stability in the earnings, whether it's with the aggregate cover, whether it's with even the cap bond, and certainly with all the underwriting changes, we have considerable conviction and the visibility that we have in the business. That's why we took guidance up. We think that when you look at our—my background as a former private investor, we looked at earnings growth and the price of earnings growth and we think that is pretty compelling at this level. It's materially below our earnings growth trajectory. That's part of the impetus, and that's why our Board has gotten comfortable with the buyback.

Tracy Benguigui

Okay. Excellent. That was very helpful. You're growing in so many different areas, but if I could just take you home to your earthquake risk. I know it is particularly within commercial that's grown pretty substantially and I'm just wondering, if others just don't have the appetite now, like what you're seeing in terms of competition and risk appetite in that space?

Mac Armstrong

Sure, Tracy. I think in commercial earthquake, the one that you specifically called out, it did have terrific growth in excess of 90-plus percent, 96%. That was as much of us being able to continue to take rate, especially in our small commercial earthquake franchise, opening up the E&S Company to our long-standing distribution partners. That allowed us to get on the risk that we previously didn't have as much access to. Call it midsize or large account business where our admitted offering really was not acceptable or not permissible because of forms and coverages and rigidity as such. I think that's what's allowed us to come on and show a very strong growth in Q1 in the commercial quake.

Competition-wise, I think there is competition in that market, but generally speaking, there is very good rate integrity. I actually touched upon it in large accounts. We're probably seeing a little pull back in the rate increases and the acceleration of rates. Small account, you are still seeing very good rate. Overarchingly, I think we got very good runway in commercial quake. I'm not saying that 96% is sustainable, but I do believe that the market condition certainly is amenable to us as a new interest, so to speak, on the E&S side, as well as the long-standing internally admitted side, along side any participant on the admitted side, continuing to take share and drive terms and conditions.

Tracy Benguigui

Thank you. A very comprehensive answer. I really appreciate it.

Mac Armstrong

Oh, thanks.

Operator

Our next question comes from the line of Meyer Shields with KBW. You may proceed with your question.

Meyer Shields

Great. Thanks. I had a couple of numbers questions first and then one bigger picture question. Yes, I'm going to direct this to Chris. If we take out the 3.3 million of adjustments, then we get underlying operating expenses at just under 11 million. Is that a good run rate for the year?

Chris Uchida

Yes, thanks, Meyer. I would say that's a decent run rate. I think as we projected before, we did expect to call it Q1 from a percentage standpoint to be up to flat compared to where it was last year, so I think that's a pretty good run rate. I do expect, let's call it with the growth of earned premiums, the scale to be more in the latter half of 2021 and from thereon. But no, I wouldn't shy away from that run rate from a materiality standpoint. I think it's a good, call it point to pick off of.

Meyer Shields

Okay. Perfect. Then on the reinstatement premiums, I just wanted—because that only impacts the, I guess, ceded earned premium, ceded written ceded earned premium, right? That doesn't impact the actual operating expenses.

Chris Uchida

That is correct. It does not impact the actual operating expenses. It's only ceded written and ceded earned. But it does impact the ratios just because it decreases the denominator that those ratios are calculated off. That's why we were doing a little bit of math earlier to help break that out. Yes, it's not in the any of the operating expense dollars. It is just going to be debt earned premium basically.

Meyer Shields

Okay. No, that's perfect. Thank you. And then, Mac, just a quick question. I know there's a lot of conversation about construction material, cost inflation. How quickly can you incorporate—I mean, if you assume that that inflation will persist, how quickly can it be incorporated in pricing? Should we worry that we're seeing the larger properties rate increases decelerate at the same time as maybe inflation getting worse?

Mac Armstrong

Hey, Meyer. Yes, it is interesting and there have been certain cases where we've had estimates move up because of the cost of lumber and the like, and so that's being factored into the underwriting. Everything that we do from underwriting at the risk level or modeling at the portfolio level and reinsurance, we always throw demand surge on to explore expected loss and average annual loss. That should be captured in how we price a risk again at the portfolio or at the individual level. What I would tell you is we should be staying ahead of that and having the E&S Company, it's allowing us to do it. I go to what I mentioned on the call, I'll pick on or highlight our builder's risk.

That's where you would most directly feel the cost day-to-day and just in terms of your projects, building them and getting them off the ground, or replacing them or improving them on the heels of loss. We're seeing 30% rate increases for—as much as 30% rate increases for large accounts and certainly north of 24 single-shot small account business, which is definitely keeping pace with the rising cost of goods in that regard. But we're watching it and it is something that I think the whole industry is focused on. We're also focused on, frankly, the potential labor shortage driven by it as well with the demand for a new build or in the areas that were materially impacted like Lake Charles, Louisiana. It's not just the cost; it's the labor. We have to factor that in as well.

Meyer Shields

Okay. That's perfect. Thank you.

Operator

Our next question comes from Adam Klauber with William Blair. You may proceed with your question.

Adam Klauber

Hi, can you talk on the scale support of field network? As you go into new products, have you been expanding that? Excuse me. How big is that today versus a year ago?

Mac Armstrong

Adam, this is Mac. Just to clarify, you're asking about the sales support in our production plan and the like? Or are you talking…

Adam Klauber

Yes, your field.

Mac Armstrong

Yes. No, great question. If you look at just year-over-year, our distribution footprint grew by 22%. Align like in the marine that grew 300%, the distribution footprint was up 63%. Residential earthquake was up 25% year-over-year. These are numbers that we—metrics that we track very closely because they can—are leading indicators of future growth as well as existing growth. I'll highlight residential earthquake, for instance, we added, on a sequential basis, a couple of hundred producers from Q4 to Q1. That was driven as much by new partnerships, so the Travelers partnership. We were able to appoint new producers.

Now, did they all start sending over a ton of submissions and then we bind it on a positive, no, that wasn't the case. But it's a good leading indicator for what the potential can be. We are definitely expanding our distribution network. The combination of partnerships, new products, and obviously just opening up PESIC, the E&S Company, to either existing or any distribution sources is the contributing factor to that.

Adam Klauber

Okay. Thanks. Then as far as the excess of loss and the Builders Risk, are those programs and who are the distribution partners on those programs?

Mac Armstrong

Yes, the exercisability is a program and that's with K2, an NGO we've known for a long time. The leadership there, a lot of us—well, the entire management team has worked with the leadership team there. Then the builder's risk is with TRU, Technical Risk Underwriters, which is part of RC. What we've done there, it's very similar to what we've done in Kuwait, where we have our in-house builder's risk team led by Robert Beyerle, who is Delta in the Marine Department. He oversees that program while he's also writing it day-to-day on small commercial or midsize account basis.

So, it's a trend performer that we've gone for large account business. We're going to work with a partner that can use our capacity to support a layered and shared strategy while writing it in-house for small single accounts or midsize accounts. That's what we've done in Kuwait, that's what we have done in builder's risk, and we've done to a lesser degree in all risk as well.

Adam Klauber

Great. Then as far as end of April, there is I think some bad storms in the South. Does your first half guidance, I guess, include those storms, and do you think those storms, for you, will have a bigger or lower impact than we saw with Uri?

Mac Armstrong

Adam, good question. First half guidance definitely incorporates thoughts on losses from those terms, and it will not look like Uri.

Adam Klauber

Okay. Then last question, I'm sorry if you said this, as you're renewing your CAT to your main CAT re for the end of the year, what's your limit going to be, your retention? Is it still going to be 10 million, or has that been pushed up?

Mac Armstrong

Adam, what I can tell you is we've actually finalized the placement yesterday after the earnings went out, and we were pleased with the outcome and the support that we received from our reinsurers. What I'll tell you right now, as we've dot the I's and cross the T's and getting all the paperwork put together, we procured more limit to support our growth. This will all be out in 8-K. We basically maintained the retention in line with what it was in 2020. The complexion is going to be a little bit different, but it's going to be basically the same number. If not, I think a little bit less. We've also incorporated all of the rate changes, including those from loss impacted layers into our guidance.

Chris Uchida

Long story short, the 6/1 went how we had hoped. We also were able to go out and secure an aggregate and put a cap on in addition to that, which gives us even more conviction on stability and predictability in the earnings.

Adam Klauber

Great. Okay. Thank you. Thank you very much.

Operator

Our last question comes from the line of Pablo Singzon with J.P. Morgan. You may proceed with your question.

Pablo Singzon

Hi, can you hear me?

Mac Armstrong

Yes, loud and clear, Pablo.

Pablo Singzon

Yes, perfect. I just wanted to follow up on your net income guidance, which increased like 2 million at both ends of the range. Did this favorable PYD factor into this at all, which I think was a little over 2 million in the first quarter, or did you have other considerations when you raised the range?

Mac Armstrong

Yes. Pablo, what I'd say is, as we raise the range, we factored in Q1 from the positive development from Uri to the—excuse me, positive development from prior quarter storms. We've also factored in the impact of Uri in the first two quarters, and then also the strong growth. We feel very good about the guidance that we've pushed up. We think that the range we've provided is achievable and also ambitious, but there's great just momentum in the business. Ultimately, there's some favorable development.

Q2, that's a nice dynamic to have—or Q1, excuse me, that's a nice dynamic to have. We're not going to hang our hat on that every quarter. We've just assumed that everything else remains flat for the course of the year in terms of development, that is. If we get continued favorable development, that's icing on the cake.

Pablo Singzon

Understood. Second question. You're clearly benefiting from pricing on the inner side. Can you talk about the pricing dynamic in admitted earthquake? How does pricing there tend to move in relation to the border things in market? Can you distinguish between commercial, which is, I guess, that's less admitted in residential versus admitted?

Mac Armstrong

Yes. So, residential earthquake, the rates are not changing beyond inflation guide that we have on the product. We have not put a rate filing in place to change rate since we've started the business. Our results have been strong. The residential market rates are not changing on an admitted basis. Now, we are writing E&S business on residential earthquake, and that tends to be more high value. Therefore, it's a different underwriting because of the content exposure, the cost of reconstruction, labor demand surge, all those questions that were asked previously of us.

There, I would say you're looking at rate increases and rate activity that's more similar to the commercial. I would bifurcate it between E&S and admitted. In residential E&S looks a lot like commercial E&S. Admitted, more standard business. You are governed by what the state permits, and we're not taking rate based on the historical action, the performance of the book.

Pablo Singzon

Got it. My last question, is this just a high level we just think about the mix of commercial and residential risk making your books? I feel your commercials going much faster. I'm not sure if it makes sense, so I look at where your book would end up by essentially looking at overall earthquake market as the right to share. Do you think at some point, just because E&S is growing so fast, that maybe commercial will become a bigger book than residential? Just high-level thoughts on how this book could develop over time.

Mac Armstrong

Yes. At a high level, we want to maintain earthquake at 50% of our business on the whole. Yes, I think commercial is ultimately a bigger end market. As our balance sheet grows and as the E&S company gets traction, I think the Delta in terms of percentage comes mix between commercial and residential could close down. But even if you just look at where we exited the year, or excuse me, exited the quarter, there's still a pretty decent head start that residential has, and residential is still growing at a pretty good clip, 25% in the quarter. I think the gap will shrink, but it's still 50% more. I think there's a ways to go.

Pablo Singzon

Okay. Thanks for your answers.

Operator

Ladies and gentlemen, we have reached the end of today's question-and-answer session. I would like to turn this call back over to Mr. Mac Armstrong for closing remarks.

Mac Armstrong

Great. Thank you, Operator, and thank you all for your time this morning. This concludes Palomar's first quarter earnings call. We appreciate your participation and questions and always your support.

We're pleased with our first quarter results and more importantly, I think we're very enthusiastic about our growth prospects on a go-forward basis. We executed across all facets of our plan during this strong quarter. Illustratively, our strong premium growth laid the ground for continued momentum in existing franchises as well.

We have new lines of business that could provide incremental growth that are just getting off the ground, where new partnerships and new geographies that we've entered into. We've also made meaningful progress on enhancing the predictability of our results. As such, we raised our guidance and we hope you can sense our enthusiasm for what lays ahead of us and hopefully share it.

Thanks, everyone. We look forward to speaking to you after the second quarter. Have a great day.

Operator

You may now disconnect your lines at this time. Thank you for your participation. Enjoy the rest of your day.