American Coastal Insurance Corp (ACIC) Update Post Q3 Earnings

Is The Thesis Playing Out (Preliminary Analysis) & Key Updates

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Key Ratio and Statistics

Recommendation	**Strong Buy**	P/B	2.46x
Market Cap	297.34	LTM P/E	N/A
52-Week Low	0.29	EV/LTM EBIT	N/A
52-Week High	9.29	Net Debt/LTM EBITDA	1.20x
Share Price	6.85	Date	11/13/2023

When pitching ACIC we thought that earnings would be a high alpha event. And we think it indeed was as ACIC delivered results that matched what we had initially thought. ACIC as of Monday's writing closed down 6.80% ($6.85) and in after-hours was up 6.42% ($7.29). **Update: ACIC on Tuesday closed up 38.10% ($9.46).**

Earnings Overview:

	Three Months Ended Sep 30, 2023				Nine Months Ended Sep 30, 2023			
	Commercial Lines	Personal Lines	Other	Total	Commercial Lines	Personal Lines	Other	Total
Gross Premiums Earned	157.80	8.00		165.80	435.60	32.80		468.40
Ceded Premiums Earned	(107.50)	(2.40)		(109.90)	(232.70)	(9.50)		-242.1
Net Premiums Earned	**50.30**	**5.60**		**55.90**	**202.90**	**23.40**		226.3
Investment & Other Revenue	1.90	0.80		2.70	(1.20)	2.40		1.2
Unrealized G(L) on Equities	0.20	0.00		0.20	0.80	0.00		0.8
Total Revenue	**52.40**	**6.40**		**58.80**	**202.50**	**25.80**		**228.3**
Underlying Loss & LAE	8.00	3.20		11.30	38.00	9.80		47.8
Current year CAT Loss & LAE	4.90	1.00		5.80	13.20	1.80		15
Prior year development	(3.10)	(0.20)		(3.30)	(11.20)	(0.50)		-11.7
Total Loss	9.80	4.00		13.80	40.00	11.10		51.1
Operating & Interest Expense	16.60	7.70	3.00	27.20	72.20	24.80	9.00	106
Total Expenses	**26.40**	**11.70**	**3.00**	**41.10**	**112.20**	**35.90**	**9.00**	**157.1**
Other Income (Loss)	0.00	(0.20)		(0.20)	0.00	1.40	0.20	1.2
Income (Loss) before Tax	**25.90**	**(5.50)**	**(3.00)**	**17.50**	**90.20**	**(8.70)**	**(9.20)**	**72.4**
Income tax expense (benefit)				3.10				7.3
Net Income (Loss) From Continuing Operations				**14.40**				**65.1**
Net Loss Ratio	19.50%	71.20%		24.70%	19.70%	47.60%		22.60%
Net Expense Ratio	33%	138.10%		44.00%	35.60%	105.90%		43.20%
Combined Ratio	**52.50%**	**209.30%**		**68.70%**	**55.30%**	**153.50%**		**65.80%**
CAT Loss	9.70%	17.20%		10.50%	6.50%	7.80%		6.60%
PY Development (F)/U	-6.20%	-4.40%		-6.00%	-5.50%	-1.90%		-5.20%
Underlying Combined Ratio	**48.90%**	**196.50%**		64.20%	**54.30%**	**147.70%**		**64.40%**

In the 3rd quarter, the book value per share increased to $2.78. Net income for the quarter was $14.4mm. The personal lines segment which we talked about later was a drag on earnings and contributed to a pre-tax loss of $5.5mm. Another important thing to note is that operating expenses are down 45.7% year over year on a quarterly basis given that they are ceding a higher proportion of their gross premiums earned. This is exactly what we had modelled out.

Hurricane Idalia:

This was a category 4 hurricane that hit the northern part of Florida. Early estimates have placed insured losses at $2.2-2.5 billion. It formed on August 26th, 2023, and had dissipated by September 8th, 2023.

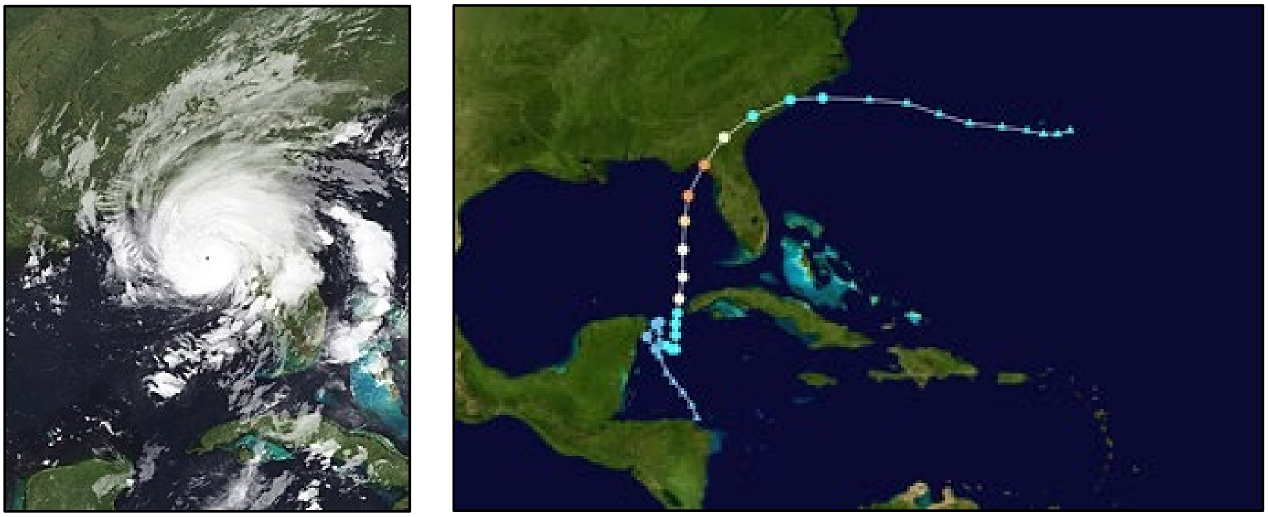

Figure 1: Track of Hurricane Idalia

Management mentioned on call that ACIC was largely unimpacted by Idalia with the current loss estimates well below the reinsurance retention limit of $10mm. Some condominiums across the Northern Gulf Coast were impacted but this too has been considered and ACIC is accordingly providing support to the insured parties. Losses stemming from Idalia are $2.5mm net of reinsurance. Current year CAT losses and loss adjustment expenses YTD have been $4.9mm for AmCo.

Interboro Insurance Company:

We had not covered ACIC's continued operation of Interboro Insurance Company (hereon referred to as IIC) throughout the pitch. This is a personal lines insurer that was a remnant of UIHC and had not been divested along with the Florida business that was put into runoff. This segment was excluded throughout the pitch because it only accounts for 7% of gross premiums earned for the AmCo+IIC entity (as of September 30th, 2023). IIC is not a business that will go under.

We were somewhat concerned by IIC as it had contributed over $8.7mm in losses in the 9 months ending September 30th, 2023. But in the Q3 earnings call, we got greater clarity on the future of IIC. ACIC has executed a non-binding term sheet with a third party to acquire IIC at GAAP book value at the time of closing. Management expects the sale to close in 2024.

Management indicated that the current GAAP book value of IIC is $23mm. We have 2 more quarters of earnings and I think it would be conservative to extrapolate that they incur another $6m in losses and thus at the close of the transaction the book value is in the $17mm range. This is the most conservative figure given that we are not factoring in the 13% rate increases that IIC has filed for with the New York Insurance Legislator. Management also expects some slight appreciation in the book value of IIC.

Management is very inclined to pursue a sale of this segment and is confident that they will be able to, and we think it will not be a drag on earnings from Q1 2024 onwards.

Florida Market Update:

Dan Peed continues to see Florida in a hard market. He expects that to remain the case in both the near and intermediate term. Dan Peed sees the commercial segment being an earnings leader for the foreseeable future.

"While the hard market creates challenges it also creates excellent opportunities for ACIC."

- *Dan Peed*

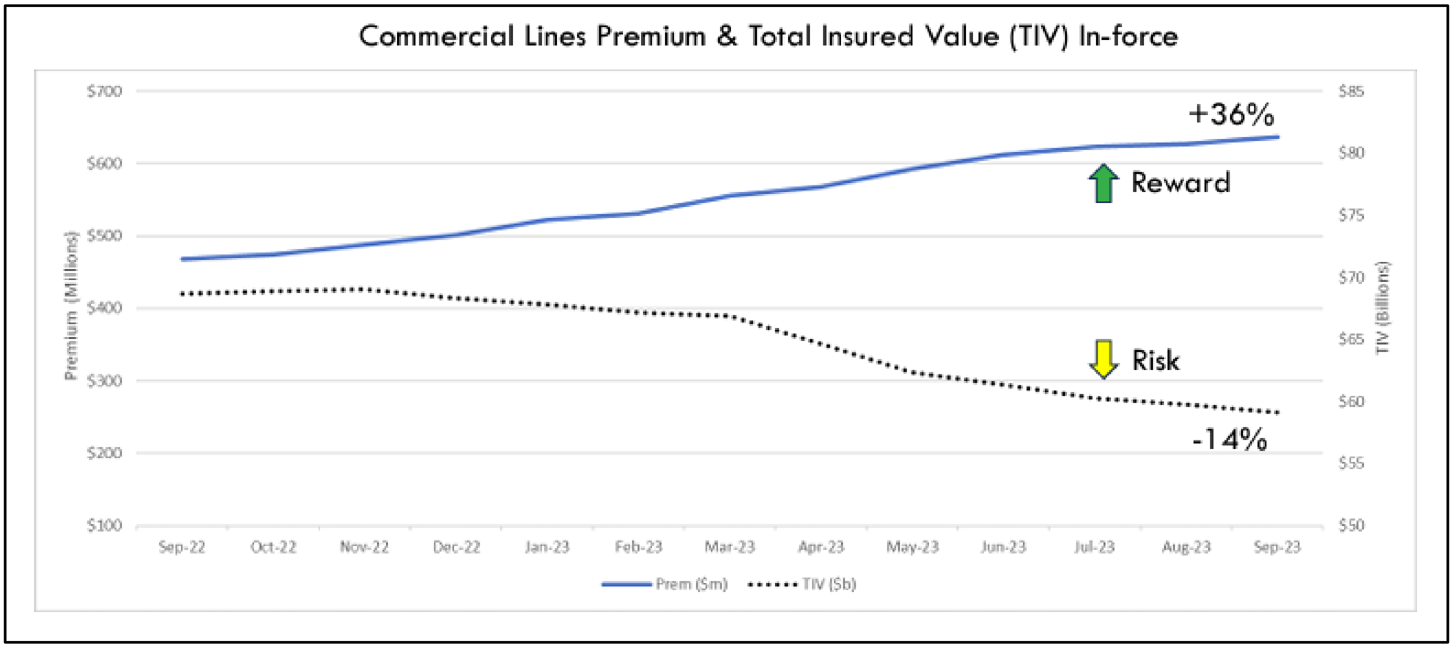

Figure 2: Commercial Lines Premium & Total Insured Value

For the commercial lines segment (AmCo) gross written premiums were up 22.3%. We wanted to get a better understanding of the split between what's driving this. Price or Volume? This figure in the IR deck helped answer that question and management also addressed this.

"The volume is down, which is reflected by the TIV. It is down 14% and the rates are up around 35-6%."

- *Dan Peed*

Thus, we are further convicted in the hard market that Florida is in currently and the pricing power edge that this gives AmCo. These only serve to further mitigate underwriting risk and increase AmCo's underwriting edge over other CAT insurers in Florida.

Figure 3: Trend in AOP & Named Windstorm Deductibles

This argument is further supported by looking at the deductibles that HOAs are being forced to take for both AOP and Named Windstorms. Deductibles are very simply the amount of money that the insured party must pay before their insurance policy starts paying for expenses that they are covered for. It is obvious as to why deductibles increasing is good for AmCo. This is purely a creation of the extremely hard market in Florida.

We also thought it would be useful to assess how AmCo's primary competitors: HRTG, UVE and HCI, are doing in this hard market where AmCo is able to deliver their current results.

HRTG:

- In the third quarter they incurred a net loss which was driven by the losses following Hurricane Idalia in the Florida Panhandle
- Losses were close to $40m net for both Maui wildfires
- Premiums in force overall are $1.3bn
- They are looking to diversify out of Florida, they emphasize that 73.5% of the total insured value falls outside Florida
- However, for Q3 they grew their commercial residential premiums-in-force by 75.3%
- They do want to grow in commercial residential properties in Florida
- They continually mention they are focused on making sure that they are nor overly concentrated in any one areas in Florida

UVE:

- Hurricane Idalia made Florida landfall, all losses are comfortably absorbed by UVE's retention
- They have started to slowly increase new business in additional territories
- They lost money in Q3 2023, the loss per share was $0.16/share
- Idalia was set as a $45m loss, that is combined with another $10-$15m in losses

Insurance Regulation Changed in Florida:

They are also seeing the benefits of the insurance reform in Florida. Litigation is down and ACIC has been able to effectively use the pre-suit notification of intent to litigate to settle claims.

Section 70152 of Chapter 627 of Title XXXVII was updated this year by the Florida State Government. It is now a condition that before filing a suit under property insurance policy the claimant must provide the department with written notice of intent to litigation on a form provided by the department. This notice must be given at least 10 business days before filing the suit. This notice must be provided by the department to the insurance company via email. This was not the case earlier. This enables AmCo to settle claim disputes out of court instead of having to incur legal fees.

The government also passed SB-2D in May of 2022. We think this change in regulation has made the insurance market in Florida structurally more attractive for ACIC. These are the key changes:

a) Created the $2bn reinsurance fund, Florida Hurricane Catastrophe Fund (FHCF)
b) The bill also states that attorney's fees are no longer recoverable under assignment of benefits except in restricted cases
c) The government has also started providing grants of up to $10,000 for homeowners to retrofit homes against hurricane damage which helps to reduce the TIVaR (total insured value at risk)

While these reforms are not idiosyncratic to ACIC we see ACIC being one of the largest beneficiaries of this regulation, and we are now starting to see that flow into results according to management.

Further Clarity on Equity Offering:

As of November 13th, 2023, the company has sold roughly 978,000 shares raising approximately $7.1mm net of expenses through their at-the-money offering. The contracted party for this ATM offering is Raymond James and they charge a 3% fee.

The prospectus allows for up to 8mm shares to be sold. But management is only targeting to raise $10mm to $20mm and plans to use the proceeds to support exposure growth and optimize reinsurance spending via increasing utilization of ACIC's captive.

Management is committed to minimizing dilution and is pursuing this ATM offering for the development of new earnings streams and the underwriting of more profitable commercial lines business by leaning further into the hard market conditions in Florida.

ACIC Value	
Equity Value	1,042,899,574
DSO	46,411,686
Equity Value per Share	**22.47**
Current Share Price	9.46
Upside	**137.53%**

Figure 4: Updated Upside Adjusting for DSO

We have adjusted the diluted shares outstanding to only increase by 3 million shares which is line with the comments that management made.

Questions We Asked:

1) What is the path for ACIC to reduce their current quota share agreements with BerkRe and ArchRe and what would the timeline look like for this
    a. Two 20% Quota Share agreements, one with BerkRe and one with ArchRe
    b. They view both Quota Share partners as instrumental in the current catastrophe reinsurance program
    c. These quotas share agreements contain a very high amount of catastrophe limit. They are gross quota shares so it grants ACIC $350mm in aggregate CAT limit in those two quota shares. $175mm per occurrence.
    d. Task number one would be to replace that CAT limit on an excess of loss in the open market, but they do not feel ready to do this yet.
    e. However, management intends to reduce these quota share agreements over time so that ACIC can retain more of the underwriting profit

	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Total XOL Reinsurance Expense	(227,000,000)	(229,100,000)	(221,559,733)	(219,649,194)	(235,923,498)	(252,438,142)	(270,108,812)	(289,467,361)
Quota Share Reinsurance Expense	(279,694,280)	(218,161,538)	(127,988,103)	0	0	0	0	0
% of Gross Premium Earned	*40.00%*	*30.00%*	*20.00%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*	*0.00%*

Figure 5: Quota Share Projections Going Forward

Given management's commentary we accordingly adjusted the quota share agreement to stay at 40% for the next 7 months and then decrease to 30% in 2024E and 20% in 2025E. We had in our original modelled tapered off with QS way too soon than would have been reasonable or possible for AmCo.

2) What is the potential for ACIC to create a captive MGA and how would they go about this?
    a. The captive has already been formed; a class-B reinsurer domiciled in the Cayman Islands
    b. Filed a 953-D election (election by foreign insurance company to be treated as a domestic corporation)
    c. Have used it in the past and intend to utilize it more extensively going forward
    d. They want to be very strategic in using the captive to approach the high expected return on capital layers and opportunities they are seeing in the reinsurance programs

Answering Professor Levich's Question:

1) You seem to have a lot of confidence in management, including Dan Peed. At the same time, they agreed to a loss sharing agreement with UPC.
    a. AmCo and UPC become a consolidated entity through an all-stock deal. As part of this deal Dan Peed, the current and also then CEO of AmCo had no purview or say in the operations of UPC. Even when UPC and AmCo were a consolidated entity, AmCo's de-consolidated financial results were outstanding and in line with what they had been historically.
    b. Only in 2020 did Dan take action along with the support of the board of directors to oust John Forney, the CEO of UPC. Once ousted, Dan worked for over two years to dispose of UPC, which was achieved by putting it into runoff and receivership.

    c. This was consummated in February of 2023 when the Florida Department of Financial Services (DFS) agreed to carve out UPC and all of its liabilities form the UIHC parent and leave UIHC with the two current subsidiaries AmCo and IIC.
    d. When we look at management, we like to look at incentive structures that drive their actions and choices. The incentives are aligned given the stake than Dan Peed holds in the business. Dan Peed currently owns approximately 53% of all outstanding shares.

2) How is reinsurance capacity in Florida affected by catastrophe events which are non-Florida, e.g., in Japan. This leads to set of circumstances where overall reinsurance rates rise but rates may not rise in Florida.
    a. There are two ways to answer this question
    b. The first is that a large portion of the reinsurance that AmCo obtains is from FHCH (Floridan Hurricane Catastrophe Fund) and FORA (Florida Optional Reinsurance Assistance Program), which are inherently Florida focused reinsurers and are thus not impacted by CAT events which occur globally
    c. The second way to think about it is to understand that reinsurance is inherently commoditized. If reinsurance rates went up as a result of hurricanes in say Japan then this would mean that the overall supply of funds available for reinsurance would decrease as reinsurers would incur losses. This would not be idiosyncratic to AmCo. It would impact all Florida based insurers in the same manner and thus would create a hard market where these higher reinsurance costs are simply passed on to policyholders.
    d. We do not see this to be a material threat or issue to the thesis.

3) How could you model and sensitize for multiple events in a given year? Can you create multiple scenarios
    a. What we presented in oversight was our belief of the most conservative expected case.
    b. The risk of the distribution of outcomes should be accounted for by the discount rate that we have used
    c. We believe that the discount rate we have applied sufficiently accounts for the risk associated with ACIC's operations.
    d. Furthermore, to help put recent events in perspective with AmCo's current reinsurance stack, Hurricane Ian would have only exhausted 30% of the stack
    e. We can also look at what were two occur were there 2 named events in a given year. Even for a second named event in a given year AmCo's retention remains at $10mm and thus the combined CAT losses would be $20m for that given year
    f. AmCo would also incur approximately $15mm in LAE (loss adjustment expenses per event)
    g. We have modelled for private XOL reinsurance costs to rise at 2% per year as a percent of gross premiums earned which is extremely fast, as historically this stayed at around 19 to 20%. In being as conservative as possible we forecast this going to 29% by 2030. This can be seen in Figure 5
    h. We also thought that while unlikely it may be possible that the per event retention increases going forward, and thus we increase the per event retention to be $12mm till 2027E and then increase further to $14mm. This would simply be a way to express the reinsurance market getting further squeezed on supply as a result of ongoing losses from the 2 named events per fiscal year.
    i. We also reduced the Exit Multiple to 8x, which would put it at the bottom of its comp set, and would imply that ACIC is a lower quality business that UVE, HCI and HRTG
    j. Even when factoring these tail end expectations which we believe to be irrationally excessively pessimistic and conservative we would get 25% of upside at the current share price of $9.46 (11/14/2023)
    k. This modelling also does not factor for the MGA opportunity which we are certain will happen and adds another $300m-$400m in NPV.

	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Private XOL Reinsurance Expense	(127,000,000)	(135,100,000)	(124,739,733)	(115,567,694)	(124,556,293)	(145,292,494)	(167,900,006)	(192,960,637)
% of GPE	*-18%*	*-19%*	*-19%*	*-21%*	*-23%*	*-25%*	*-27%*	*-29%*

Figure 6: Private XOL as a % of GPE

	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
CAT Lossess								
Number of Named Events	1	2	2	2	2	2	2	2
(1) CAT Losses, Direct	(50,000,000)	(52,000,000)	(53,560,000)	(57,577,000)	(61,607,390)	(65,919,907)	(70,534,301)	(75,471,702)
(2) American Coastal per-event Retention	(7,500,000)	(10,000,000)	(12,000,000)	(12,000,000)	(12,000,000)	(14,000,000)	(14,000,000)	(14,000,000)
(3) American Coastal per-event LAE	(15,000,000)	(15,000,000)	(15,000,000)	(15,000,000)	(15,000,000)	(15,000,000)	(15,000,000)	(15,000,000)
(4) CAT Losses, Losses Borne by Reinsurance, XOL	20,000,000	27,000,000	28,560,000	32,577,000	36,607,390	40,919,907	45,534,301	45,534,301
(5) CAT Losses, Losses Borne by Reinsurance, Quota Share	12,000,000	6,250,000	3,750,000	2,500,000				
Less: Net CAT Losses Borne by American Coastal (2 + 3 + 5)	(10,500,000)	(43,750,000)	(50,250,000)	(51,500,000)	(54,000,000)	(58,000,000)	(58,000,000)	(58,000,000)

Figure 7: Losses Borne by AmCo if 2 Named CAT Events/Year

<u>Historical Hurricanes in Florida:</u>

The reason for this section is because we wanted to specifically analyze the areas where AmCo insurers and the traditional path of hurricanes to better assess whether these areas are more or less likely to get hit by hurricanes, and what the historical path of hurricanes has been.

American Coastal currently has approximately 25% of its policies within the tri-county (according to Sohra Peak estimates, we were not able to independently verify this). Among the category 5 hurricanes that have made landfall in Florida, only Hurricane Andrew in 1992 made landfall on the tri-county.

Unfortunately, none of AmCo's data on the location of the properties they insure are available in the public domain. But we will continue to work to better quantify the risk from a geographic perspective.

<u>Hurricane Ian:</u>

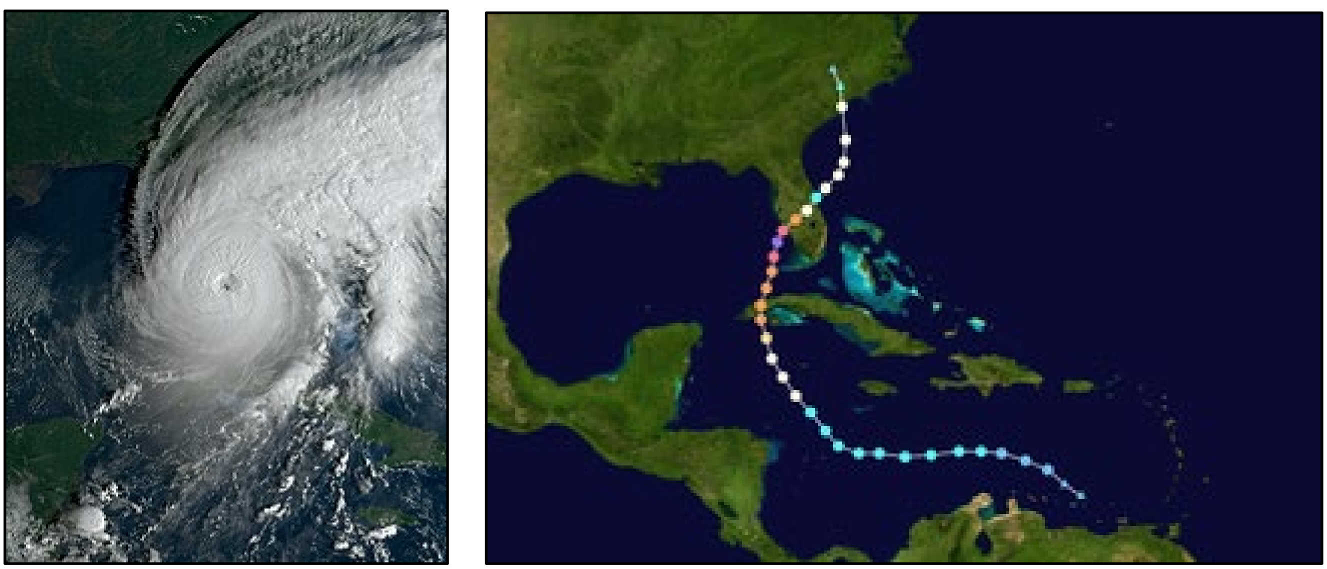

Figure 8: Track of Hurricane Ian

On September 28, 2022, Hurricane Ian made landfall as a category 4 major hurricane near Cayo Costa.

Figure 9: Cayo Costa on map of Florida

According to the NOAA, Ian caused an estimated $112.9 billion worth of total damage in the US, making Ian the third costliest US hurricane on record. Of that total $109.5 billion of the damages occurred in Florida, making Ian the costliest hurricane to ever affect the state of Florida.

Questions We Still Have:

1) What are the terms and conditions of AmCo's quota share agreements. Do BerkRe and ArchRe get 40% of the gross premiums and therefore must also pay 40% of the LAEs, CAT losses and the brokerage fees due to AmRisc?
    a. I have started reading 'Reinsurance and the Law of Aggregation Event, Occurrence, Cause' to get a better understanding of the typical terms of both XOL and QS reinsurance contracts
    b. We are also hoping to set up a call with Dan Peed, subject to him responding, and I think we will be able to get a lot of answers from him
2) What does this captive insurance mean for AmCo (question 2 that we asked on the call)
    a. I think that we can partly get answers to this by things already mentioned above

Appendix:

Updated Valuation:

ACIC Net Income Valuation								
As of 11/14/2023								
Year	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Period	*0.63*	*1.63*	*2.63*	*3.63*	*4.63*	*5.63*	*6.63*	*7.63*
Net Income	28,251,760	89,789,407	99,555,519	86,517,647	87,966,383	96,128,656	104,862,286	113,831,442
PV Of Net Income	26,689,221	77,442,639	78,394,396	62,199,804	57,738,525	57,605,833	57,371,678	56,859,771
PV of Stage 1	**474,301,866**							
Final-Year Net Income	113,831,442							
Exit Multiple	10x							
Terminal Value	1,138,314,420							
PV of TV	**568,597,708**							

ACIC Value	
Equity Value	1,042,899,574
DSO	46,411,686
Equity Value per Share	**22.47**
Current Share Price	9.46
Upside	**137.53%**