Palomar Holdings, Inc. Does Not Deserve Its Earnings Multiple

10/23/22

Palomar Holdings, Inc. has an earnings multiple far above that of its peers:

Company (symbol)	P/E
Palomar Holdings, Inc.(PLMR)	60.4
Kinsale Capital Group, Inc. (KNSL)	51.6
American Financial Group, Inc. (AFG)	27.9
RLI Corp. (RLI)	27.8
Selective Insurance Group, Inc. (SIGI)	19.9
HCI Group, Inc. (HCI)	6.3
Universal Insurance Holdings, Inc. (UVE)	2.2

Of course, the companies in the above table are not all *exactly* comparable. But they are all property & casualty insurers and similar to each other in many respects. There is nothing about Palomar that justifies its P/E being so much higher than the others. In fact, there are compelling reasons why it should be lower, not higher.

For one thing, Palomar is a catastrophe insurer. Catastrophes tend to be infrequent, but they often cause insurance losses that are very severe. So a catastrophe insurer's earnings can be expected to vary a lot from one year to the next.

> “. . . most of the policies we write subject us to catastrophe losses. Catastrophe losses are certain losses resulting from events involving multiple claims and policyholders, including earthquakes, hurricanes, floods, convective storms, terrorist acts or other aggregating events.” 10-k FY 12/31/21

Some of the other companies also insure catastrophe risks, but none of them focus on it as much as Palomar. The earnings of any P&C company in any given year is hard to predict. But Palomar's earnings are even more unpredictable because of it's catastrophe focus. Clearly Palomar's catastrophe focus is not a reason to award it such a high P/E ratio.

Another reason that Palomar should not have such a high P/E is that Palomar's earnings are heavily dependent on a single line of insurance: earthquake, mostly California earthquake.

Most P&C companies seek to diversify among as many uncorrelated lines of business as possible. That diversification is one way of preventing a single loss or wave of related losses from disturbing the even flow of profits that insurers want.

But with Palomar, there is another reason why diversification is so important:

> **Palomar needs to diversify to grow.**

At present, Palomar is a relatively tiny company operating within a few niche markets. Palomar's niche insurance lines have been a cash cow for them because those lines generate a lot of premium revenue and almost no claims costs. But there's a problem. The catastrophe niche markets that Palomar prefers (such as California earthquake and Hawaii hurricane) are tiny markets compared to the major insurance markets. Although Palomar has expanded rapidly within its niche markets, it cannot expand indefinitely due to the tiny size of the markets.

Palomar needs to diversify to grow.

Palomar management appears to be well aware of that fact. After starting in 2013 insuring almost 100% California earthquake risks, they claim to have made progress in diversifying. But their diversification efforts have not turned out all that well. For example:

- Starting in 2016, they branched out into the commercial all-risk business. But in 2020, they decided to exit their admitted all-risk line, presumably due to poor performance.
- Palomar has been insuring Hawaii hurricane risks since before its 2019 IPO. But that market is just another very small catastrophe market. It certainly is not a platform for long term growth. As of 2021, Hawaii hurricane remains a tiny contributor to Palomar's overall earnings.
- Palomar had a specialty homeowner's line before its IPO. But, they appear to have backed away from that. In 2020, they exited their Louisiana specialty homeowners line of business.
- Palomar has long had a specialty homeowner's line that insured wind risks in Texas. But they now reinsure effectively 100% of that business. So although Texas accounted for 12% of gross written premiums in FY 2021, the Texas specialty homeowner's is much less significant than it appears.
- Palomar has been insuring flood risks since early in its history. But that line, like the Hawaii hurricane, has never been an important contributor to its earnings.

The reality is that, after roughly 9 years in business, Palomar still relies heavily on its earthquake line.

But there's another uncomfortable reality. Even if Palomar should try to diversify into a major insurance market, its high-expense business model would be unlikely to work in that market. The below table compares Palomar's expense ratio to some peers.

Company	Expense ratio FY 2021[1]
Palomar Holdings, Inc. (PLMR)	62%
HCI Group, Inc. (HCI)	45%
RLI Corp. (RLI)	40%
Selective Insurance Group, Inc. (SIGI)	33%
Universal Insurance Holdings, Inc. (UVE)	30%
American Financial Group, Inc.	28%
Kinsale Capital Group, Inc. (KNSL)	21%

1. Expense ratio is the underwriting expenses divided by net earned premiums.

Palomar's underwriting expenses are high largely due to very high payments to people who sell the policies, the so-called “acquisition expenses”. Here's how Palomar's acquisition expenses compare.

Company	Acquisition expense as % of net earned premiums, FY 2021
Palomar Holdings, Inc. (PLMR)	41%
RLI Corp. (RLI)	32%
HCI Group, Inc. (HCI)	25%
Universal Insurance Holdings, Inc. (UVE)	22%
Selective Insurance Group, Inc. (SIGI)	21%
American Financial Group, Inc. (AFG)	19%
Kinsale Capital Group, Inc. (KNSL)	13%

So far, Palomar has been able to afford to pay high expenses and still be profitable. That's because, for the last few years, its niche catastrophe markets have generated premiums without the need to pay any significant claims. The last major earthquake event in California was the Northridge quake in 1994. The last big hurricane to hit Hawaii was Hurricane Iniki in 1992.

But as soon as Palomar ventures into a line of business where they have to pay significant claims costs, their high-expense business model may falter. And Palomar needs to expand into the big money insurance markets if it wants to be anything other than a tiny niche player. The table below shows how much premium revenue (“Earned premiums” column) is generated nationwide in various insurance lines. You can see that the really big insurance lines tend to generate significant claims costs (“Average loss ratio” column).

NAIC Nationwide Property & Casualty Industry Statistics FY 2021		
Insurance line	Earned premiums ($millions)	Average loss ratio
Earthquake	3,709	2.7%
Commercial multiple peril (liability portion)	16,815	49%
Allied lines	18,000	75%
Inland Marine	28,342	49%
Commercial multiple peril (non-liability portion)	31,422	66%
Workers Comp.	55,245	52%
Private passenger auto physical damage	106,680	71%
Homeowners multiple peril	113,989	69%

In fact, Palomar's actual loss ratios have played out roughly consistent with the national averages. The below table summarizes Palomar Specialty Insurance Company's net earned premiums and losses for its earthquake and non-earthquake lines.

Palomar Specialty Insurance Co. Statistics FY 2020 and 2021			
Insurance line	Earned premiums ($millions)	Losses ($millions)	Approx. loss ratio
Earthquake	258.2	less than 0.1	0.0%
All other insurance lines	126.7	94.6	74.7%

If you combine the non-earthquake loss ratio of about 75% with Palomar's roughly 62% expense ratio, the result is a combined ratio of 75% + 62% = 137%. Any loss ratio over 100% means they would be losing money in underwriting. The above table is consistent with the notion that Palomar's high-expense business model could prevent it from ever being more than a tiny niche player. That is certainly not a reason to award it a P/E ratio that is far above those of companies that have competed in big insurance markets successfully.