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United Insurance Holdings Corp (UIHC)

July 14, 2013

Quantifying risk is perhaps one of the most difficult tasks and fortunately for patient investors, complacency reigns when there is a perception that money will not be loss. Reinsurance is seeing growing complacency and more risk is being taken on by a larger group of individuals than ever has before. The investment opportunity with this complacency is not a spectacular short (perhaps there will be in the future), but in a high quality long.

United Insurance Holdings Corp (UIHC) is a Florida domiciled homeowner insurance company selling at a significant discount on both an absolute and relative basis. UIHC is growing premiums at a rapid rate in Florida and other coastal states while seeing a large decrease in reinsurance rates. The company is now able to write more business and take on less risk.

Investors in UIHC are able to purchase a well-run insurer trading at a 15% premium to book value. I believe the rapid growth in policies and the extended period of lower reinsurance rates will allow UIHC to compound book value at 10-40% per year, depending on catastrophes and the successful rollout into other coastal states. Unlike other insurers who will be hurt by rising interest rates, UIHC will benefit by being able to reinvest premium proceeds into higher yielding asset classes.

Downside is protected by book value and future growth that should occur outside of Florida. I expect the valuation gap to disappear as sell-side coverage is initiated and premium growth is successful in other states.

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Florida Insurance Market

Florida has over $1.8 trillion in insured residential property exposure and it is estimated that a 1 in 100 year storm would have a probable maximum loss of more than $60 billion. This makes it the largest reinsurance market in the world, and as expected, prone to boom and bust periods. Following Hurricane Andrew, which was only a 1 in 67 year storm, 11 insurance companies went bankrupt and many more withdrew from Florida after their surpluses were depleted. This exodus resulted in the creation of Citizens Property Insurance Corporation, the state backed insurer of last resort.

Citizens became a political tool which twisted the Florida insurance market. Following the election of Governor Rick Scott and several bills, Citizens has shrunk by "depopulating" (letting private insurers take on policies formerly held by Citizens). Even before depopulation became widespread, insurers like State Farm were pulling out of Florida, unable to keep operating costs down in the face of state-mandated discounts. Even large insurers like Chartis are now just a blip on the insurance map. The table below shows the largest companies by both policy and exposure.

Table 1. Florida Property Insurance Market Policy Count and Exposure

Company(Stock Symbol)	Policies(2012)		Exposure
Citizens Property	1,449,617	$	466,495,487,958
State Farm	430,746	$	169,215,063,814
Universal Property & Casualty(UVE)	552,548	$	119,890,593,078
St. Johns Insurance	175,379	$	65,109,116,886
United Services Automobile Association	137,694	$	58,331,478,660
American Integrity Insurance Co	115,220	$	31,987,371,753
Florida Peninsula	122,214	$	42,889,652,618
Security First Insurance	174,240	$	50,491,174,041
Homeowners Choice Property(HCI)	101,327	$	27,444,290,267
United Property & Casualty Insurance(UIHC)	109,614	$	46,139,315,956

Source: Florida OIR, 2012 UIHC 10K

It is obvious that Citizens takes on tremendous amounts of risk relative to other insurers and unfortunately this risk is concentrated within high risk segments(mobile homes and coastal homes). Citizens admits that these policies are at least 40% below private market rates and they hope that yearly 10% premium increases will price policies close to private market rates.

Even with the large number of policies that are currently below private market rates, about 250,000 polices are "rate adequate" and could be included in the depopulation program. Over the next several years Citizens hopes to bring their policies in force down to ~800,000 meaning there is plenty of room for insurers like UIHC to expand in Florida. UIHC is different than other insurers though and is actively looking to expand into other states.

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Other States

There will be plenty of competition for UIHC in Florida, some of it from politically connected parties. So far UIHC has managed to stay out of the spotlight by focusing on sourcing policies in northern and western parts of Florida (diversifying coverage to lower risk parts of the state) and expanding into other states. Right now UIHC is writing policies in South Carolina, Rhode Island, Massachusetts and North Carolina. The company expects to enter New York this year and management believes that there are 17 states that they could enter into. In the table below the early results of policy growth can be seen in three states.

Table 2. UIHC State data sourced from 2012 10K.

State	FY 2012 Gross Written Premiums	Average Policy Cost	FY 2011 Gross Written Premiums	Average Policy Cost
Florida	$228,280,000	$1,866.07	$ 194,020,000	$1,858.18
South Carolina	$16,678,000	$1,510.96	$9,616,000	$1,397.88
Rhode Island	$3,617,000	$1,069.80	N/A	N/A
Massachusetts	$6,334,000	$1,425.29	$170,000	$1,666.67

While the rollout into other states is early, I have been encouraged by my discussions with independent agencies. Agency principals have generally said that UIHC is aggressively pricing their product in a bid to take up market share but their policies are very easy to sell. Typically policies are priced at a 10-25% discount to other insurers. The obvious risk is that a large storm hits several states in the next year or two and wipes out any surplus accumulated in the state. While I do not know exactly what types of risks are being taken on, agencies have said that the policies being written are good risks. The loss triangle in UIHC's 10K shows that the company has historically priced risk well.

Management at UIHC is confident that they can attain 2-5% market share in each of the states they enter, so aggressive pricing may be necessary for now as long as it is part of a prudent longer term plan. Luckily for UIHC, large incumbents are risk adjusting their portfolios, although some aren't always doing it publicly. These legacy carriers are leaving a void in some states as they adjust their risk exposure to whatever Wall Street thinks is prudent.

Based on my talks with agencies the de-risking is taking place and companies that can price aggressively will take market share. I believe that the management of UIHC has reasonable goals based on the success of other insurers. St. John's entered South Carolina in 2009 and now has over 3,000 policies, which according to the CEO of St. John's, was slow by design. Universal Insurance and American Strategic Insurance Group also entered South Carolina several years ago and have been successful developing in developing their brands.

The same dynamics that took place in South Carolina are now taking place in numerous east coast states, likely due to more advanced catastrophe models. If UIHC can keep hiring quality sales reps (the

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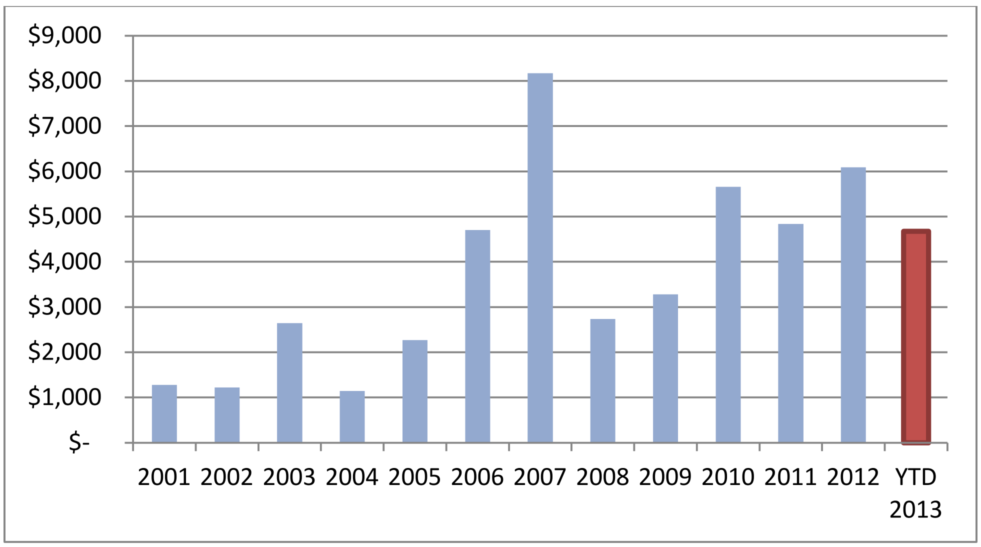
agencies I spoke with reported that their UIHC contacts were top notch) it seems reasonable that the same plan that is working in South Carolina can be applied to other states. The company will also be taking less risk as it writes each policy due to the softening reinsurance market.

Reinsurance

Part of being a Florida domiciled insurer is transferring risk to other reinsurers so a single storm that centers on Miami-Dade county doesn't result in bankruptcy. Typically this risk is shared by companies such as Everest Re, Validus, Catlin, Flagstone, Aspen, etc. The pool for reinsurance has become much larger though and these companies are now competing with hedge funds, pension funds, and other institutions looking for returns that are not correlated with the general market. The hunt for yield has pushed up issuance of cat bonds, shown on the graph below.

Graph 1. Catastrophe Bond Issuance in millions $



Source: Artemis, Swiss Re

It is very likely that cat bond issuance in 2013 will reach record highs, surpassing 2007's numbers. Obviously mortality risk and other risks are embedded in there so the chart below shows cat bonds that have significant tranches dedicated to US based catastrophes.

Even with the record issuance this is a drop in the bucket for large institutions. Willis Re estimates that if global pension funds allocated just 0.5% of their funds to Insurance Linked Securities (ILS) an additional $150 billion of capacity would be created. Given the record low interest rates and need for return I believe that third party capital (hedge funds and pension funds) is here to stay. Hurricane Sandy was a $30 billion disaster, but the ILS machine kept on moving and I think it will take far larger and more frequent storms before institutional investors leave the reinsurance market.

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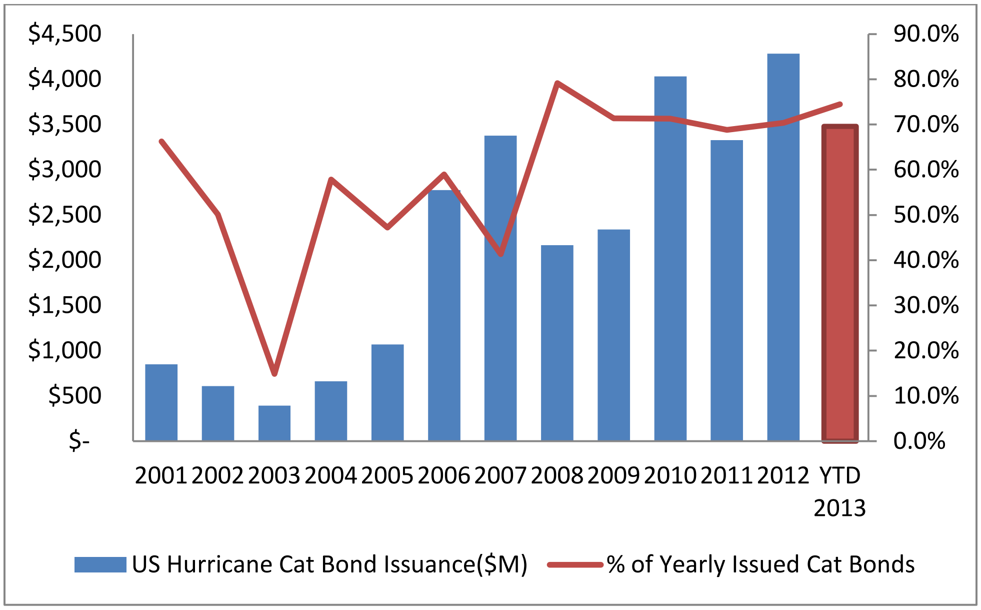
Chart 2. US Catastrophe bond Issuance from Artemis, Swiss Re, Lane Financial



Other reinsurance brokers agree. Guy Carpenter's Global Head of Business Intelligence, David Flandro, stated "At July 1(2013), we saw continued significant decreases in U.S. property catastrophe program pricing. Although the impact of convergence was less dramatic elsewhere, general downward pressure on rates was observed for property business in several other regions and across some casualty lines. Without further significant catastrophe losses in the remainder of 2013, we expect that this downward pricing trend will likely continue through the remainder of the year and into the January 1, 2014 renewals."

So how does this impact UIHC and other carriers? Simply put, the flood of capital into the sector suppresses rates. Bermuda reinsurers can often write very profitable insurance on excess lines that cat bonds normally occupy. Now that third party capital is here in record amounts, these lines are less profitable and lower tranches of risk see even more capital. Cat bonds are typically written to cover risk over three year periods, giving the insurance industry vision into future capital needs.

In 2012 46% of UIHC's costs were reinsurance, their largest cost. In 2012, at a cost of $110 million, UIHC was protected from all losses greater than $20 million and less than $536 million. In the 2013 June renewal UIHC purchased $781.6 million of protection for $111.6 million. In a nutshell this means that there is more coverage for less money. All that coverage is good in any state that UIHC operates in, allowing them to expand into other states and not worry about catastrophes.

Valuation

I'm not a fan of paying for growth; it reminds me of greater fool theory too much. Today investors in UIHC can purchase a company at 115% of tangible book value. Premiums should grow in Florida, although there is plenty of competition and the 2014 election season could change the pace and scope

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of the depopulation program. Policies should grow in the three other states that UIHC has established itself in: Massachusetts, South Carolina, and Rhode Island. Below are my policy estimates based on talks with management, agencies, and public filings.

Table 3. Policy Count Estimate

Policy Count	2012	2013	2014
Florida	122,322	143,571	150,750
Massachusetts	4,444	9,444	14,444
South Carolina	11,038	16,038	21,038
Rhode Island	3,381	6,881	10,381
Total	**141,185**	**175,934**	**196,613**

Obviously this is not exact and could change based on a number of factors. I believe that it should prove conservative over the next couple of years as the distribution network of UIHC becomes more engrained in agencies. If this is remotely correct I believe that we can estimate Net Income and Book Value growth for the next two years based on the average premium that were seen in 2011 and 2012. To be conservative I have kept premiums flat. Management has stated that there isn't a lot of room for rate increases but policy changes (higher deductibles, coverage changes, etc) could help improve the bottom line. The table below ignores those potential changes.

Table 4. Conservative Estimated Income Statement

	2013	2014
Gross Premiums Written	$310,483,000	$342,134,000
Gross Premiums Earned	$273,225,000	$301,078,000
Reinsurance	$111,000,000	$114,409,000
Net Premiums Earned	$162,225,000	$186,668,000
Investment Income	$3,043,000	$4,954,000
Other Revenue	$4,000,000	$4,000,000
Total Revenue	$169,269,00	$195,623,000
Loss Adjustments	$70,246,000	$81,183,000
Corp Expenses	$79,048,000	$91,356,000
Income Before Taxes	$19,973,000	$23,083,000
Net Income	$12,982,000	$15,004,000
BV End of Year	**$108,684,000**	**$123,689,000**
BV/Share	$6.74	$7.68

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There are several things to keep in mind. First, the return on investment was assumed to be 2.0%, in line with what 2012 was. While I believe that interest rates will go up, I do not know when, why, or how. However I thought it was prudent to not let that belief influence the valuation so I have kept investment returns equal to 2012's returns. I estimate that investment returns will increase by ~$1 million/year for every 1% rise in interest rates. Again, I have no insight when or how much rates will rise.

The numbers above also exclude any business written in New Jersey and North Carolina. Both of these states have large coastal tracts that UIHC knows how to write for. I believe that these two states could add up to 8,000 policies per year, which at an average policy premium of $1,500, would equal an additional $12 million in premiums per year.

Finally, I assumed that loss ratio's and expense ratios were in line with their eight and six year respective averages. Expense ratios should drop as the insurance network becomes more widespread but I have assumed that it will not improve.

With those assumptions known, it should be obvious that I believe UIHC will grow their book value by at least 15% per year. This assumes no contribution from any of the new states entered into and no improvement in interest rates. It seems reasonable that a company growing tangible book value by 15% annually should command a healthy premium to their current book value. I believe that at the minimum the company should be valued at is 1.5-1.7X book value, a 24-45% premium to today's share price.

With today's price to book premium of ~25% investors are not looking that far out and the margin of safety is clear, book value will soon grow to match market cap.

Risks

There are several risks to an investment in UIHC, these include ones special to UIHC and general risks that all insurers will have to face.

1. Political Risk

It's no secret that private insurance companies have flourished under Florida Governor Rick Scott. Whether or not his methods or insurance math are correct is a topic for another time, the net result that UIHC investors should care about is that he's in office for another two years.

Scott spent $75 million of his own money to get elected originally. With a current net worth estimated at $83 million reelection will not be as simple as buying votes, especially with a 43% approval rating. With that said, the necessary changes to Florida law have been made and will take time to unwind. I believe a total unwinding is unlikely though as many of these policies that have been depopulated were "rate-adequate" anyways.

On top of that, most people recognize the risk that Citizens brings to the state of Florida. Management of UIHC knows that future rate hikes are not going to happen which should insulate them from the

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wrath of a potential Charlie Crist governorship. Even if Crist is elected in 2014 it seems unlikely that he will be able to pass the bills necessary to shift all the risk back to the State of Florida.

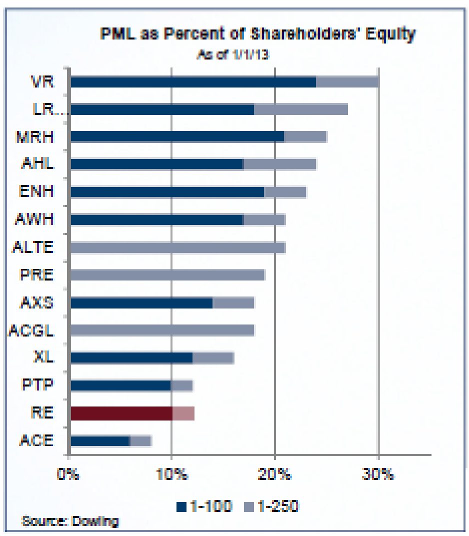
2. Not Successful in Other States

The rollout into other states is a key part to this thesis which helps diversify risk. I believe that investors today are not paying for growth into states such as New York, New Jersey, Texas, Louisiana, Maryland, Delaware, or North Carolina. Management has proven that they are capable of moving into other states and we can use South Carolina, Massachusetts, and Rhode Island as examples. As long as investors are not paying up for the growth I believe that this risk is relatively low.

3. Catastrophe Risk

This risk is present on two fronts, immediate catastrophe risk and counterparty risk following a catastrophe. The picture below is from the Everest Re Q1 2013 presentation and shows PML.

Graphic 1. Major Reinsurance companies PML as % of Equity Source: Everest Re



There are two things that should let UIHC investors sleep at night. The first is that Hurricane Andrew was a 1:67 year storm so a similar storm should be of minimal impact to major reinsurance companies (by the chart above). Second, reinsurance contracts are being cash collateralized this year, a shift from years past and a clear indication of how soft the reinsurance market is. Obviously this is a good thing for UIHC because they no longer need to worry about reinsurance funds being allocated to other insurers/risks.

I personally believe, when compared to catastrophe risk, an interest rate spike will be a far worse for reinsurance companies. There are some estimates that surplus will decline by $40 billion for every 1% hike in rates. That is almost the same impact as Hurricane Katrina and far more than Hurricane Andrew in today's dollars ($23 billion). If UIHC can grow their book >15%/year interest rate spikes will not have as great of an effect because policies can be reinvested into higher yielding assets.

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4. Management becomes determined to build an empire

Greg Branch (Chairman) owns 1.529 million shares, John Forney (CEO) owns 118,000 shares, and Kent Whittemore (Director) owns 221,000 shares. While I am encouraged by the insider ownership and the recent buys in December of 2012, there is a poison pill following an activist campaign. This makes it significantly more difficult to stage a takeover. I have ascribed very little value to the chance of a takeover.

I also worry that if management cannot achieve the 2-5% market share in each state that they will continue to hold rates low in a futile attempt to capture more of the market. This risk can hopefully be determined by checking in with agencies.

Conclusion

United Insurance Holdings is one of the best insurance companies today because they are actually growing and should deliver strong returns on equity over the next several years. The opportunity is available to investors today because the company is not followed by the sell-side and operates in an industry that is regarded as very risky from both an absolute and political basis (Florida catastrophe insurance).

These misconceptions are unfounded though as the company is led by management and a board that own a significant number of shares, have priced risk well in the past, and are now diversifying risk by moving into other states. As more and more states are added, UIHC will reduce their single event risk and their political risk. The company is also able to write premiums at better terms due to the current soft market that exists in property reinsurance.

Over the next three years I expect book value to grow between 30%-100% depending on numerous factors. Investors today are protected by the low relative price to book ratio and strong historical performance.

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