

**SKYWARD SPECIALTY INSURANCE GROUP, INC.
AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE
GROUP, LTD.)**

**CONSOLIDATED FINANCIAL STATEMENTS
WITH INDEPENDENT AUDITOR'S REPORT
As of and for the Years Ended December 31, 2020 and 2019**

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
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INDEPENDENT AUDITOR'S REPORT

To the Audit Committee of the Board of Directors
Skyward Specialty Insurance Group, Inc.
(Formerly Houston International Insurance Group, Ltd.)

We have audited the accompanying consolidated financial statements of Skyward Specialty Insurance Group, Inc. and Subsidiaries (formerly Houston International Insurance Group, Ltd.), (the "Company"), which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a reasonable basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2020 and 2019 and the consolidated results of its operations and its cash flows for the years ended December 31, 2020 and 2019 in accordance with accounting principles generally accepted in the United States of America.

Houston, Texas
March 16, 2021

Ham, Langston & Brezina, LLP

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2020 AND 2019

(In Thousands, except for share and per share amounts)

	2020	2019
ASSETS		
Investments:		
Fixed maturity securities, available for sale, at fair value (amortized cost of \$299,454 and \$247,828, respectively)	\$ 315,001	\$ 254,512
Fixed maturity securities, held to maturity, at amortized cost	28,393	-
Equity securities, at fair value (cost of \$74,112 and \$70,339, respectively)	77,773	75,004
Receivable for securities sold	-	410
Investment in separately managed accounts	57,342	73,935
Investment in limited partnerships	42,099	38,918
Other invested assets	8,246	8,763
Short-term investments, at fair value	<u>235,957</u>	<u>260,163</u>
Total investments	764,811	711,705
Cash and cash equivalents	54,633	39,741
Restricted cash	57,432	46,249
Premiums receivable, net of allowance	113,994	112,590
Reinsurance recoverables	562,329	424,729
Ceded unearned premium	164,627	180,409
Deferred policy acquisition costs	53,593	56,202
Deferred federal income taxes	41,138	24,203
Goodwill and intangible assets, net	86,207	142,906
Other assets	<u>54,500</u>	<u>38,108</u>
Total assets	<u>\$ 1,953,264</u>	<u>\$ 1,776,842</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Losses and loss adjustment expenses ("LAE")	\$ 856,857	\$ 683,970
Unearned premiums	342,473	341,291
Deferred ceding commission	39,907	43,320
Reinsurance and premium payables	122,590	118,213
Funds held for others	26,880	26,383
Accounts payable and accrued liabilities	41,323	31,249
Payable for securities sold	86	-
Notes payable	50,000	83,827
Subordinated debt, net of debt issuance costs	<u>78,448</u>	<u>78,367</u>
Total liabilities	<u>1,558,564</u>	<u>1,406,620</u>
Stockholders' Equity:		
Preferred stock, \$0.01 par value, 2,000,000 and 0 shares authorized, 1,976,310 and 0 shares issued, 1,976,310 and 0 shares outstanding as of December 31, 2020 and 2019, respectively	20	-
Common stock, \$0.01 par value, 168,000,000 and 170,000,000 shares authorized; 67,052,434 and 66,990,694 shares issued, 65,646,007 and 66,192,625 shares outstanding as of December 31, 2020 and 2019, respectively	671	670
Treasury stock, at par value, 1,406,427 and 798,069 shares, as of December 31, 2020 and 2019, respectively	(14)	(8)
Additional paid-in capital	574,549	478,164
Stock notes receivable	(10,787)	(3,547)
Accumulated other comprehensive income	13,337	6,334
Accumulated deficit	<u>(183,076)</u>	<u>(111,391)</u>
Total stockholders' equity	<u>394,700</u>	<u>370,222</u>
Total liabilities and stockholders' equity	<u>\$ 1,953,264</u>	<u>\$ 1,776,842</u>

The accompanying notes are an integral part of these consolidated financial statements.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
FOR THE YEARS ENDED DECEMBER 31, 2020 AND 2019
(In Thousands)

	<u>2020</u>	<u>2019</u>
Revenues:		
Net earned premium	\$ 396,307	\$ 385,116
Commission and fee income	6,376	5,119
Net investment income	15,533	19,776
Net unrealized (losses) gains on equity securities	(1,021)	13,995
Net realized gains	1,067	8,199
Other operating income	<u>129</u>	<u>449</u>
 Total revenues	 <u>418,391</u>	 <u>432,654</u>
Expenses:		
Losses and loss adjustment expenses, net	325,598	281,130
Policy acquisition costs	26,744	24,090
Other operating and general expenses	82,846	78,853
Loss portfolio transfer expense	10,784	-
Impairment charges	56,188	-
Interest expense	5,532	6,837
Amortization expense	<u>1,472</u>	<u>1,800</u>
 Total expenses	 <u>509,164</u>	 <u>392,710</u>
 (Loss) Income before federal income tax expense	 (90,773)	 39,944
 Federal income tax (benefit) expense	 <u>(19,088)</u>	 <u>7,667</u>
 Net (loss) income	 <u>(71,685)</u>	 <u>32,277</u>
Other comprehensive income:		
Unrealized gains and losses on investments:		
Net change in unrealized gains and losses on investments, net of tax	4,319	15,526
Reclassification adjustment for gains and losses on securities no longer held, net of tax	<u>2,684</u>	<u>(7,551)</u>
 Total other comprehensive income	 <u>7,003</u>	 <u>7,975</u>
 Comprehensive (loss) income	 <u>\$ (64,682)</u>	 <u>\$ 40,252</u>

The accompanying notes are an integral part of these consolidated financial statements.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2020 AND 2019
(In thousands, except share amounts)

	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Treasury Stock</u>	<u>Additional Paid-In Capital</u>	<u>Stock Notes Receivable</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Accumulated Deficit</u>	<u>Total</u>
Balance at December 31, 2018	\$ -	\$ 669	\$ (7)	\$ 478,427	\$ (3,842)	\$ (9,012)	\$ (136,297)	\$ 329,938
Reclassification of net unrealized loss on equity securities to accumulated deficit for adoption of ASU 2016-01 (see Note 3)	-	-	-	-	-	7,371	(7,371)	-
Employee share activity	-	-	(1)	(262)	295	-	-	32
Issuance of indemnification shares	-	1	-	(1)	-	-	-	-
Net income	-	-	-	-	-	-	32,277	32,277
Other comprehensive income, net of tax	-	-	-	-	-	7,975	-	7,975
Balance at December 31, 2019	\$ -	\$ 670	\$ (8)	\$ 478,164	\$ (3,547)	\$ 6,334	\$ (111,391)	\$ 370,222
Issuance of Series A Convertible Preferred Stock	20	-	-	99,745	(9,587)	-	-	90,178
Employee share activity	-	1	(2)	(2,115)	1,437	-	-	(679)
Treasury stock repurchased	-	-	(4)	(1,245)	910	-	-	(339)
Net loss	-	-	-	-	-	-	(71,685)	(71,685)
Other comprehensive income, net of tax	-	-	-	-	-	7,003	-	7,003
Balance at December 31, 2020	<u>\$ 20</u>	<u>\$ 671</u>	<u>\$ (14)</u>	<u>\$ 574,549</u>	<u>\$ (10,787)</u>	<u>\$ 13,337</u>	<u>\$ (183,076)</u>	<u>\$ 394,700</u>

The accompanying notes are an integral part of the consolidated financial statements.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2020 AND 2019
(In Thousands)

	<u>2020</u>	<u>2019</u>
Cash flows from operating activities:		
Net (loss) income	\$ (71,685)	\$ 32,277
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net realized gains	(1,067)	(8,199)
Depreciation and amortization expense	6,067	5,023
Stock-based compensation expense	(25)	(98)
Provision for bad debts	812	861
Unrealized gains (losses) on equity securities	1,021	(13,995)
Earnings on illiquid investments	(6,313)	(10,010)
Deferred income tax, net	(18,750)	7,377
Impairment charges	56,188	729
Changes in operating assets and liabilities:		
Premiums receivable, net	(2,216)	(13,286)
Reinsurance recoverables	(137,600)	(42,483)
Ceded unearned premium	15,782	(21,984)
Deferred policy acquisition costs	2,610	(7,731)
Losses and loss adjustment expenses	172,887	84,584
Unearned premiums	1,182	58,493
Deferred ceding commission	(3,413)	4,175
Reinsurance and premium payables	4,377	23,366
Funds held for others	496	(3,983)
Accounts payable and accrued liabilities	9,367	5,808
Other, net	(17,973)	13,882
	<u>11,747</u>	<u>114,806</u>
Net cash provided by operating activities		
Cash flows from investing activities:		
Purchase of fixed maturity securities, available for sale	(146,639)	(17,290)
Purchase of investment securities, held to maturity	(35,881)	-
Purchase of equity securities	(36,880)	(22,251)
Purchase of other invested asset	(210)	-
Purchase of interest in limited partnerships	-	(970)
Investment in separately managed accounts	17,920	461
Net cash paid for acquisitions	-	(1,707)
Purchase of property and equipment	(2,072)	(3,441)
Sales and maturities of investment securities	136,065	63,848
Distributions from limited partnerships	-	2,422
Distributions from investment in affiliate	1,000	305
Sale of investment in affiliate	-	20,140
Change in short-term investments	24,207	(202,553)
Other, net	496	873
	<u>(41,994)</u>	<u>(160,163)</u>
Net cash (used in) provided by investing activities		
Cash flows from financing activities:		
Employee share purchases	276	80
Issuance of preferred shares	90,413	-
Proceeds from notes payable	-	118,827
Repayments of notes payable	(33,827)	(116,000)
Repurchase of common stock	(540)	-
Proceeds from subordinated debt	-	20,000
	<u>56,322</u>	<u>22,907</u>
Net cash provided by financing activities		
Net (decrease) increase in cash and cash equivalents and restricted cash	26,075	(22,450)
Cash and cash equivalents and restricted cash at beginning of year	<u>85,990</u>	<u>108,440</u>
Cash and cash equivalents and restricted cash at end of year	<u>\$ 112,065</u>	<u>\$ 85,990</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 5,530	\$ 8,226
Cash refunds for federal income taxes	\$ -	\$ 526

The accompanying notes are an integral part of the consolidated financial statements.

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Nature of Operations

Skyward Specialty Insurance Group, Inc. (formerly Houston International Insurance Group, Ltd. (“HIIG”)), (the “Company”, collectively we, us or our), an insurance holding company, is a Delaware corporation that was organized in 2006. We underwrite select property and casualty and accident and health insurance coverages through our subsidiaries.

Insurance Companies

We conduct operations principally through five insurance companies. Houston Specialty Insurance Company (“HSIC”), our largest insurance subsidiary, underwrites multiple lines of insurance on a surplus lines basis in 50 states and the District of Columbia. Imperium Insurance Company (“IIC”), a subsidiary of HSIC, underwrites on an admitted basis in all 50 states and the District of Columbia. Great Midwest Insurance Company (“GMIC”), a subsidiary of IIC underwrites multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia and is T-listed with the Department of Treasury. Boston Indemnity Company (“BIC”), a subsidiary of GMIC, underwrites surety business in all 50 states and the District of Columbia and is T-listed with the Department of Treasury. Oklahoma Specialty Insurance Company (“OSIC”), a subsidiary of BIC, is an approved surplus lines company in 34 states.

Reinsurance Company

HIIG Re is a wholly owned captive reinsurance company domiciled in the Cayman Islands that was incorporated on January 7, 2020. HIIG Re assumes net reserves for certain divisions, related to a loss portfolio transfer, from our insurance companies and retrocedes the net reserves to a third-party reinsurer.

Non-insurance Companies

Skyward Underwriters Agency, Inc. (“SUA”), a subsidiary of HIIG, is a managing general insurance agent and reinsurance broker for property and casualty and accident and health risks in specialty niche markets. Skyward Service Company (formerly HIIG Service Company), also our subsidiary, provides various administrative services to our subsidiaries.

2. Summary of Significant Accounting Policies

Basis of Presentation

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), and include the accounts of the Company and its subsidiaries as of and for the years ended December 31, 2020 and 2019. All significant intercompany transactions and balances have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid short-term investments. We consider all short-term investments purchased with an original maturity of three months or less to be cash equivalents. The carrying value of the Company’s cash and cash equivalents approximates fair value.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Restricted Cash

Cash with a legal restriction as to withdrawal or use is recorded as restricted cash. The carrying value of the Company's restricted cash approximates fair value.

Our insurance agency collects premiums from clients, and after deducting commissions and any applicable fees, remits these premiums to our insurance companies. We hold unremitted insurance premiums in a fiduciary capacity, as restricted cash with the related liability reported as premium payable within reinsurance and premiums payables. Interest on these unremitted funds is reported as net investment income.

We are required by state regulations to maintain assets on deposit with certain states and hold cash as collateral for certain reinsurance balances. Cash that we hold in a depository account for others or which is restricted by a state is recorded as restricted cash.

Investments

Available for Sale

Our investments in fixed maturity securities and equity securities are classified as available for sale and are reported at fair value based on quoted market prices or dealer quotes. Unrealized gains and losses for fixed maturity securities are excluded from earnings and reported in stockholders' equity, net of taxes, as a component of accumulated other comprehensive income (loss). Unrealized gains and losses on equity securities are included in the statements of operations and comprehensive income (loss). If quoted market prices or dealer quotes are not available, we estimate fair value based on recent trading information. Premiums and discounts on mortgage-backed securities are amortized using the retroactive method adjusted for anticipated prepayments and the estimated economic life of the securities. Adjustments related to changes in prepayment assumptions are included in net investment income.

Held to maturity

Our investments in fixed maturity securities where we have demonstrated the intent and ability to hold until maturity have been classified as held to maturity and are reported at amortized cost.

Other-than-Temporary Impairments

We evaluate declines in the market value of invested assets below amortized cost, for other-than-temporary impairment losses, on a quarterly basis. Impairment losses for declines in the value of our fixed maturity securities and investments in separately managed accounts ("SMAs") below amortized cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For all our investments with unrealized losses due to market conditions or industry-related events where we do not have the intent to sell the security and we have the ability to hold the investment for either a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. When we consider the impairment of the value of an investment to be other-than-temporary, we report the decrease in value in the statement of operations as a realized investment loss and adjust the carrying value accordingly.

Investment in Separately Managed Accounts

Our investments in SMAs are comprised primarily of direct or indirect investments in collateralized loans and commercial mortgage loans. We record directly owned collateralized loans and commercial mortgage loans at cost and recognize interest on the loans as interest receivable which we include in other invested assets on the balance sheet. If we obtain title to collateral in lieu of repayment, we derecognize the loan and recognize the collateral within other assets. As of December 31, 2020 and 2019, we maintained an allowance for uncollectible accounts of \$1.3 million and \$0.3 million, respectively.

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

2. Summary of Significant Accounting Policies, continued

Investments, continued

Investments in Limited Partnerships

We have investments in certain limited partnerships. We use the equity method to account for our investments in limited partnerships. Under the equity method, our initial investment is recorded at cost and is subsequently adjusted based on our proportionate share of distributions and net income or loss of the partnership.

Other Invested Assets

Our other invested assets include investments in affiliates which are investments in primarily insurance agencies, managing general underwriters (“MGUs”) and investments in private bank holding companies. We use the equity method to account for investments where we have significant influence. For investments where we do not have significant influence and for which there does not exist a readily determinable fair value, we carry these investments at cost, minus impairment, if any, and changes resulting from observable price changes in orderly transactions for identical or similar investments of the same issuer.

Short-Term Investments

Our short-term investments consist primarily of money market funds and are carried at cost which approximates fair value.

Net Investment Income and Net Realized Gains and Losses

Net investment income consists of interest, dividends and equity in earnings (losses) of investees net of investment expenses. Interest income is recognized on the accrual basis, and dividends as earned at the ex-dividend date. Interest income on mortgage-backed and asset-backed securities is recognized using the effective-yield method based on estimated principal repayments. Included in interest income is the amortization of premium and accretion of discounts on debt securities.

We recognize net realized gains and losses on investments in earnings based upon the specific identification method.

Reinsurance

We purchase prospective reinsurance for certain lines of business on a proportional, excess of loss and facultative basis. Proportional reinsurance requires us to share the losses and expenses with the reinsurer in exchange for a share of the premiums. Excess of loss reinsurance shares losses, either a proportion of or in its entirety, above a certain dollar threshold, in exchange for a negotiated cost. Facultative reinsurance covers specific risks and/or policies on either a proportional or excess of loss basis.

We purchase retroactive reinsurance on certain lines of business in the form of loss portfolio transfers (“LPT”) and adverse development covers. These contracts provide indemnification of losses related to past loss events where the reinsurer shares losses, either a proportion of or in its entirety, depending on certain dollar thresholds.

We report ceded unearned premium and reinsurance balances recoverable, on paid and unpaid losses and settlement expenses, separately as assets, instead of netting them with the related liabilities, since reinsurance does not relieve us of our legal liability to our policyholders. Reinsurance on unpaid losses and settlement expenses represent estimates of the portion of the liabilities recoverable from reinsurers.

We continuously monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance recoverables by monitoring the financial strength rating of our reinsurers from A.M. Best, a widely recognized rating agency with an exclusive insurance industry focus. We also assess the adequacy of collateral obtained, where applicable. We have \$246.5 million and \$128.3 million of collateral from various reinsurers as of December 31, 2020 and 2019, respectively. When our review indicates the existence of uncollectible amounts from reinsurers, our policy is to charge earnings and provide an allowance for estimated uncollectible amounts. As of December 31, 2020 and 2019, we determined that no allowance was required.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Deferred Policy Acquisition Costs

Policy acquisition costs consist of commissions and premium taxes that vary with and are directly related to the successful production of new or renewal business. We defer policy acquisition costs and related ceding commissions and charge or credit them to earnings in proportion with the premium earned.

We recognize a premium deficiency if the sum of expected losses, loss adjustment expenses, and unamortized acquisition costs exceed our related unearned premiums. We first recognize a premium deficiency by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If our premium deficiency is greater than unamortized acquisition costs, we accrue a liability for the excess deficiency. We consider anticipated investment income in the determination of premium deficiencies. Based on the analysis performed by management, we believe that no premium deficiency existed as of December 31, 2020 and 2019.

Goodwill and Intangible Assets

Goodwill and intangible assets are recorded as a result of a business combination. Goodwill represents the excess of the purchase price over the fair value of the assets acquired and liabilities assumed. We amortize identifiable intangible assets with a finite useful life over the period that the intangible asset is expected to contribute directly or indirectly to our future cash flows. We do not amortize indefinite lived intangible assets.

In accordance with ASC 350-20, we evaluate goodwill and identifiable intangible assets for recoverability annually in the fourth quarter or on an interim basis should events or changes in circumstances indicate that a carrying amount may not be recoverable.

To test for impairment, we first perform a qualitative assessment to determine if it is more likely-than-not that the fair value of a reporting unit is less than its carrying value, including goodwill. If the more likely-than-not threshold is met, we perform a quantitative impairment test by comparing the estimated fair value with the carrying value. If the carrying value of the net assets associated with the reporting unit exceeds the fair value of the reporting unit, goodwill is considered impaired and will be determined as the amount by which the reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill.

Determining the fair value of our reporting units is subjective in nature and involves the use of significant estimates and assumptions, including projected net cash flows, discount and long-term growth rates. We determine the fair value of our reporting units based on an income approach, whereby the fair value of the reporting unit is derived from the present value of estimated future cash flows associated with the reporting unit. The assumptions about estimated cash flows include factors such as future premiums, loss and LAE expenses, general and administrative expenses and industry trends. We consider historical rates and current market conditions when determining the discount and long-term growth rates to use in our analysis. We consider other valuation methods, such as the cost approach or market approach, if the facts and circumstances indicate these methods provide a more representative approximation of fair value. Changes in these estimates based on evolving economic conditions or business strategies could result in material impairment charges in future periods. We base our fair value estimates on assumptions we believe to be reasonable. Actual results may differ from those estimates.

As a result of the process described above, we recorded a goodwill impairment charge of \$55.3 million for the year ended December 31, 2020. This amount is included in "Impairment charges" in the consolidated statements of operations. See Note 4, Goodwill and Intangible Assets. No goodwill impairment charges were recorded for the year ended December 31, 2019.

Property and Equipment

We record property and equipment, which is included in other assets in the consolidated balance sheets, at cost less accumulated depreciation and recognize depreciation expense on a straight-line basis for financial statement purposes over periods ranging from four to eight years for software and equipment and for leasehold improvements over the life of our leases.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Losses and LAE Reserves

Losses and LAE reserves represent our best estimate of the ultimate net cost of all reported and unreported losses that are unpaid as of the balance sheet dates. Our estimated reserves for losses and LAE include the accumulation of estimates for claims reported and unpaid prior to the balance sheet dates, estimates (based on projections of relevant historical data) of increases in claims costs for claims already reported, of claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred and unpaid claims. We estimate our reserves on an undiscounted basis, using individual case-basis valuations, statistical analyses, and various actuarial procedures. We project future claim payments and reporting based on an analysis of our historical experience, supplemented by analyses of industry loss data.

Losses and LAE reserves are subject to uncertainty from various sources, including changes in reporting patterns, claims settlement patterns, judicial decisions, legislation, and economic conditions. Therefore, our actual loss experience may not conform to the assumptions used in determining the estimated amounts for such liability at the balance sheet dates. Management believes that, subject to the inherent variability in any such estimate, the reserves are within a reasonable and acceptable range of adequacy. We continually monitor and review reserves, and as settlements are made or reserves adjusted, the differences are reported in the current year.

Because of the nature of business we have historically written, management believes that we have limited exposure to environmental and other toxic tort type claim liabilities.

Premiums

We earn and recognize property and casualty and surety premiums on a pro-rata basis over the terms of the policies. We earn accident and health premiums as billed, based on census data. Gross premiums written are reduced by ceded premiums from proportional, facultative and excess of loss reinsurance costs. Our premiums receivable include deferred premiums, which represent installment payments we are due from insureds under the payment terms of their policies. We recorded an allowance for estimated uncollectible premiums receivable of approximately \$1.1 million as of December 31, 2020 and 2019.

Unearned premiums represent the portion of premiums written which is applicable to the unexpired terms of insurance policies or reinsurance contracts in force. These unearned premiums are calculated on a pro-rata basis over the terms of the policies for direct and ceded amounts.

Fee and Commission Income

We recognize commissions on the effective date of the policies or the billing date, whichever is later. We recognize any subsequent premium adjustments, including policy cancellations, upon notification from the insurance carriers, or insured, as applicable. We record an allowance for estimated return commissions and fees that may be required to be repaid based on early termination of policies. As of December 31, 2020 and 2019, we determined that no allowance was required.

Profit Commissions

We have entered into contractual agreements with program managers that transfer a limited amount of a program's profits or losses through contingent commissions. Contingent commissions incurred for the years ended December 31, 2020 and 2019 was \$0.6 million and \$0.5 million, respectively.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Income Taxes

We accrue income tax expense for the tax effects of transactions reported in the consolidated financial statements and this provision for income taxes consists of taxes currently due plus deferred taxes resulting from temporary differences between amounts reported for financial statement and income tax purposes. We establish a valuation allowance for any deferred tax asset not expected to be realized.

We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date.

We record a liability for uncertain tax positions where it is more likely-than-not that the tax position will not be sustained upon examination by the appropriate tax authority. Changes in the liability for uncertain tax positions are reflected in income tax expense in the period when a new uncertain tax position arises, judgment changes about the likelihood of an uncertainty, the tax issue is settled or the statute of limitation expires. Any potential net interest income or expense and penalties related to uncertain tax positions are recorded in the consolidated statements of operations.

We file a consolidated federal income tax return in the United States and certain other state tax returns. Our admitted insurance subsidiaries pay premium taxes on gross written premiums in lieu of most state income or franchise taxes. Premium tax expense is recognized within policy acquisition costs in the consolidated statement of operations.

Stock Based Compensation

We currently grant common stock to our employees and non-employee directors under our Equity Incentive Program. The Equity Incentive Program requires a minimum investment from the participant once the participant has committed to a specified amount. The remainder is issued as a note receivable to us and is recorded as stock notes receivable within Stockholders' Equity. Additionally, once the grant amount has been confirmed, we match 100% of the grant. We recognize compensation costs over the applicable vesting period for share-based payments to employees, former employees and non-employee directors at fair value of the common stock on the grant date.

Risk and Uncertainties

Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our consolidated financial statements. The more significant risks and uncertainties, as well as our attempt to mitigate, quantify and minimize such risks, are presented below and throughout the notes to the consolidated financial statements.

COVID-19

The onset of COVID-19 resulted in various emergency restrictions instituted by various state and local governments in the United States. These restrictions have caused and are expected to continue to cause considerable economic disruption which may include reduced economic activity, changes in consumer behavior, business closures and deterioration in the credit quality of policyholders and/or reinsurers or the inability of policyholders to pay their premiums and reinsurers to pay covered losses. The cumulative effects of COVID-19 on the Company cannot be predicted at this time but could reduce demand for our insurance policies, result in increased levels of losses, claims settlement expenses or operating expenses. These events could have an impact in future periods on certain estimates used in the preparation of our consolidated financial statements, including, but not limited to additional impairments of goodwill and intangible assets, the realizability of our deferred tax assets, collectability of receivables and valuation of investments.

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
(FORMERLY HOUSTON INTERNATIONAL INSURANCE GROUP, LTD.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

2. Summary of Significant Accounting Policies, continued

Risk and Uncertainties, continued

Financial Strength Rating Risk

The A.M. Best financial strength rating is an important factor in establishing the competitive position of our insurance companies to our distribution channels, which consists of a network of independent agents, brokers and managing general underwriter partners. There can be no assurances that we will not receive a ratings downgrade which may result in an adverse effect on our business, financial condition and operating results as a result of the inability to write certain lines of business and the impact on relationships within our distribution channels.

As of December 31, 2020 all of our insurance company subsidiaries are group rated and have financial strength ratings of "A-" (Excellent) from A.M. Best Company with a "Stable" outlook. Our ratings are subject to periodic review by A.M. Best and the maintenance of those ratings cannot be assured.

Underwriting Risks

Underwriting risks are defined as the risk of loss due to inadequate pricing and reserving practices. These risks may be caused by the fluctuations in timing, frequency and severity of insured events and claim settlements in comparison to the expectations at the time of underwriting. If we do not price our products appropriately based on risk and set our reserves adequately, our operating results could be adversely affected.

Competitor Risks

We compete with numerous companies within our various lines of select property and casualty and accident and health insurance businesses. Some of our competitors have a larger capital base, a higher A.M. Best financial strength rating and larger or more established distribution channels. No assurance can be given that we will be able to compete successfully within each line of business. Increased competition within each line of business could impact the price of our products which will impact our ability to retain existing business or underwrite new business on favorable terms. If increased competition limits our ability to transact business, our operating results could be adversely affected.

Access to Capital

Our insurance subsidiaries are subject to risk-based capital requirements by their respective state insurance regulatory body. A risk-based capital system is a measure of the minimum amount of capital that is appropriate for an insurance entity to support business operations in consideration of its size and risk profile. The risk-based capital is intended to be a minimum regulatory capital standard and not necessarily the full amount of capital that we would want to hold to meet safety and competitive objectives.

We are a privately held insurance holding company and our access to capital is primarily from our current equity holders and issuers of our debt. Should we attempt to access capital from other parties, it may not be available to us on commercially favorable terms.

Information Technology Risks

We are dependent upon the successful and uninterrupted access of our information technology resources. These resources are subject to risks ranging from cybersecurity risks to natural disaster risks. We maintain a highly trained information technology group committed to developing and maintaining security measures, to counteract cybersecurity risks, and disaster recovery, data storage and backup plans, in response to natural disasters. There are no assurances that the security measures and disaster recovery, data storage and backup plans will be sufficient to address all risks and our ability to transact business could be affected.

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2. Summary of Significant Accounting Policies, continued

Risk and Uncertainties, continued

Acquisition Integration and Execution Risks

Our strategy for growth may include acquiring businesses. This strategy presents risks that could have a material effect on our businesses and financial performance such as the risk that we fail to integrate the operations of the new business and/or fail to retain key employees related to the integration and/or execution of the business. We cannot know if we will be able to successfully integrate all acquired businesses and whether we would be able to successfully execute the plans related to running acquired businesses. If we fail to appropriately integrate new businesses and/or fail to execute the plans related to running acquired businesses, our operating results could be adversely affected which may result in an impairment to intangible assets and/or goodwill.

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ materially from these estimates.

Insurance Risks

Our loss and LAE reserves are based on estimates and may be inadequate to cover our actual insured losses, which would negatively impact our profitability. As of December 31, 2020, we had \$856.9 million of total gross loss and LAE reserves. Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. As part of the reserving process, we review historical data and consider the impact of various factors such as trends in claim frequency and severity, emerging economic and social trends, inflation and changes in the regulatory and litigation environments. If the actual amount of insured losses is greater than the amount we have reserved for these losses, our profitability could suffer.

Reinsurance Risk

Reinsurance does not discharge us from our primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, we would be liable. We continuously monitor the financial condition of prospective and existing reinsurers. As a result, we purchase reinsurance from a number of financially strong reinsurers. We provide an allowance for reinsurance balances deemed uncollectible. See further discussion of reinsurance exposures in Note 18.

Investment Risk

Our investment portfolio is subject to market, credit, liquidity and interest rate risks. Our equity portfolio will fluctuate with movements in the overall stock market, while our bond portfolio is affected by interest rate changes and movement in credit spreads. We attempt to mitigate our interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities with varied maturities. Downturns in the financial markets could have a negative effect on our portfolio. However, we attempt to manage this risk through asset allocation, duration and security selection. Our investment in fixed maturity securities (held to maturity), separately managed accounts, investments in limited partnerships and other invested assets are relatively illiquid and represent 17.8% and 17.1% of total investments as of December 31, 2020 and 2019, respectively. Investments in fixed maturity securities, held to maturity, are private notes with a term of approximately 5 years. Investments in separately managed accounts and limited partnerships are generally comprised of loans with relatively short duration but subject to contractual withdrawal conditions. Other invested assets are generally investments in privately held companies.

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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2. Summary of Significant Accounting Policies, continued

Risk and Uncertainties, continued

Concentration Risk

Financial instruments that potentially subject us to concentrations of credit risk are primarily cash and cash equivalents, restricted cash, investments, premiums receivable and reinsurance recoverable balances.

Cash equivalents and short-term investments include investments in money market funds and securities backed by the U.S. government. Investments are diversified throughout many industries and geographic regions. We limit the amount of credit exposure with any one financial institution or issuer and believe that no significant concentration of credit risk exists with respect to cash and investments. As of December 31, 2020 and 2019, the outstanding premiums receivable are generally diversified due to the large number of entities comprising our customer base and their dispersion across many different lines of business and geographic regions. Failure by distribution sources to remit premiums could result in premium write-offs and a corresponding loss of income.

Reinsurance recoverables presents potential exposures to individual reinsurers. To alleviate this risk the Company monitors the reinsurer's financial strength rating from A.M. Best. We also review the reinsurer's annual financial statements and obtain collateral in the form of funds held, trust accounts or letters of credit to minimize our exposure. The following table lists the individual reinsurers which represent 10% or more of our reinsurance recoverable balances and the respective financial strength rating from A.M. Best:

	<u>A.M. Best Rating</u>	<u>2020</u>	<u>2019</u>
Everest Re	A+	31.8%	35.2 %
Randall & Quilter Bermuda (SAC) Ltd	Not rated	11.9%	Below 10 %
Lloyd's syndicates	A	Below 10%	17.0 %

We have no credit risk exposure to Randall & Quilter Bermuda (SAC) Ltd as we are the beneficiary of a reinsurance trust with assets in excess of our reinsurance recoverable.

Reclassifications

Certain 2019 amounts have been reclassified to conform to the 2020 presentation. Such reclassifications had no effect on our Consolidated Balance Sheets, Consolidated Statements of Operations and Comprehensive Income (Loss), Consolidated Statements of Changes in Stockholders' Equity or Consolidated Statements of Cash Flows.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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3. Recent Accounting Pronouncements

On January 1, 2019, we adopted Accounting Standards Update (“ASU”) No. 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Liabilities*, to improve the recognition and measurement of financial instruments. The impact of this adoption resulted in a reclassification of \$7.4 million, net of tax, from accumulated other comprehensive income to accumulated deficit in the statement of changes in stockholders’ equity. Also after adoption, changes in fair value related to our equity securities are recognized in net income.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. ASU No. 2014-09 was issued to specify the accounting for revenue from contracts with customers. The ASU requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled. While insurance contracts are excluded from this ASU, fee income related to any brokerage operations are subject to this updated guidance. ASU No. 2014-09 is effective for interim and annual periods beginning after December 15, 2017 for public entities and December 15, 2019 for private entities. We adopted this ASU effective January 1, 2019. The adoption of this ASU did not have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-08, Premium Amortization on Purchased Callable Debt Securities, provided guidance that shortens the amortization period for certain callable debt securities held at a premium by requiring the premium to be amortized to the earliest call date. The standard does not require an accounting change for securities held at a discount, which continue to be amortized to maturity. This ASU is effective for nonpublic entities with fiscal years beginning after December 15, 2019. We adopted this ASU effective January 1, 2020. The adoption of this ASU did not have a material impact on our consolidated financial statements.

In February 2017, the FASB issued ASU No. 2016-02, Leases, to improve the financial reporting of leasing transactions. Under legacy guidance for lessees, leases are only included on the balance sheet if certain criteria, classifying the agreement as a capital lease, are met. This pronouncement requires the recognition of a right-of-use asset and a corresponding lease liability, discounted to the present value, for all leases that extend beyond 12 months. For operating leases, the asset and liability will be expensed over the lease term on a straight-line basis, with all cash flows included in the operating section of the statement of cash flows. For finance leases, interest on the lease liability will be recognized separately from the amortization of the right-of-use asset in the income statement and the repayment of the principal portion of the lease liability will be classified as a financing activity in the statements of cash flows while the interest component will be included in the operating activities in the statements of cash flows. This ASU is effective for reporting periods beginning after December 15, 2018 for public entities and reporting periods beginning after December 15, 2020 for private entities. Early adoption is permitted and, accordingly, we adopted this ASU effective January 1, 2020. The adoption of this ASU resulted in the recognition of a \$12.2 million right-of-use asset within other assets and a \$11.8 million lease liability within accounts payable and accrued liabilities on the consolidated balance sheets.

In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments (Topic 326). ASU 2016-13 requires organizations to estimate credit losses on certain types of financial instruments, including receivables and available-for-sale debt securities, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. The guidance is effective for fiscal years beginning after December 15, 2022. Early adoption is permitted. We are currently evaluating the impact that the adoption of the ASU will have on our consolidated financial statements.

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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4. Goodwill and Intangible Assets

The carrying amount of goodwill and identifiable intangible assets by reporting unit for the years ended December 31, 2020 and 2019 are as follows (in thousands):

	2020	2019
Goodwill:		
Accident and Health	\$ 46,756	\$ 84,731
Hospitality	-	10,361
Mining	10,052	10,052
Exterminator Pro	4,838	11,809
Other	4,681	4,681
Total goodwill	66,327	121,634
Other intangibles assets:		
Indefinite lived intangible assets	16,141	16,141
Finite lived intangible assets	17,472	23,503
Total other intangibles	33,613	39,644
Less accumulated amortization	(13,733)	(18,372)
Total other intangible assets, net	\$ 19,880	\$ 21,272
Total goodwill and other intangible assets, net	\$ 86,207	\$ 142,906

During the annual impairment assessment performed in the fourth quarter of 2020, we determined that the fair value of goodwill on three reporting units were below carrying value. This determination was driven by the finalization of our budgeting process for 2021, comparison of 2020 actual results to budget and additional clarity and insight on the impact of COVID-19 on our business during the fourth quarter of 2020. A description behind the facts and circumstances behind the goodwill impairment assessment by reporting unit is as follows:

Accident and Health – Our qualitative assessment indicated that it was more likely than not that this reporting unit's fair value was less than its carrying value due to the poor performance of this reporting unit during the year ended December 31, 2020 and the reduction in expected future earnings during the 2021 budgeting process. We engaged a third-party valuation firm to value the goodwill based on a discounted cash flow model utilizing the board approved budget for 2021, forecasts for 2022 and 2023 and a reasonable growth rate for 2024 and beyond. This valuation indicated the carrying value exceeded fair value by \$30.0 million. Based on this analysis, we recorded \$30.0 million of goodwill impairment charges and an additional reclassification in goodwill of \$8.0 million to offset the increase in deferred taxes on this reporting unit in accordance with ASU No. 2017-04.

Exterminator Pro – We entered into an agreement with an unrelated third-party on January 14, 2021 to sell the Exterminator Pro business and purchase a surety book of business. Based on the valuation of the surety business, the implied valuation of the Exterminator Pro business was \$5.0 million resulting in \$7.0 million of goodwill impairment.

Hospitality – During the year ended December 31, 2020, we reduced headcount and underwriting in specific geographic areas and was in the process of evaluating a complete exit from this line of business. Our qualitative assessment indicated that it was more likely than not that this reporting unit's fair value was less than its carrying value due to the impact of COVID-19 on this reporting unit during the year ended December 31, 2020 and the reduction in expected future earnings during the 2021 budgeting process. We used a discounted cash flow model utilizing the board approved budget for 2021, the 2022 and 2023 forecasts, and a reasonable growth rate for 2024 and beyond. This valuation indicated the carrying value of goodwill was \$0.0 million resulting in \$10.3 million of goodwill impairment.

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4. Goodwill and Intangible Assets, continued

Our indefinite lived intangible assets relate to insurance licenses and trademarks. Our finite lived intangible assets, which relate to policy renewals, agency relationships and non-compete/exclusivity agreements, have a weighted average useful life of ten years.

We recognized amortization expense of approximately \$1.4 million and \$1.7 million for the years ended December 31, 2020 and 2019, respectively.

Estimated future net amortization expense of intangible assets for the next five years is as follows (in thousands):

<u>Year Ending December 31,</u>	<u>Amount</u>
2021	\$ 1,023
2022	1,023
2023	1,023
2024	611
2025	46

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5. Investments

The amortized cost and the fair value of our investments as of December 31, 2020 and December 31, 2019 are summarized as follows (in thousands):

	<u>Gross Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2020				
Fixed maturity securities, available for sale:				
U.S. government securities	\$ 53,304	\$ 1,515	\$ (2)	\$ 54,817
Corporate securities and miscellaneous	63,573	5,859	(8)	69,424
Municipal securities	53,200	5,153	-	58,353
Residential mortgage-backed securities	78,678	2,849	(3)	81,524
Commercial mortgage-backed securities	2,872	56	(27)	2,901
Asset-backed securities	<u>47,827</u>	<u>544</u>	<u>(389)</u>	<u>47,982</u>
Total fixed maturity securities, available for sale	<u>\$ 299,454</u>	<u>\$ 15,976</u>	<u>\$ (429)</u>	<u>\$ 315,001</u>
Total fixed maturity securities, held to maturity	<u>\$ 28,393</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 28,393</u>
Equity securities:				
Common stocks	\$ 44,742	\$ 6,640	\$ (4,245)	\$ 47,137
Mutual funds	<u>29,370</u>	<u>1,268</u>	<u>(2)</u>	<u>30,636</u>
Total equity securities	<u>\$ 74,112</u>	<u>\$ 7,908</u>	<u>\$ (4,247)</u>	<u>\$ 77,773</u>
	<u>Gross Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2019				
Fixed maturity securities, available for sale:				
U.S. government securities	\$ 67,374	\$ 1,039	\$ (42)	\$ 68,371
Corporate securities and miscellaneous	46,796	1,999	-	48,795
Municipal securities	43,220	2,457	-	45,677
Residential mortgage-backed securities	71,557	1,326	(145)	72,738
Commercial mortgage-backed securities	4,201	11	(12)	4,200
Asset-backed securities	<u>14,680</u>	<u>51</u>	<u>-</u>	<u>14,731</u>
Total fixed maturity securities, available for sale	<u>\$ 247,828</u>	<u>\$ 6,883</u>	<u>\$ (199)</u>	<u>\$ 254,512</u>
Equity securities:				
Common stocks	\$ 59,690	\$ 8,867	\$ (5,119)	\$ 63,438
Mutual funds	<u>10,649</u>	<u>917</u>	<u>-</u>	<u>11,566</u>
Total equity securities	<u>\$ 70,339</u>	<u>\$ 9,784</u>	<u>\$ (5,119)</u>	<u>\$ 75,004</u>

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

The amortized cost and estimated fair value of fixed maturity securities, available for sale, at December 31, 2020 by contractual maturity are shown below (in thousands). Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Also, changing interest rates, tax considerations or other factors may result in portfolio sales prior to maturity.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in less than one year	\$ 23,411	\$ 23,632
Due after one year through five years	78,339	82,249
Due after five years through ten years	54,058	59,529
Due after ten years	14,269	17,184
Mortgage-backed securities	81,550	84,425
Asset-backed securities	<u>47,827</u>	<u>47,982</u>
Total	<u>\$ 299,454</u>	<u>\$ 315,001</u>

The amortized cost and estimated fair value of fixed maturity securities, held to maturity, at December 31, 2020 by contractual maturity are shown below (in thousands). Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Asset-backed securities	<u>\$ 28,393</u>	<u>\$ 28,393</u>
Total	<u>\$ 28,393</u>	<u>\$ 28,393</u>

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5. Investments, continued

The following tables summarize gross unrealized losses and the corresponding fair values of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position (in thousands).

	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>	<u>Gross Unrealized Losses</u>
December 31, 2020						
U.S. government securities	\$ 108	\$ (2)	\$ -	\$ -	\$ 108	\$ (2)
Corporate securities and miscellaneous	976	(8)	-	-	976	(8)
Residential mortgage-backed securities	5,502	(3)	-	-	5,502	(3)
Commercial mortgage-backed securities	327	(27)	-	-	327	(27)
Asset-backed securities	<u>3,247</u>	<u>(389)</u>	<u>-</u>	<u>-</u>	<u>3,247</u>	<u>(389)</u>
Total fixed maturity securities, available for sale	10,160	(429)	-	-	10,160	(429)
Common stocks	7,102	(2,033)	7,940	(2,212)	15,042	(4,245)
Mutual funds	<u>150</u>	<u>(2)</u>	<u>-</u>	<u>-</u>	<u>150</u>	<u>(2)</u>
Equity securities	<u>7,252</u>	<u>(2,035)</u>	<u>7,940</u>	<u>(2,212)</u>	<u>15,192</u>	<u>(4,247)</u>
Total	<u>\$ 17,412</u>	<u>\$ (2,464)</u>	<u>\$ 7,940</u>	<u>\$ (2,212)</u>	<u>\$ 25,352</u>	<u>\$ (4,676)</u>

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2019						
Corporate securities and miscellaneous	\$ 679	\$ (1)	\$ 9,428	\$ (41)	\$ 10,107	\$ (42)
Residential mortgage-backed securities	12,149	(81)	5,243	(64)	17,392	(145)
Commercial mortgage-backed securities	1,060	(7)	411	(5)	1,471	(12)
Total fixed maturity securities, available for sale	13,888	(89)	15,082	(110)	28,970	(199)
Equity securities	5,359	(1,329)	11,165	(3,790)	16,524	(5,119)
Total	\$ 19,247	\$ (1,418)	\$ 26,247	\$ (3,900)	\$ 45,494	\$ (5,318)

We do not have the intent to sell and it is not more likely-than-not that we will be required to sell these fixed maturity securities, available for sale, before the securities recover to their amortized cost value. In addition, we believe that none of the declines in the fair values of these fixed maturity securities, available for sale relate to credit losses. We have the intent and ability to hold equity securities in an unrealized loss position for a period of time sufficient to allow for the recovery of cost. We believe that none of the declines in the fair value of these fixed maturity securities, available for sale, and equity securities were other-than-temporary at December 31, 2020. We recognized no other-than-temporary impairment adjustments on fixed maturity securities, available for sale, or equity securities for the years ended December 31, 2020 and 2019.

The components of net realized (losses) gains for the years ended December 31, 2020 and 2019 are as follows (in thousands):

	2020	2019
Gross realized gains		
Fixed maturity securities, available for sale	\$ 982	\$ 123
Equity securities	7,075	1,112
Other invested assets	-	9,303
Other	-	44
Total	8,057	10,582
Gross realized losses		
Fixed maturity securities, available for sale	(885)	(602)
Equity securities	(5,678)	(1,016)
Other invested assets	(283)	-
Other	(144)	(765)
Total	(6,990)	(2,383)
Net realized (losses) gains	\$ 1,067	\$ 8,199

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5. Investments, continued

Proceeds from sales and maturities, of fixed maturity securities, available for sale, fixed maturity securities, held to maturity, and equity securities, for the year ended December 31, 2020 were approximately \$94.0 million, \$7.7 million and \$34.4 million, respectively. Proceeds from sales and maturities, of fixed maturity securities, available for sale, and equity securities, for the year ended December 31, 2019 were approximately \$16.0 million and \$47.8 million, respectively.

Our net investment income for the years ended December 31, 2020 and 2019 is summarized as follows (in thousands):

	<u>2020</u>	<u>2019</u>
Income:		
Fixed maturity securities, available for sale	\$ 7,479	\$ 7,831
Fixed maturity securities, held to maturity	792	-
Equity securities	1,639	1,459
Investment in affiliate	1,173	763
Investment in partnerships	4,034	3,957
Investment in SMAs	3,181	7,653
Short term investments and cash	1,278	2,041
Other	<u>576</u>	<u>376</u>
 Total investment income	 20,152	 24,080
 Investment expenses	 <u>(4,619)</u>	 <u>(4,304)</u>
 Net investment income	 <u>\$ 15,533</u>	 <u>\$ 19,776</u>

The change in net unrealized gains (losses) on investments, net of deferred income taxes, in other comprehensive income for the years ended December 31, 2020 and 2019 is as follows (in thousands):

	<u>2020</u>	<u>2019</u>
Fixed maturity securities	\$ 8,864	\$ 9,320
Investment in separately managed accounts	(198)	879
Short-term investments	(25)	6
Reclassification of tax effects	176	(75)
Deferred income taxes	<u>(1,814)</u>	<u>(2,155)</u>
 Total	 <u>\$ 7,003</u>	 <u>\$ 7,975</u>

We are required by various state regulations to maintain cash, investment securities or letters of credit on deposit with the states in a depository account. At December 31, 2020 and 2019, cash and investment securities on deposit had fair values of approximately \$58.2 million and \$82.7 million, respectively.

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6. Fair Value Measurements

Our financial instruments include assets and liabilities carried at fair value, as well as assets and liabilities carried at cost or amortized cost but disclosed at fair value in our financial statements. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 - Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.

Level 2 - Inputs are other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with market data at the measurement date.

Level 3 - Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

We used the following methods and assumptions in estimating the fair value disclosures for financial instruments in the accompanying consolidated financial statements and in these notes:

Our Level 1 investments consist of U.S. Treasury and equity securities traded in an active exchange market. We use unadjusted quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed maturity securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities and certain mortgage-backed and asset-backed securities. We measure fair value for the majority of the Level 2 investments using quoted prices of securities with similar characteristics.

We use data provided by a third-party investment manager to value our investments and we perform periodic analyses on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. Our analyses include a review of month-to-month price fluctuations and, as needed, a comparison of pricing services' valuations to other pricing services' valuations for the identical security.

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6. Fair Value Measurements, continued

The following table summarizes fair value measurements by level at December 31, 2020 and 2019 for assets and liabilities measured at fair value on a recurring basis (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2020				
Fixed maturity securities, available for sale:				
U.S. government securities	\$ 54,817	\$ -	\$ -	\$ 54,817
Corporate securities and miscellaneous	-	69,424	-	69,424
Municipal securities	-	58,353	-	58,353
Residential mortgage-backed securities	-	81,524	-	81,524
Commercial mortgage-backed securities	-	2,901	-	2,901
Asset-backed securities	-	47,982	-	47,982
	<u>54,817</u>	<u>260,184</u>	<u>-</u>	<u>315,001</u>
Total fixed maturity securities, available for sale				
Common stocks:				
Consumer discretionary	1,462	-	-	1,462
Consumer staples	11,317	-	-	11,317
Energy	2,299	-	-	2,299
Finance	22,105	-	-	22,105
Industrial	5,669	-	-	5,669
Information technology	1,706	-	-	1,706
Materials	1,923	-	-	1,923
Other	656	-	-	656
	<u>47,137</u>	<u>-</u>	<u>-</u>	<u>47,137</u>
Total common stocks				
Mutual funds	<u>30,636</u>	<u>-</u>	<u>-</u>	<u>30,636</u>
	<u>77,773</u>	<u>-</u>	<u>-</u>	<u>77,773</u>
Total equity securities				
Short-term investments	<u>235,957</u>	<u>-</u>	<u>-</u>	<u>235,957</u>
Grand total	<u>\$ 368,547</u>	<u>\$ 260,184</u>	<u>\$ -</u>	<u>\$ 628,731</u>

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6. Fair Value Measurements, continued

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2019				
Fixed maturity securities, available for sale:				
U.S. government securities	\$ 68,371	\$ -	\$ -	\$ 68,371
Corporate securities and miscellaneous	-	48,795	-	48,795
Municipal securities	-	45,677	-	45,677
Residential mortgage-backed securities	-	72,738	-	72,738
Commercial mortgage-backed securities	-	4,200	-	4,200
Asset-backed securities	-	14,731	-	14,731
	<u>68,371</u>	<u>186,141</u>	<u>-</u>	<u>254,512</u>
Total fixed maturity securities, available for sale				
Common stocks:				
Consumer discretionary	2,406	-	-	2,406
Consumer staples	12,208	-	-	12,208
Energy	5,006	-	-	5,006
Finance	29,017	-	-	29,017
Industrial	6,025	-	-	6,025
Information technology	4,171	-	-	4,171
Material	1,295	-	-	1,295
Other	3,310	-	-	3,310
	<u>63,438</u>	<u>-</u>	<u>-</u>	<u>63,438</u>
Total common stocks				
Mutual funds	<u>11,566</u>	<u>-</u>	<u>-</u>	<u>11,566</u>
Total equity securities				
	<u>75,004</u>	<u>-</u>	<u>-</u>	<u>75,004</u>
Short-term investments				
	<u>260,163</u>	<u>-</u>	<u>-</u>	<u>260,163</u>
Grand total				
	<u>\$ 403,538</u>	<u>\$ 186,141</u>	<u>\$ -</u>	<u>\$ 589,679</u>

The following table summarizes fair value measurements by level at December 31, 2020 for assets with a fair value measurement on a non-recurring basis (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2020				
Fixed maturity securities, held to maturity:				
Asset-backed securities	\$ -	\$ 28,393	\$ -	\$ 28,393
Total fixed maturity securities, held to maturity				
	<u>\$ -</u>	<u>\$ 28,393</u>	<u>\$ -</u>	<u>\$ 28,393</u>

The non-recurring fair value measurements for our fixed maturity securities, held to maturity, consists of the initial capital investment other investors paid for the same instrument during 2020. The instruments were not traded on an active market and we do not expect recurring transactions for these instruments.

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6. Fair Value Measurements, continued

We measure certain assets, including investments in separately managed accounts, investments in limited partnerships and other invested assets, at fair value on a nonrecurring basis only when they are deemed to be other-than-temporarily-impaired.

In addition to the preceding disclosures on assets and liabilities recorded at fair value in the consolidated balance sheets, we are also required to disclose the fair values of certain other financial instruments for which it is practicable to estimate fair value. Estimated fair value amounts, defined as the quoted market price of a financial instrument, have been determined using available market information and other appropriate valuation methodologies. However, considerable judgements are required in developing the estimates of fair value where quoted market prices are not available. Accordingly, these estimates are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimating methodologies may have an effect on the estimated fair value amounts.

We used the following methods and assumptions in estimating the fair value disclosures of subordinated debt and notes payable:

Subordinated debt: Subordinated debt consists of two debt instruments, the Junior Subordinated Interest Debentures, due September 15, 2036, and Unsecured Subordinated Notes, due May 24, 2039. The carrying value of the Junior Subordinated Interest Debentures approximates the estimated fair value as the instrument accrues interest at current market rates plus a spread. The carrying value of the Unsecured Subordinated Notes approximates the estimated fair value as this debt instrument was executed May 2019 and there have been no indications of significant changes in the Company's credit ratings between the execution date and December 31, 2020.

Notes payable: The carrying value approximates the estimated fair value for notes payable as the notes payable accrue interest at current market rates plus a spread.

Other financial instruments qualify as insurance-related products and are specifically exempted from fair value disclosure requirements.

7. Investment in Separately Managed Accounts

During 2016, we began investing in a Separately Managed Account ("SMA1"), managed by Arena Investors, LP ("Arena"), which is affiliated with The Westaim Corporation ("Westaim") who, through Westaim HIIG LP, is our controlling shareholder. We committed a total investment of \$44.0 million for SMA1 and had unfunded commitments as of December 31, 2020 and 2019 of \$1.5 million. As of December 31, 2020 and 2019, the carrying value of our investment in the SMA1 is \$45.2 million and \$54.9 million, respectively. As of December 31, 2020, we held direct and indirect investments in notes receivable from various creditors through the SMA1. The interest rate we earned on the notes ranged from 8.1% to 24.0% and the remaining term of the individual notes as of December 31, 2020 ranged from 1 month to 34 months. The SMA notes are subject to collateral requirements and certain notes also include owner guarantees. As of December 31, 2020, approximately \$9.7 million of mortgage loans were in the process of foreclosure. The carrying value of the mortgage loans in foreclosure approximates the fair value of the collateral less costs to sell. During the years ended December 31, 2020 and 2019, we recorded investment income, net of expenses, of \$1.0 million and \$4.4 million, respectively, related to our investment in SMA1.

During 2017, we began investing in a second Separately Managed Account ("SMA2"), managed by Arena. We committed to a total investment of \$50.0 million for SMA2 and had unfunded commitments as of December 31, 2020 and 2019 of \$33.0 million. As of December 31, 2020 and 2019, the carrying value of our investment in SMA2 is \$12.1 million and \$19.0 million, respectively. The interest rate we earned was 7.5% and the remaining term as of December 31, 2020 is 4 months. All notes owned through the SMA2 are subject to collateral requirements and certain notes include owner guarantees. During the years ended December 31, 2020 and 2019 we recorded investment income, net of expenses of \$0.5 million and \$1.1 million, respectively, related to our investment in SMA2.

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8. Investment in Limited Partnerships

During 2012, we made a commitment to invest \$10.0 million in Dowling Capital Partners (“DCP”), which represents approximately a 6% ownership interest in DCP. As of December 31, 2020 and 2019, we have unfunded commitments of \$0.4 million. During the years ended December 31, 2020 and 2019, we recorded a loss of \$0.5 million and income of \$0.1 million, respectively. Our investment in DCP as of December 31, 2020 and 2019 is approximately \$2.2 million and \$2.6 million, respectively. For the years ended December 31, 2020 and 2019, we received distributions of \$0.0 million and \$2.4 million, respectively.

During 2015, we invested \$25.0 million in Arena Special Opportunities Fund, LP. During the years ended December 31, 2020 and 2019, we recorded investment income, net of expenses of \$2.7 million and \$3.0 million, respectively, related to this investment. As of December 31, 2020 and 2019, our investment is approximately \$39.0 million and \$36.3 million, respectively.

During the first quarter of 2020, we invested in multiple investment products issued by Arena Special Opportunities Partners (Feeder) I, LP (“Arena SOP”) managed by Arena, which is affiliated with Westaim. As of December 31, 2020 we invested \$28.4 million in senior and junior notes issued by Arena SOP and had unfunded commitments of \$16.9 million. The senior and junior notes are debt securities classified as held to maturity and presented on the consolidated balance sheets within fixed maturity securities, held to maturity. During the year ended December 31, 2020 we recorded investment income, net of expenses of \$0.5 million related to the senior and junior notes. Income in excess of return targets on the senior and junior notes is allocated to the investment in Arena SOP limited partnership. During the year ended December 31, 2020 we recorded investment income of \$1.0 million related to our investment in Arena SOP limited partnership units. As of December 31, 2020, the carrying value of our investment in Arena SOP limited partnership units is approximately \$1.0 million.

9. Other Invested Assets

Investment in Affiliates

In December 2010, we invested in our former subsidiary, ClearView Risk Holdings, LLC (“CVR”). In January 2019, we sold our investment in CVR. We received \$19.6 million in cash related to the transaction and recorded a realized gain of \$9.3 million.

In March 2015, we purchased a 20% ownership interest in Regional Insurance Services Company, LLC and its affiliates (“RISCOM”). The initial purchase price was \$3.2 million in cash. Concurrent with the close of the transaction, a principal of RISCOM purchased units of Westaim HIIG LP for \$1.0 million in cash. During the years ended December 31, 2020 and 2019, we recorded equity in income of approximately \$1.2 million and \$1.1 million, respectively, from our investment in RISCOM, which represented our pro rata share of RISCOM’s net income. During the years ended December 31, 2020 and 2019, we received distributions of approximately \$1.0 million and \$0.0 million, respectively from our investment in RISCOM. The carrying value of our investment in RISCOM as of December 31, 2020 and 2019 is approximately \$5.9 million and \$5.7 million, respectively.

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9. Other Invested Assets, continued

Investment in Bank Holding Companies

Beginning in 2017 and through 2018, we acquired a \$2.0 million investment in Captex Bancshares, a Texas bank holding company. Our assessment of our total investment and influence through one of our employees on the Board of Directors of Captex Bankshares indicates that we do not have significant influence over the investee. We carry our investment in Captex Bancshares at cost, less impairment or observable changes in price. We review these investments for impairment or observable changes in price during each reporting period. There were no impairments or observable changes in price during the years ended December 31, 2020 and 2019.

During the first quarter of 2020, we acquired a \$2.0 million investment in Gulf Capital, a Texas bank holding company. Our assessment of our total investment indicates that we do not have significant influence over the investee. During the fourth quarter of 2020 we sold approximately \$1.8 million of shares to other owners of Gulf Capital at cost. We carry our investment in Gulf Capital at cost, less impairment or observable changes in price. There were no impairments or observable changes in price during the year ended December 31, 2020.

10. Property and equipment

The following table presents the components of property and equipment, which are included within other assets on the consolidated balance sheets.

	<u>2020</u>	<u>2019</u>
Leasehold improvements	\$ 2,777	\$ 3,498
Furniture and equipment	29,294	35,174
Other	<u>94</u>	<u>94</u>
	32,166	38,766
Accumulated depreciation	<u>(20,796)</u>	<u>(25,813)</u>
Total	<u>\$ 11,370</u>	<u>\$ 12,953</u>

Depreciation expense for the years ended December 31, 2020 and 2019 was \$3.6 million and \$2.9 million respectively.

11. Leases

The Company adopted ASU No. 2016-02, *Leases*, on January 1, 2020, which resulted in the recognition of right-of-use assets and a corresponding lease liability on the balance sheet within other assets and other liabilities, respectively. Refer to Note 3 for additional information on the adoption of this ASU.

We determine if a contract contains a lease at inception and recognize a right-of-use asset and lease liability based on the present value of future lease payments. In cases where our leases do not provide an implicit interest rate, we use our incremental borrowing rate based on the information available on the inception date to determine the lease liability.

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11. Leases, continued

Our leases are primarily for office facilities which have been classified as operating leases. Our leases have remaining lease terms ranging from less than 1 year to 10 years, some of which include options to extend the leases. Lease expense for the year ended December 31, 2020 was \$2.9 million. The following table provides information on our leases as of December 31, 2020 (in thousands).

	2020
Operating lease right-of-use assets	\$ 11,259
Operating lease liabilities	11,594
Operating lease weighted-average remaining lease term	6.64 years
Operating lease weighted-average discount rate	3.16 %

	2020
Operating lease expense	\$ 2,613
Short-term lease expense	291
Total lease expense	\$ 2,904
Operating cash outflows from operating leases	\$ 2,505

Future minimum lease payments under operating leases as of December 31, 2020 are as follows (in thousands):

	2020
2021	\$ 2,283
2022	1,951
2023	1,857
2024	1,850
2025	1,549
Thereafter	3,684
Total future minimum operating lease payments	\$ 13,174
Less imputed interest	(1,580)
Total operating lease liability	\$ 11,594

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12. Subordinated Debt

The following table summarizes our subordinated debt as of December 31, 2020 and 2019 (in thousands).

	2020	2019
Junior Subordinated Interest Debentures, due September 15, 2036, interest payable quarterly.		
Principal	\$ 59,794	\$ 59,794
Less: debt issuance costs	(753)	(802)
Unsecured Subordinated Notes, due May 24, 2039, interest payable quarterly		
Principal	20,000	20,000
Less: debt issuance costs	(593)	(625)
Subordinated debt, net of debt issuance costs	\$ 78,448	\$ 78,367

In May 2019, the Company entered into agreements with EJV Portfolio Vehicle I LLC and Blackstone Diversified Multi-Strategy Fund to purchase unsecured subordinated notes (the "Notes") with an aggregate principal amount of \$20.0 million. Interest on the Notes is fixed at 7.25% for the first 8 years and fixed at 8.25% thereafter. Principal is due at maturity on May 24, 2039 and interest is payable quarterly. The Notes have junior priority to all previously issued debt. We report the debt related to the Notes in our December 31, 2020 and 2019 consolidated balance sheets, net of debt issuance costs of approximately \$0.6 million. These deferred financing costs are presented as a direct deduction from the carrying amount of the subordinated debt.

On August 2, 2006, Delos Capital Trust n/k/a HIIG Capital Trust I (the "Trust"), a Delaware statutory trust, issued \$58.0 million of fixed/floating rate capital securities guaranteed by us. The Trust also issued us \$1.8 million of common stock. The sole asset of the Trust consists of Fixed/Floating Rate Junior Subordinated Deferrable Interest Debentures (the "Debentures") with a principal amount of \$59.8 million issued by us. The Debentures are an unsecured obligation, are redeemable on or after September 15, 2011, and have a maturity date of September 15, 2036. Interest on the Debentures is payable quarterly at an annual rate based on the three-month LIBOR (0.24% at December 31, 2020) plus 3.4%. We have not consolidated the Trust that issued the capital securities, as it does not meet the criteria for consolidation under guidance issued by the FASB. We reflect the debt related to the Debentures in our December 31, 2020 and 2019 consolidated balance sheets, net of debt issuance costs of approximately \$0.8 million. These deferred financing costs are presented as a direct deduction from the carrying amount of the subordinated debt.

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13. Notes Payable

The following table summarizes our notes payable as of December 31, 2020 and 2019 (in thousands).

	<u>2020</u>	<u>2019</u>
Term loan, due December 31, 2024, interest payable quarterly	\$ 50,000	\$ 50,000
Revolving line of credit, due December 31, 2024, interest payable quarterly	-	33,827
Notes payable	<u>\$ 50,000</u>	<u>\$ 83,827</u>

On December 11, 2019, the Company entered into a new credit agreement with an unrelated financial institution, which provided the Company with a \$50.0 million term loan and a \$50.0 million revolving line of credit. Subject to lender approval, the Company has the right to increase the borrowing capacity on the \$50.0 million revolving line of credit to \$75.0 million. \$75.0 million of proceeds from the term loan and revolving line of credit were used to pay off, in its entirety, the remaining principal balance on the existing \$40.0 million term loan note that was executed on April 30, 2014 and \$50.0 million revolving promissory note that was executed on May 1, 2015.

The interest rate on the \$50.0 million term loan is the lesser of the one-month LIBOR (0.14% on December 31, 2020) plus the Applicable Margin, which is defined as 1.65%, or the highest lawful rate. Interest-only payments are due and payable on a quarterly basis through December 31, 2024. The entire principal balance of the \$50.0 million term loan is due December 31, 2024.

The interest rate on the \$50.0 million revolving line of credit is the lesser of the prime rate, as published by the Wall Street Journal, or the one-month LIBOR (0.14% on December 31, 2020) plus the Applicable Margin, which is defined as the lesser of 1.65%, or the highest lawful rate. The revolving promissory note includes a fee of 0.25% on the unused portion. Interest-only payments are due and payable on a quarterly basis through December 31, 2024. The entire principal balance of the \$50.0 revolving line of credit is due December 31, 2024.

The indebtedness is collateralized by a perfected first priority security interest in all of the assets of HIIG and SUA and the outstanding capital stock of HSIC.

Our credit agreement includes financial covenants that require the Company maintain minimum surplus and risk based capital on HSIC, minimum net worth, and a minimum fixed charge coverage ratio as well as other customary covenants and events of default. As of December 31, 2020, the Company was in compliance with all covenants in our credit agreement.

14. Stockholders' Equity

Preferred Share Rights Offering

On April 24, 2020 the Company closed a private preferred share rights offering. Existing holders of common stock were given the right to subscribe for shares, on a pro rata basis, of Series A Convertible Preferred Stock (the "Preferred Shares") with a face value of \$50.00 per share. The Company issued \$100.0 million of Preferred Shares and received \$90.2 million of cash, net of issuance costs. Employees of the Company participating in the offering financed their purchase with \$9.6 million in stock notes receivable. Approximately \$33.8 million of the proceeds were used to repay, in its entirety, the remaining principal balance on the Company's revolving line of credit that was executed on December 11, 2019.

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14. Stockholders' Equity, continued

Conversion into Common Stock

The Preferred Shares provide the holder the option at any time to convert the Preferred Shares into common stock based on the Option Conversion Rate. The Option Conversion Rate will be adjusted upon the completion of the audit of the financial statements as of and for the year ended December 31, 2021. The adjustments to the Option Conversion Rate will consist of (i) the after-tax impact of any co-participation expense related to the LPT; (ii) the development of losses and LAE reserves in excess of limits on the LPT; and (iii) the after-tax impact of development on losses and LAE reserves not subject to the LPT subsequent to December 31, 2019. The Option Conversion Rate will not be updated subsequent to December 31, 2021. As of December 31, 2020, the 1,976,310 outstanding Preferred Shares could be converted into 66,567,849 common shares utilizing an Option Conversion Rate that reflects the December 31, 2019 balance sheet and after-tax LPT expense incurred for committing to the LPT during the first quarter of 2020.

The Preferred Shares are subject to mandatory conversion upon a defined change of control transaction or the closing of an initial public offering at the Mandatory Conversion Rate. The Mandatory Conversion Rate is similar to the Option Conversion Rate but is adjusted for the after-tax impact of any co-participation expense related to the LPT, the development of losses and LAE reserves in excess of limits on the LPT and the after-tax impact of development on losses and LAE reserves not subject to the LPT on the final day of the last quarter-end prior to when a defined change of control transaction or closing of an initial public offering occurs.

Preference

The Preferred Shares have preference in liquidation over common stock in the amount of the face value of \$50.00 per share and any declared but unpaid dividends to related common shares at the applicable conversion rate.

15. Income Taxes

Income tax (benefit) expense consists of the following for the years ended December 31, 2020 and 2019 (in thousands):

	<u>2020</u>	<u>2019</u>
Current income tax expense	\$ 190	\$ 290
Deferred tax (benefit) expense related to temporary differences	<u>(19,278)</u>	<u>7,377</u>
Total income tax (benefit) expense	<u>\$ (19,088)</u>	<u>\$ 7,667</u>

The differences between income taxes expected at the Federal statutory income tax rate of 21% and the reported income tax expense for the years ended December 31, 2020 and 2019 are summarized as follows (in thousands):

	<u>2020</u>		<u>2019</u>	
	<u>Amount</u>	<u>Percentage</u>	<u>Amount</u>	<u>Percentage</u>
Income tax (benefit) expense at federal statutory rate	\$ (19,062)	21.0 %	\$ 8,388	21.0 %
Tax advantaged investments	(197)	0.2	(187)	(0.5)
Earnout liability revaluation	-	-	(94)	(0.2)
Other	<u>171</u>	<u>(0.2)</u>	<u>(440)</u>	<u>(1.1)</u>
Total income tax (benefit) expense	<u>\$ (19,088)</u>	<u>21.0 %</u>	<u>\$ 7,667</u>	<u>19.2 %</u>

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15. Income Taxes, continued

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands) as of December 31, 2020 and 2019:

	2020	2019
Deferred tax assets:		
Net operating losses	\$ 31,351	\$ 24,408
Losses and loss adjustment expenses	5,354	5,532
Unearned premiums	7,496	6,782
Intangibles	3,264	-
Deferred loss on LPT	2,265	-
Stock options/awards	944	949
AMT credits	-	531
Impairments	1,389	1,389
Indemnity settlement	-	196
Other	1,727	1,280
	<u>53,790</u>	<u>41,067</u>
Total deferred tax assets		
Less valuation allowance	(586)	(586)
	<u>53,204</u>	<u>40,481</u>
Total deferred tax assets after valuation allowance		
Deferred tax liabilities:		
Deferred policy acquisition costs	2,856	2,688
Intangibles	-	6,850
Discount on fixed maturity securities	136	129
Depreciation	1,791	849
Unrealized gains on investments	4,336	2,736
Other	2,947	3,026
	<u>12,066</u>	<u>16,278</u>
Total deferred tax liabilities		
Net deferred tax assets	<u>\$ 41,138</u>	<u>\$ 24,203</u>

We made no payments for federal income taxes, during the year ended December 31, 2020 and received a \$0.5 million refund on Alternative Minimum Tax during the year ended December 31, 2019.

As of December 31, 2020, there were no material uncertain tax positions for which our management believes it is more likely-than-not that, the total amounts will significantly increase or decrease within twelve months of the reporting date. We classify all interest and penalties related to tax contingencies as income tax expense. As of December 31, 2020 and 2019, there was no accrued interest recorded as an income tax liability.

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15. Income Taxes, continued

We provide a valuation allowance against deferred tax assets when it is more likely-than-not that some portion, or all, of deferred tax assets will not be realized. Our deferred tax valuation allowance for the years ended December 31, 2020 and 2019 is as follows (in thousands):

	<u>2020</u>	<u>2019</u>
Balance at beginning of year	\$ 586	\$ 586
Increase (decrease) related to:		
Net operating losses	<u>-</u>	<u>-</u>
Balance at end of year	<u>\$ 586</u>	<u>\$ 586</u>

Management has determined that a valuation allowance of \$0.6 million is required for a portion of the tax effected net operating loss carryforward. This valuation allowance has been established due to limitations imposed by Internal Revenue Code Section 382 on the utilization of net operating losses following a majority interest ownership change.

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16. Losses and Loss Adjustment Expenses

A reconciliation of unpaid losses and loss adjustment expenses as reported in the consolidated balance sheet as of and for the years ended December 31, 2020 and 2019 are as follows (in thousands):

	<u>2020</u>	<u>2019</u>
Reserves for losses and LAE, beginning of period	\$ 683,970	\$ 599,386
Less reinsurance recoverable on unpaid claims	<u>(333,283)</u>	<u>(306,115)</u>
Reserves for losses and LAE, Beginning of period, net of reinsurance	<u>350,687</u>	<u>293,271</u>
Incurred, net of reinsurance, related to:		
Current period	276,045	267,213
Prior years	<u>49,553</u>	<u>13,917</u>
Total incurred, net of reinsurance	<u>325,598</u>	<u>281,130</u>
Paid, net of reinsurance, related to:		
Current period	109,644	91,398
Prior years	<u>108,540</u>	<u>132,316</u>
Total paid	<u>218,184</u>	<u>223,714</u>
Net reserves for losses and LAE, end of period	458,101	350,687
Plus reinsurance recoverable on unpaid claims	<u>398,756</u>	<u>333,283</u>
Reserves for losses and LAE, end of period	<u>\$ 856,857</u>	<u>\$ 683,970</u>

Our estimate of incurred losses and LAE attributable to insured events of prior years' reflects adverse development of approximately \$49.6 million and \$13.9 million for the years ended December 31, 2020 and 2019, respectively. Of this amount, approximately \$32.1 million relate to continuing business segments and \$17.5 million from lines of business in runoff. Of the \$49.6 million of adverse development for the year ended December 31, 2020, \$49.0 million was covered by the LPT. These increases are driven by a combination of incurred loss emergence in liability lines as well as management's strengthening of IBNR reserves on these years.

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16. Losses and Loss Adjustment Expenses, continued

Short Duration Contract Disclosures

The following tables present incurred losses and LAE and cumulative paid losses and LAE by accident year, on a net basis after reinsurance, but excluding the benefit of the LPT, for the years 2012 to 2020 for each of our operating segments (in thousands). Results are presented for accident years 2012 and after, as business written before 2012 is primarily related to discontinued business that are not related to ongoing operations. The information included in the following tables is unaudited.

Accident & Health (“A&H”) – Group Medical Stop Loss insurance written on an excess basis known as Stop Loss business including both aggregate and specific coverage provided to self-funded medical programs for small and medium size employee groups.

Accident & Health Incurred Losses and LAE, Net of Reinsurance											As of December 31, 2020		
Years Ended December 31,													
Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2020 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims	
2012	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-	
2013	-	-	-	-	-	-	-	-	-	-	-	-	
2014	-	-	-	-	-	-	-	-	-	-	-	-	
2015	-	-	-	25,063	27,500	28,210	28,113	28,113	28,113	-	-	112	
2016	-	-	-	-	38,435	40,518	40,411	40,421	40,421	-	53	649	
2017	-	-	-	-	-	23,807	24,011	24,038	24,038	-	2	915	
2018	-	-	-	-	-	-	21,579	23,542	23,542	-	78	731	
2019	-	-	-	-	-	-	-	38,807	38,807	-	276	1,749	
2020	-	-	-	-	-	-	-	-	31,402	-	7,083	461	
Total	-	-	-	-	-	-	-	-	186,323	-	\$ 7,492	4,617	
Cumulative net paid loss and LAE from the table below	-	-	-	-	-	-	-	-	(167,914)	-	-	-	
Net reserves for loss and LAE and prior year development before 2012	-	-	-	-	-	-	-	-	-	-	-	-	
Total net reserves for loss and LAE and prior year development	-	-	-	-	-	-	-	-	\$ 18,409	-	-	-	

Accident & Health Cumulative Paid Losses and LAE, Net of Reinsurance										
Years Ended December 31,										
Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	
2012	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
2013	-	-	-	-	-	-	-	-	-	-
2014	-	-	-	-	-	-	-	-	-	-
2015	-	-	-	12,010	25,328	27,913	28,113	28,113	28,113	28,113
2016	-	-	-	-	26,609	36,693	39,843	40,266	40,368	40,368
2017	-	-	-	-	-	17,892	23,932	24,029	24,036	24,036
2018	-	-	-	-	-	-	16,272	23,932	23,465	23,465
2019	-	-	-	-	-	-	-	22,474	37,719	37,719
2020	-	-	-	-	-	-	-	-	14,213	14,213
Total	-	-	-	-	-	-	-	-	\$ 167,914	\$ 167,914

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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16. Losses and Loss Adjustment Expenses, continued

Short Duration Contract Disclosures, continued

Property & Casualty (“P&C”) – Standard and specialty lines of property & casualty insurance written on both an admitted and non-admitted basis through intermediaries such as agents, wholesalers and brokers with specialty expertise and/or key relationships with the target customer base.

Property & Casualty Incurred Losses and LAE, Net of Reinsurance										As of December 31, 2020		
Years Ended December 31,												
Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2020 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
2012	\$ 41,510	\$ 43,220	\$ 51,276	\$ 62,249	\$ 64,551	\$ 62,740	\$ 62,986	\$ 63,343	\$ 63,343	\$ -	\$ 846	2,572
2013		102,605	110,164	110,484	121,985	123,954	124,161	125,498	125,998	500	508	4,902
2014			166,577	153,413	177,236	176,788	178,224	179,242	182,958	3,716	3,304	8,484
2015				168,888	187,600	190,844	191,150	195,548	210,054	14,506	15,661	9,441
2016					153,316	152,115	153,395	156,928	159,928	3,000	5,026	8,844
2017						146,160	146,452	148,016	150,016	2,000	12,412	8,586
2018							161,998	158,998	167,386	8,388	16,293	9,598
2019								225,208	225,208	-	58,134	10,309
2020									188,489	-	92,934	9,020
Total									\$1,473,380	\$ 32,110	\$ 205,118	71,756
Reclass of net reserves to Corporate & Other segment									(17,145)	-	-	
Cumulative net paid loss and LAE from the table below									(1,109,606)	-	-	
Net reserves for loss and LAE and prior year development before 2012									1,932	-	-	
Total net reserves for loss and LAE and prior year development									\$ 348,561	\$ 32,110	-	

Property & Casualty Cumulative Paid Losses and LAE, Net of Reinsurance
Years Ended December 31,

Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020
2012	\$ 7,423	\$ 24,851	\$ 39,937	\$ 49,392	\$ 54,275	\$ 57,314	\$ 61,105	\$ 62,248	\$ 62,484
2013		28,492	62,398	91,539	108,067	119,582	121,017	124,270	125,329
2014			44,212	100,595	127,610	146,625	164,943	167,605	170,503
2015				53,065	114,459	150,942	168,007	179,591	188,133
2016					65,560	102,347	120,835	136,234	140,189
2017						61,108	98,553	110,165	114,235
2018							51,950	114,482	125,766
2019								67,298	122,190
2020									60,777
Total									\$ 1,109,606

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16. Losses and Loss Adjustment Expenses, continued

Short Duration Contract Disclosures, continued

Corporate & Other – Consist of lines of business in run-off and activity not included within Accident & Health and Property & Casualty.

Corporate & Other Incurred Losses and LAE, Net of Reinsurance										As of December 31, 2020		
Years Ended December 31,												
Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2020 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
2012	\$ 16,232	\$ 16,216	16,752	\$ 17,717	\$ 17,820	\$17,812	\$17,812	\$17,812	\$17,812	\$ -	\$ 34	702
2013		11,173	13,909	14,360	14,581	15,012	15,012	15,012	15,012	-	16	785
2014			9,784	9,529	11,831	13,612	13,692	13,692	13,692	-	14	468
2015				6,612	7,323	8,757	9,689	9,689	9,689	-	(2,376)	335
2016					10,517	12,031	12,335	14,586	17,586	3,000	288	493
2017						6,581	6,882	6,882	9,882	3,000	(2,930)	518
2018							7,102	7,102	13,102	6,000	826	409
2019								3,197	8,640	5,443	408	165
2020									56,154	-	53,173	65
Total									\$161,569	\$ 17,443	49,453	3,940
Reclass of net reserves from P&C segment									17,145	-		
Cumulative net paid loss and LAE from the table below									(89,327)	-		
Net reserves for loss and LAE and prior year development before 2012									1,745	-		
Total net reserves for loss and LAE and prior year development									\$ 91,132	\$ 17,443		

Corporate & Other Cumulative Paid Losses and LAE, Net of Reinsurance

Years Ended December 31,									
Accident Year	2012	2013	2014	2015	2016	2017	2018	2019	2020
2012	\$ 7,913	\$ 13,977	\$15,806	\$ 16,839	\$ 17,336	\$ 17,562	\$ 17,562	\$ 17,708	\$ 17,731
2013		6,027	10,383	12,126	13,404	14,795	14,795	14,895	14,949
2014			2,598	4,853	8,189	10,311	10,665	12,757	13,494
2015				1,007	2,761	4,805	5,793	7,719	11,580
2016					1,319	5,185	7,813	7,712	11,818
2017						1,216	1,530	3,688	8,841
2018							640	1,600	6,789
2019								1,628	3,102
2020									1,023
Total									\$ 89,327

**SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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16. Losses and Loss Adjustment Expenses, continued

Short Duration Contract Disclosures, continued

The table below presents the reconciliation of the net incurred and paid claims development to loss reserves in the consolidated balance sheets as of December 31, 2020 for our operating segments (in thousands):

	2020
Net reserves for losses and LAE:	
Accident & Health	\$ 18,409
Property & Casualty	348,561
Corporate & Other	91,132
Reserves for losses and LAE, net of reinsurance	458,101
Reinsurance recoverable on unpaid claims:	
Accident & Health	36,954
Property & Casualty	319,391
Corporate & Other	42,411
Total reinsurance recoverable on unpaid claims	398,756
Gross reserves for losses and LAE at end of year	\$ 856,857

The following table presents supplementary information about average historical claims duration as of December 31, 2020, by operating segment:

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance										
Years	1	2	3	4	5	6	7	8	9	10 and older
Accident & Health	34.0%	64.1%	1.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Property & Casualty	36.9%	22.6%	14.0%	8.3%	5.0%	3.0%	1.9%	1.4%	1.0%	5.9%
Corporate & Other	29.8%	20.3%	14.1%	10.1%	7.9%	5.6%	5.7%	3.2%	1.4%	1.8%

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17. Premiums

Direct and assumed premiums written by line of business for the years ended December 31, 2020 and 2019 are as follows:

	<u>2020</u>	<u>2019</u>
Property	26.6%	25.6%
Other liability occurrence	24.3	25.1
Commercial auto liability	23.3	20.4
Accident and health	12.2	14.2
Workers' compensation	7.4	9.9
Auto physical damage	4.4	4.0
Other	1.8	0.8
	<u>100.0%</u>	<u>100.0%</u>
Total	<u>100.0%</u>	<u>100.0%</u>

For the years ended December 31, 2020 and 2019, our direct and assumed premiums written were produced from the following states:

	<u>2020</u>	<u>2019</u>
Texas	13.5%	14.9%
Louisiana	11.6	10.8
California	9.1	8.2
Florida	7.2	7.9
New York	4.3	4.6
New Jersey	4.2	3.0
Georgia	3.9	4.2
Illinois	3.4	2.6
Oklahoma	3.2	3.9
Pennsylvania	3.1	3.9
All other states	36.5	36.0
	<u>100.0%</u>	<u>100.0%</u>
Total	<u>100.0%</u>	<u>100.0%</u>

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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18. Reinsurance

Certain premiums and benefits are assumed from and ceded to other insurance companies under various reinsurance agreements. The reinsurance agreements provide us with increased capacity to write larger risks and maintain our exposure to loss within our capital resources. We remain obligated for amounts ceded in the event that the reinsurers do not meet their obligations. The effects of reinsurance on premiums written and earned for the years ended December 31, 2020 and 2019 are as follows (in thousands):

	2020		2019	
	Written	Earned	Written	Earned
Direct premiums	\$ 774,436	\$ 775,666	\$ 775,653	\$ 728,122
Assumed premiums	99,177	96,765	102,627	91,664
Ceded premiums	<u>(460,341)</u>	<u>(476,124)</u>	<u>(456,580)</u>	<u>(434,670)</u>
Net premiums	<u>\$ 413,272</u>	<u>\$ 396,307</u>	<u>\$ 421,700</u>	<u>\$ 385,116</u>
Ceded losses and LAE incurred		<u>\$ 360,827</u>		<u>\$ 373,332</u>

Reinsurance recoverables on unpaid losses and loss adjustment expense reserves ceded at and December 31, 2020 and 2019 were approximately \$398.8 million and \$333.3 million, respectively. The balance as of December 31, 2020 includes \$86.3 million of recoverables related to the LPT. Reinsurance recoverables on paid losses and loss adjustment expense ceded at December 31, 2020 and 2019 were approximately \$77.2 million and \$91.4 million, respectively. Ceded unearned premiums at December 31, 2020 and 2019 were approximately \$164.6 million and \$180.4 million, respectively.

We have entered into agreements with several of our reinsurers, whereby the reinsurer established funded trust accounts with the Company as the sole beneficiary. These trust accounts provide us additional security to collect claim recoverables under reinsurance contracts. At December 31, 2020, the market value of these accounts was approximately \$142.4 million, representing case and incurred but not recorded loss reserves. The agreements provide that, as was customary in the past, the reinsurer will continue claim payment reimbursements without disturbing the trust balances. The trust amount will be adjusted periodically, by mutual agreement, based on the current activities of loss reserve recoverables.

Effective October 2017, we entered into a retroactive reinsurance agreement with Everest Re for \$20.0 million which is accounted for as a deposit of \$18.0 million and \$2.0 million as deferred expense which will be amortized over the expected payout of the agreement. The deposit and deferred expense are included in other assets as of December 31, 2020 and 2019. During each of the years ended December 31, 2020 and 2019, we recorded amortization of \$0.5 million and \$0.3 million, respectively, related to these assets. The retroactive reinsurance agreement provides us with coverage of up to \$20.0 million of loss development primarily related to continuing business with policies effective 2015 and prior. As of December 31, 2020 and 2019, we have ceded \$20.0 million of reinsurance under this contract. In accordance with the contract, we incur an annual maintenance fee at a minimum rate of 6.5% and a maximum rate of 8.5% based on the ceded amount under the contract. We incurred a maintenance fee of \$1.7 million for the years ended December 31, 2020 and 2019.

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18. Reinsurance, continued

During the first quarter of 2020, we entered into a LPT retroactive reinsurance agreement. Under the LPT, the Company agreed to cede \$97.1 million of net reserves for certain divisions, primarily related to 2017 and prior policy years. The LPT provides reinsurance protection of approximately \$127.4 million above the ceded losses and LAE reserves and is subject to co-participations at specified amounts. The LPT resulted in \$43.5 million of expense to enter the agreement netted against \$32.7 million of gain due to increased recoverables from adverse development on the LPT reserves. We recognized approximately \$10.8 million of net LPT expense for the year ended December 31, 2020.

Subsequent to the first quarter of 2020, we recognized adverse development on reserves for certain divisions covered by the LPT of \$49.0 million resulting in an increase in the amount ceded under this agreement. The increase in the amount ceded resulted in \$32.7 million of gain. The following table presents the impact of the LPT on the statements of operations for the year ended December 31, 2020 (in thousands):

	2020
Reserves ceded at contract inception	\$ (97,100)
Reinsurance recoverables from the LPT	53,624
Expense to enter the LPT	(43,476)
Adverse development on LPT reserves	(49,013)
Underwriting gain from adverse development on LPT reserves	32,692
Pretax impact of the LPT	\$ (59,797)

19. Stock Based Compensation

We have two active plans, the Employee Share Program (the “2011 Program”) and the Equity Incentive Program (the “2016 Program”), to incentivize our employees. The 2011 and 2016 Programs are administered by the Compensation Committee of our Board of Directors.

The 2011 Program and 2016 Program allow key employees to purchase our common stock at a price based on fair value of the Company at the end of the quarter in which the employee commits to the purchase. We then match all purchases with stock grants. The programs require an initial cash payment of at least 30% of the committed fair value of the purchase with any remaining commitment recorded as a note receivable to the Company which is included in Stockholders’ Equity. Grants awarded prior to 2016, vest as the employee makes cash payments for the purchase of our common stock over a period of up to nine years. Commencing in 2016, grants awarded vest after two conditions are met (i) the employee has worked for us for three years and (ii) cash payments are made for stock purchases. All grants awarded under the 2011 plan are fully vested and have been expensed. Grants awarded under the 2016 plan vest annually over a three-year service period and are expensed on a pro rata basis over the service period.

For the years ended December 31, 2020 and 2019, stock based compensation expense was \$0.0 million and \$0.1 million, respectively. Key employees purchased 30,870 shares and 0 shares of our common stock during the years ended December 31, 2020 and 2019, respectively. In accordance with the plan, we granted a match of 30,870 shares and 0 shares of our common stock during December 31, 2020 and 2019, respectively. The weighted-average grant-date fair value of common shares granted during the year ending December 31, 2020 was \$3.24 per common share.

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19. Stock Based Compensation, continued

Under both the 2011 and 2016 programs, the Company will finance up to 70% of the purchased shares with a stock note receivable. These stock notes receivable are recorded as a reduction to Stockholders' Equity. At December 31, 2020 and 2019 stock notes receivable related to these programs totaled \$2.5 million and \$3.5 million, respectively. The stock notes receivable bear interest at a rate ranging from 0.95% to 2.80%, based on the Internal Revenue Service applicable federal rates.

A summary of the status of our non-vested restricted common stock awards as of December 31, 2020, and changes during the year, is presented below:

	<u>Weighted-average Grant-date Fair Value</u>	<u>Number of Common Shares</u>
Non-vested at January 1, 2020	\$ 5.01	525,380
Granted	3.24	30,870
Vested	4.45	(15,469)
Forfeited	5.07	<u>(202,096)</u>
Non-vested at December 31, 2020	\$ 4.87	<u>338,685</u>

As of December 31, 2020 the total unrecognized compensation cost (net of forfeitures) related to non-vested, share-based compensation awards was \$0.1 million and the weighted average period over which that cost is expected to be recognized is 1.1 years.

20. Employee Benefit Plans

We sponsor the HIIG 401(k) Plan (the "Plan"). The Plan, available to substantially all of our employees, is subject to provisions of the Employee Retirement Income Security Act of 1974. We match employee contributions on a discretionary basis. We expensed \$1.3 million and \$1.4 million of matching contributions during the year ended December 31, 2020 and 2019, respectively.

21. Related Party Transactions

Westaim

In 2014 and continuing through 2015 Westaim HIIG LP (a limited partnership controlled by Westaim, a Canadian public company) acquired a majority of our common stock. As of December 31, 2020 and 2019, Westaim HIIG LP owns 72% and 71% of our common stock, respectively. The changes in Westaim HIIG LP's ownership percentage were due to transactions related to our stock-based compensation programs.

In 2015, we purchased 3,076,924 shares of Westaim common stock for \$8.3 million. Our investment in Westaim is included in equity securities in the consolidated balance sheet as of December 31, 2020 and 2019. The unrealized loss on this investment is \$2.0 million and \$2.1 million, respectively, as of and December 31, 2020 and 2019.

On April 24, 2020, Westaim HIIG LP affiliates participated in our preferred share rights offering and purchased \$68.6 million of Preferred Shares in exchange for \$68.1 million of cash and \$0.5 million of stock notes. Within this group, Westaim purchased \$44.0 of Preferred Shares in exchange for \$44.0 million of cash. As of December 31, 2020 Westaim owns 44.5% of our preferred stock.

SKYWARD SPECIALTY INSURANCE GROUP, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

21. Related Party Transactions, continued

Westaim, continued

Westaim performs consulting and certain other services for us pursuant to an agreement (the "Advisory Services Agreement"). Pursuant to the Advisory Services Agreement, we are required to pay Westaim \$1.0 million per year for the first three years, beginning in 2015 and \$0.5 million in years four and five, plus reasonable expenses incurred to provide the services. The Advisory Services Agreement was amended during 2017, and increased the fees paid to Westaim from \$0.5 million to \$1.0 million in years four and five. The Advisory Services Agreement will terminate on the earliest of (a) July 2019, (b) upon an Initial Public Offering or a change of control, or (c) when Westaim HIIG LP owns less than 8% of the Company. A new Management Services Agreement was entered into as of August 1, 2019 and we are required to pay \$0.5 million a year. The agreement will be effective until the termination date. The termination date is the earliest of (a) the date on which Westaim HIIG LP owns less than 8% of the number of shares outstanding, (b) the date on which the Company's initial public offering is consummated, or (c) the date upon which a change in control occurs. Pursuant to the current Management Services Agreement and the former Advisory Services Agreement, we incurred fees and expenses of approximately \$1.5 million and \$0.8 million, respectively, related to services provided by Westaim and expense reimbursements during the years ended December 31, 2020 and 2019, respectively.

Contingent Consideration Related to Acquisitions

We potentially owe earn-out liabilities to former owners of assets and business acquired. Included in accounts payable and accrued liabilities are \$0.5 million of earn-out liabilities as of December 31, 2020 and 2019.

RISCOM

During 2016, we entered into an intercompany agency agreement with RISCOM, in which we hold a 20% ownership interest, for wholesale brokerage services in addition to the already existing managing general agency agreement between the parties. We generated \$67.0 million and \$55.7 million of net earned premium during the years ended December 31, 2020 and 2019, respectively, related to these agreements. Premium receivable from RISCOM was \$12.5 million and \$12.3 million, respectively, as of December 31, 2020 and 2019.

KIS Surety

During 2017, we entered into a managing general agency agreement with KIS Surety, in which we hold a 20% ownership interest, for a construction bond program. We had \$0.0 million and \$0.8 million of net earned premium for the years ended December 31, 2020 and 2019, respectively, related to this agreement. As of December 31, 2020, the managing general agency agreement with KIS Surety is in runoff.

Reinsurance

We have a reinsurance agreement with XL Re, Ltd., which is a limited partner of Westaim HIIG LP. We recorded \$0.5 million and \$0.2 million of reinsurance premiums ceded during the years ended December 31, 2020 and 2019, respectively, related to the agreement. Reinsurance recoverable from XL Re, Ltd. net of premium payables, was \$0.5 million and \$0.5 million, respectively, as of December 31, 2020 and 2019.

We have reinsurance agreements with Everest Re, an affiliate of Mt. Whitney Securities, LLC, a limited partner of Westaim HIIG LP. We recorded \$139.0 million and \$119.9 million of reinsurance premiums ceded during the years ended December 31, 2020 and 2019, respectively, related to the agreement. Reinsurance recoverable from Everest Re, net of premium payables, was \$195.3 million and \$186.6 million, respectively, as of December 31, 2020 and 2019.

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21. Related Party Transactions, continued

Other

During the years ended December 31, 2020 and 2019, we paid approximately \$1.7 million and \$0.8 million, respectively, of advisory and professional services fees and expense reimbursements to various affiliated shareholders and directors.

During the years ended December 31, 2020 and 2019, we paid approximately \$0.3 million and \$1.0 million, respectively, of transportation costs to companies owned by an affiliated shareholder, member of management and director of the Company.

On April 24, 2020, an affiliated shareholder, member of management and director of the Company, along with his immediate family, purchased approximately \$10.6 million of Preferred Shares in exchange for \$4.5 million in cash and \$6.1 million in stock notes. Another affiliated shareholder and director of the Company purchased approximately \$13.1 million of Preferred Shares in exchange for \$13.1 million in cash.

See Note 7, 8 and 9 for investments and loans to affiliated companies and additional related party transactions.

See Note 14 for related party transactions related to our preferred share rights offering.

22. Commitments and Contingencies

Litigation

We are named as a defendant in various legal actions arising from claims made under insurance policies and contracts. Those actions are considered by us in estimating the losses and loss adjustment expense reserves. Also, from time to time, we are a defendant in various legal actions that relate to bad faith claims, disputes with third parties or that involve alleged errors and omissions. We record accruals for these items to the extent the losses are probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from outside legal counsel, our management believes the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on our consolidated financial position, results of operations or cash flows. During the years ended December 31, 2020 and 2019, we recorded no provision for various contingencies.

During the year ended December 31, 2020, we recorded \$4.5 million of income related to the settlement of previous contingencies paid and recorded by the Company. This recovery was included in other operating expenses for the year ended December 31, 2020 and collected on February 12, 2021.

COVID-19

During the first quarter of 2020, the onset of COVID-19 resulted in various emergency restrictions instituted by various state and local governments in the United States. These restrictions have caused considerable economic disruption and may have a significant impact on our policyholders, particularly those served by our Hospitality division. As of December 31, 2020 we are unable to estimate the duration or ultimate effect of COVID-19 on the economy.

We assessed our insurance policies and we believe we do not have material claim exposure to the impacts of COVID-19. Many of our property policies provide business interruption coverage and require physical damage to trigger a loss. Many of these policies also have a virus exclusion. While we believe we do not have incremental business interruption liability, we are monitoring lawmaker proposals at the state level to retroactively amend business interruption insurance policies to cover claims related to COVID-19 when such policies otherwise would exclude these risks. If these efforts are successful and enforceable, the Company may be forced to pay claims under policies for which we received inadequate premiums to cover such risks. As of December 31, 2020 we are unable to determine the likelihood or estimated impact of any legislation to amend business interruption insurance policies.

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22. Commitments and Contingencies, continued

COVID-19, continued

In anticipation of the impacts of COVID-19 on our business, we believe we will incur additional legal and claim defense costs and increased credit risk from our policyholders and reinsurers. As of December 31, 2020 we believe we have appropriately accrued for the potential additional legal and claim defense costs of approximately \$2.0 million within losses and LAE reserves. As of December 31, 2020 we believe our allowance for uncollectible receivables on our premiums receivable and reinsurance recoverables appropriately reflects the increased credit risk.

Indemnification

In relation to the 2014 subscription agreement with Westaim HIIG LP, we provided indemnifications to specified litigation, claims and disputes (the "Indemnity Obligations"). During the year ended December 31, 2019, we evaluated the inception to date expense and accruals related to the Indemnity Obligations which indicated an indemnifiable loss of \$0.7 million. During the year ended December 31, 2019, the indemnifiable loss was settled with Westaim HIIG LP through the issuance of 81,875 shares of our common stock, in accordance with the terms of the 2014 subscription agreement.

In conjunction with the sale of business assets and subsidiaries, we have provided indemnifications to certain of the buyers. Certain indemnifications cover typical representations and warranties related to the responsibilities to perform under the sales contracts. The amount of potential exposure covered by the indemnifications is difficult to determine because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. However, at this time we do not have reason to believe any such significant claims exist.

23. Regulatory Matters

A significant amount of the consolidated assets represent assets of our insurance company subsidiaries, HSIC, IIC, GMIC, BIC and OSIC. IIC, BIC, OSIC and GMIC are all direct and indirect wholly-owned subsidiaries of HSIC. HSIC is restricted by Texas law as to the amount of dividends it may pay without the approval of regulatory authorities. The maximum amount of dividends which can be paid by HSIC without prior approval is subject to restrictions relating to policyholder surplus, net income, and dividends declared or distributed during the preceding 12 months. As of December 31, 2020, HSIC cannot pay ordinary dividends. HSIC did not declare or pay any dividends during the years ended December 31, 2020 and 2019.

Property and casualty insurance companies are subject to certain Risk Based Capital ("RBC") requirements as specified by the National Association of Insurance Commissioners ("NAIC"). Under those requirements, the amount of capital and surplus maintained by a property and casualty insurance company is to be determined based on the various risk factors related to it. At December 31, 2020 and 2019, our insurance company subsidiaries met the RBC requirements.

The capital and surplus and RBC level of HSIC on a consolidated statutory basis (including IIC, GMIC OSIC, and BIC) as of and for the years ended December 31, 2020 and 2019 were as follows (in thousands):

	<u>2020</u>	<u>2019</u>
Statutory capital and surplus	\$ 342,256	\$ 338,486
RBC authorized control level	67,838	69,656

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24. Statutory Accounting Principles

The statutory capital and surplus for our principal operating subsidiaries at December 31, 2020 and 2019 were as follows (in thousands):

	2020	2019
HSIC	\$ 342,256	\$ 338,486
IIC	149,623	191,588
GMIC	144,280	129,377
BIC	26,058	25,951
OSIC	21,063	20,905

These amounts include ownership interests in affiliated insurance subsidiaries. The statutory net income (loss) for our principal operating subsidiaries for the years ended December 31, 2020 and 2019 was as follows (in thousands):

	2020	2019
HSIC	\$ (4,044)	\$ 11,663
IIC	(21,038)	1,069
GMIC	(17,526)	365
BIC	(38)	3
OSIC	143	344

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25. Subsequent Events

During January 2021, the Company acquired the assets of a surety underwriting program from Aegis Surety Bonds and Insurance Services, LLC in exchange for the assets of our Exterminator Pro underwriting program and \$10.0 million in cash. We will record this business combination using the purchase method of accounting. Accordingly, the purchase price will be allocated based on the relative fair value of assets acquired with an implied purchase price of \$15.0 million. We are currently in the process of determining the purchase price allocation and the relative fair value of the assets acquired.

The Company's 2021 Long-Term Incentive Plan (the "2021 Plan"), approved in December 2020 by the Compensation Committee of the Company's Board of Directors, provides for the granting of restricted stock, restricted stock units, and performance share awards, as well as cash-based performance awards, to select employees and non-employee directors of the Company. The Company's previous Equity Incentive Program remains in effect only as it relates to outstanding awards previously granted under that plan. Under the new 2021 Plan, the Compensation Committee of the Company's Board of Directors ratifies the selection of participants for each year's grants which are, subject to the terms and conditions of the 2021 Plan. On March 1, 2021, the Compensation Committee of the Company's Board of Directors approved approximately \$2.5 million in shares for grant or award based on the grant date fair value. The grants consisted of the following types of equity awards:

Time-based awards

The Company grants time-based restricted common stock awards and/or time-based restricted common stock unit awards that are settled in shares to its employees which vest after three years of continuous employment. We recognize compensation costs over the applicable vesting period at fair value of the common stock on the grant date.

Performance-based awards

The Company grants compensation awards to its employees that are based on the Company's achievement of certain Company-based performance objectives as well as the Company's achievement of certain market-based objectives. The awards vest after three years. With regard to the Performance-based awards, the final number of shares vesting or cash being paid is in a range of 0 – 150% of shares awarded depending on achievement of performance metrics.

Market-based awards

The Company grants market based awards based on growth in tangible book value per share to the Chief Executive Officer and Chief Financial Officer.

Our management has evaluated subsequent events through March 16, 2021, which is the date the consolidated financial statements were available to be issued and has concluded that there are no other significant events requiring additional disclosure in the consolidated financial statements.