United Fire Group, Inc.

Q3 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Randy Patten - *AVP of Finance and Investor Relations*

Randy Ramlo - *Chief Executive Officer*

Michael Wilkins - *Chief Operating Officer*

Dawn Jaffray - *Chief Financial Officer*

PRESENTATION

Operator
Good morning. My name is Nicole and I'll be your conference operator today. At this time, I would like to welcome everyone to the United Fire Group Third Quarter 2017 Financial Results Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*), then one (1) on your telephone keypad. To withdraw your question, please press star (*), then two (2), and please note this event is being recorded.

Thank you and I will now turn the call over to Randy Patten, AVP of Finance and Investor Relations. Please go ahead.

Randy Patten
Good morning, everyone, and thank you for joining this call. Earlier today, we issued a news release on our results. To find a copy of this document, please visit our website at ufginsurance.com. Press releases and slides are located under the Investor Relations tab.

Our speakers today are Chief Executive Officer, Randy Ramlo; Michael Wilkins, our Chief Operating Officer; and Dawn Jaffray, Chief Financial Officer.

Please note that our presentation today may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties are not a guarantee of future performance. These forward-looking statements are based on management's current expectations and we assume no obligation to update them. The actual results may differ materially due to a variety of factors, which are described in our press release and SEC filings.

Please also note that in our discussion today, we may use some non-GAAP financial measures. Reconciliations of these measures to the most comparable GAAP measures are also available in our press release and SEC filings.

At this time, I'm pleased to present Mr. Randy Ramlo, Chief Executive Officer of UFG.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to the UFG Insurance third quarter 2017 Conference Call. Earlier this morning, we reported a net loss of $0.72 per diluted share, operating loss of $0.73 per share, and a GAAP combined ratio of 118.1% for the third quarter 2017. This compares with a net income of $0.48 per diluted share, operating income of $0.41 per diluted share, and a GAAP combined ratio of 100.9% in the third quarter of 2016.

The third quarter results were impacted by three powerful hurricanes that caused devastation in Texas, Florida, and Puerto Rico. These storms caused much more than economic damage. They displaced families and caused tremendous stress and uncertainty for everyone affected, and we hope for a speedy recovery for all those impacted by Harvey, Irma, and Maria. I'd also like to thank our catastrophe claims teams that were in Texas and Florida before the storms made landfall, ready to assist our policyholders. Their quick response and ability to handle these claims in a timely fashion, help our insurers get back in business or get back to the sense of normalcy, which is appreciated during times like this.

Along with elevated cat losses during the third quarter, results were also impacted by an increase in the number of large commercial auto claims, which we define as those above $500,000. We are disappointed in the continued poor results in our commercial auto line, but we are not alone. We believe this is an industry-wide issue. Commercial auto loss ratios have been increasing for the past couple of years. In the October 2017 *Best's Review* insurance magazine, it showed the average adjusted loss ratio for US commercial auto writers increased from 63.9% at the end of 2014 to 69% at the end of 2016, or an increase of 5.1 percentage points.

We have a number of initiatives that we are putting in place to address this issue, which we have discussed the past few quarters in our conference calls. One of our responses to our and the industry's continued issues with commercial auto is to address distracted driving. In the third quarter, we launched a new distracted driving campaign. This campaign, which we are calling "Worth It", is a comprehensive educational and marketing program to remind drivers that life is worth it, distracted driving is not. This collection of resources is designed to teach and engage. It can be used by any business owner, insurance agents, educators, or individuals, basically anyone interested in helping fight the epidemic of distracted driving.

Another initiative, which we continue to work on, is rate increases on our commercial auto line. We initially set out with an aggressive plan for rate increases, but in reality, we did not execute it across all regions, so we need to refocus on execution of our plan. Moving forward, we will further reinforce the importance of a rate adequacy, given the exposure. We think it will take some time before we see improvement in the results, but with the rate increases, along with other ongoing initiatives, we are confident we can return this line to profitability. Mike will discuss the initiatives we are putting in place to improve our underwriting performance in this line in more detail.

Moving on to catastrophe losses, cats added 12 percentage points to the combined ratio in the third quarter of 2017, compared to 5.2 percentage points in the third quarter of 2016. The CAT load for the third quarter of 2017 is higher than our 10-year historical average of 8.9 percentage points. The increase in CATs this quarter is the result of the three hurricanes, which I previously discussed. During the quarter, $10 million of the $30.7 million of CAT losses occurred on assumed reinsurance for these hurricanes.

Our expense ratio continues to meet our expectations, but was up to 30.8% for the third quarter 2017, which is slightly higher than the third quarter 2016 at 30.2%. The increase in the three month period ended September 30, 2017, was due to two items. First, the deterioration in the profitability of the commercial and personal auto lines of business, which accelerates the amortization of our deferred acquisition costs. Second, we are investing in a new multi-year project to upgrade our technology platform to enhance core underwriting decisions and productivity. These were both partially offset by a decrease in the post-retirement benefit expenses and a decrease in contingent commission expenses.

As many of you are aware, we issued a press release on September 19, announcing we had reached a definitive agreement with Kuvare US Holdings to sell our life insurance subsidiary, United Life Insurance Company. The decision to sell our life subsidiary to Kuvare was made in the best interest of UFG, its shareholders, and United Life from both a business perspective and a personal perspective. By selling United Life to Kuvare, we have established a solid future for our life insurance employees, insurance agents, and customers, while allowing us to continue to build on the success of our property and casualty operations. The closing of this sale is currently expected to occur in the first half of 2018, subject to customary conditions and

regulatory approval.

Finally, to wrap up my portion of the discussion, during the third quarter A. M. Best affirmed our rating of A Excellent, as we expected.

With that I will turn the discussion over to Mike Wilkins. Mike?

Michael Wilkins
Thanks, Randy, and good morning, everyone. As Randy indicated, we had further deterioration in our core loss ratio in the third quarter of 2017, driven by an increase in the number of large losses in our commercial auto line of business. Much of this deterioration between the second and third quarter 2017 is due to strengthening of prior year reserves. This reserve strengthening is partially due to bodily injury loss inflation, which we and the industry are experiencing. There were also a number of catastrophe claims from the three hurricanes in the third quarter, which contributed to the increase in the commercial auto loss ratio.

In the third quarter of 2017, we had 17 large commercial auto claims, compared to 10 large commercial auto claims in the third quarter of 2016. Year-to-date, we had 45 large commercial auto claims, as compared to 21 large claims in the prior year-to-date. This increase in the number of severe commercial auto losses is the primary reason for the deterioration in the core loss ratio. Many of these commercial auto losses occurred on policies with umbrella coverage, which increased our loss ratio on our other liability line of business this quarter, as well. On Slide 10 of our deck, we have provided a breakdown of the geographic distribution of the large commercial auto claims received year-to-date.

As Randy also touched on, we have not been diligent enough in all regions pushing the approved rate increases in our commercial auto line of business. Moving forward, all of our regions and branches will be more aggressive with our rate increases for this line, especially on our marginally performing accounts. They will also continue to review and non-renew our underperforming accounts.

Some other initiatives, we continue to work on include having our loss control reps focus their efforts on accounts with significant auto exposure. These efforts include ensuring that insureds have acceptable hiring practices, driver screening practices, vehicle use policies, and vehicle maintenance policies and ensuring that they are being followed and enforced. Our new analytics department also continues to assist us by providing pricing and acceptability guidance on our commercial auto book as well as business intelligence insights to assist underwriters in making better acceptability and pricing decisions. We are confident that with continued rate increases and these initiatives, we will return our commercial auto book back to our desired level of profitability.

Moving on to market conditions, we continued to experience competitive market conditions during the quarter for both renewal and new business. Renewal pricing on larger accounts is flat to down slightly, and pricing on smaller accounts is flat to a small percentage increase. Overall, average renewal pricing change for commercial lines increased slightly, driven by commercial auto, with pricing varying depending on the region and size of account. Commercial auto and commercial property rate increases continued to be in the mid- to upper-single-digits with negative rate changes for our workers compensation line of business. Overall, average renewal pricing increase slightly for personal lines but increases in the low single digits. All regions continue to aggressively address our poor performing accounts through non-renewal or large pricing increases.

Premium and policy retention remained strong at 84% and 81%, respectively, during the third quarter of 2017. Our success ratio on quoted accounts decreased 5% from the prior quarter to 28%. This decrease was largely driven by a significant drop in the success rate of our specialty division due to a large increase in quote requests for this division in September. As we continue to address the deterioration in our auto book of business, our expectation is that premium and policy retention may be negatively impacted.

With that, I'll turn the financial discussion over to Dawn Jaffray.

Dawn Jaffray
Thanks, Mike, and good morning. For the third quarter 2017, we reported a consolidated net loss of $17.9 million, or $0.72 per diluted share, compared to consolidated net income of $12.4 million, or $0.48 per diluted share in the third quarter of 2016. Through nine-months, 2017 year-to-date consolidated net income was $5 million, or $0.20 per diluted share, compared to $37.9 million, or $1.47 per diluted share in the same period of 2016. The decrease in quarter-over-quarter and year-over-year net income is primarily due to deterioration in our core loss ratio and elevated catastrophe losses previously discussed by Randy and Mike.

Consolidated net premiums earned increased 3.8% in the third quarter 2017 as compared with 2016, and total revenues increased 2.5%. Year-to-date consolidated net premiums earned and total revenues both increased 3.8% as compared with 2016.

As Randy mentioned, during the third quarter, we reached a definitive agreement to sell our life subsidiary. Throughout our press release and 10-Q this quarter, we have classified the results from our life subsidiary as discontinued operations and the results from our P&C business as continuing operations, as required by accounting guidance.

Just looking at continuing operations, we reported a consolidated net loss of $0.77 per diluted share and $0.01 per diluted share in the third quarter and year-to-date 2017, respectively, as compared to net income of $0.45 per diluted share and $1.44 per diluted share in the same period of 2016. Net premiums earned from our continuing operations grew by 6.8% and 6.6%, respectively, in the third quarter and year-to-date 2017, as compared to the same periods in 2016.

As we have discussed in our prior conference calls, our expectation for premium growth in 2017 is 4% to 6%. With the initiatives that we are aggressively pursuing in our commercial auto line of business, we expect our premium growth will slow in the fourth quarter of 2017 and as a result meet these expectations.

We experienced unfavorable reserve development of $3.2 million in the quarter, compared with $700,000 of favorable development in the third quarter of 2016. Year-to-date in 2017, favorable reserve development was $38 million, compared to $27.1 million in the first nine months of 2016. The development impact on net income for the third quarter and year-to-date in 2017 was a decrease of $0.08 and an increase of $0.96 per diluted share, respectively, compared to an increase of $0.02 and $0.68 per diluted share in the same periods of 2016.

Looking at reserve development in more detail, in the third quarter of 2017, the majority of the unfavorable development was from two lines, other liability and commercial auto, which was partially offset by favorable development in workers compensation. Year-to-date 2017, the majority of the favorable development is from other liability lines and workers compensation,

partially offset by reserve strengthening in our commercial fire and allied and commercial auto lines.

The combined ratio in the third quarter of 2017 was 118.1%, compared to 100.9% for the third quarter of 2016. Year-to-date 2017, the combined ratio was 107.6%, compared to 99.5% for the same period of 2016. Removing the impact of catastrophe losses and reserve development, our core loss ratio deteriorated 8.9 percentage points in the third quarter and 7.7 percentage points year-to-date 2017, as compared to 2016. The primary driver of the deterioration in the core loss ratio is an increase in the number of severe commercial auto losses, as previously discussed. Referring to Slide 9 in our slide deck on our website, we've provided a detailed reconciliation of the impact of catastrophes and development on the combined ratio.

Return-on-equity was 0.7% year-to-date 2017, compared to 5.5% in 2016. The decrease in return-on-equity as compared to the same quarter last year was primarily due to the net loss for the quarter. Our return on equity, excluding unrealized investments gains, was 0.9% for 2017.

During the third quarter, we declared and paid a $0.28 per share cash dividend to stockholders of record on September 1, 2017. We have paid a quarterly dividend every quarter since March of 1968.

Also, during third quarter of 2017, we remained active with our share repurchase program. During the third quarter, we repurchased 205,291 shares of our common stock at an average price of $41.89 and a total cost of $8.6 million and year-to-date through September; we've repurchased 701,899 shares of our common stock for a total cost of $29.8 million. We purchase United Fire common stock from time-to-time on the open market and/or through privately negotiated transactions as the opportunity arises. The amount and timing of any purchases will be at management's discretion and will depend on a number of factors, including the share price, general economic and market conditions, and corporate and regulatory requirements. We are authorized by our Board of Directors to purchase an additional 2.2 million shares of common stock under our share repurchase program, which expires in August of 2018.

And with that I will now open the line for question. Operator?

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star (*), then one (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*), then two (2). At this time, we will pause momentarily to assemble our roster.

And our first question comes from Paul Newsome of Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning, thanks for the call. Could you tell me or give us a sense of how many years of profit were overtaken by the loss in the assumed reinsurance business? I'm just trying to think about sort of the payback period of time for that kind of business.

Randy Ramlo
Want to take that, Mike?

Michael Wilkins
Yes, Paul, good morning, this is Mike Wilkins. We, just yesterday, were looking at a 10-year total for the results of the assumed business, including this year. And I think our, I don't have it with me, but I think our underwriting profit on that business for the last 10 years was around $60 million. So it's been very profitable. It's our most profitable segment, but it does have a lot of volatility to it. So when you have years like this year or the year of the Japan earthquake and tsunami, you have bad results in those years, but over the long run, it's definitely a good segment to be in.

Paul Newsome
Great and then do you have any sense about implementation time for the rates on the commercial auto business? Are you actually raising rates at the moment, if you've been doing it for a while? Obviously, I mean, the rate is really what's going to fix this thing. So just curious as to how fast you're getting your rate through the commercial auto business and I'd also like to know your willingness just to let business go in that line.

Michael Wilkins
Yes, this is Mike again, Paul. We're gaining momentum. I think Randy's comments, he said that maybe not all regions are on board, but I think we've corrected that in the last quarter. Our analytics group has done a nice job of getting us solid metrics on what we're achieving on commercial auto rate. Going back to the last three months, this is overall rate increases across all regions, July was 4.8%, August was 6.0%, September was 8.0%. So nice momentum being gained there as everybody is getting on board with those rate increases. I think the market continues to firm, so I don't think we're at the top yet, I think we can get north of 10% in that line, going forward, so that's encouraging.

The other thing I would say is rate will certainly help and probably the fastest thing we can do to improve the loss ratio, but we have to do more than that to get it to where we want it. So we continue to work on the other areas that we mentioned, as well. One thing that's really going to help, in our slide deck, we showed breakdown of large losses by region and you can see our West Coast is really contributing more than their fair share of large losses.

We did get a fairly large rate approval through the California Insurance Department this quarter, so that will help things out there as we go forward, as well. So I think some positive is finally coming through and some trends that are encouraging.

Randy Ramlo
Paul, this is Randy Ramlo. I just wanted to kind of reiterate one of the things Mike said that, for UFG, rate alone will not cure this. We know we have to let some of our poorer performing accounts go. So all of our regions absolutely have the message that we're not looking to grow in this area and we have to, if you price something up and you lose it, that's a win.

Michael Wilkins
And, Paul, maybe one more comment along those lines. So our policy count in auto is up, but our unit count is down. And one of the things that we've found with our analytics business intelligence, on some of our larger accounts, the accounts with larger fleets, are our most unprofitable accounts. And I just think there's a tendency on those large accounts to over credit them from an underwriting perspective. Bigger accounts tend to get more credits. A lot of times on the auto, there's not good fundamental reasons why those credits should be applied. It's just, they're larger accounts just because they have more units, not because they're better accounts, because they don't necessarily have safety programs, or driver training, or better

driver screening. So those are the types of things you really have to look at when applying credits and not the size of the account and I think, unfortunately, in the past, some of those large accounts got credit just because they're large accounts. So I think we're making progress there, too, as we tend to focus more on the accounts with fewer units but more profitable, more adequately priced.

Paul Newsome
Great, thank you. Thank you very much.

Randy Ramlo
Thank you, Paul.

Operator
Our next question comes from Brian Hollenden of Sidoti. Please go ahead.

Brian Hollenden
Good morning and thanks for taking my questions. Can you talk about the likely uses of capital from the life insurance segment sale, given the challenges in the core business?

Randy Ramlo
This is Randy Ramlo. We've kind of mentioned before, we developed a capital committee as part of our Board. And we'll, obviously, just have to wait for our life insurance deal to close, which we hope we'll do sometime early in 2018. And at that time, our capital committee will, I think will look at, we continue to look at outside acquisitions, but maybe slightly less aggressively than we have in the past.

Dawn mentioned our track record of paying dividends. We would consider even a special dividend, more share repurchases, depending on kind of where our stock price is. So I think we'll take a multipronged approach to putting those funds to use or returning some to the shareholders.

Brian Hollenden
Thanks and then can you talk a little bit about your direct or perhaps your reinsurance exposure to the California wildfires?

Randy Ramlo
Let Mike handle that one.

Michael Wilkins
Yes, this is Mike Wilkins. I would say it's too early to know the impact yet. I don't think it would be anywhere near as significant as the Harvey/Irma/Maria exposure. But as a fourth quarter event and we have not gotten updates from the reinsurer, the companies that we reinsure yet to have a good feel for that.

Randy Ramlo
In general, we try to, I guess, minimalize reinsurance exposure to US CATs, because we have that exposure on the primary side. So Maria came mostly from our Puerto Rican exposure, which we don't have any on the primary side. So not to say that we won't have any, but we do try to kind of watch US exposure to any kind of CAT business because we have it on the primary side already.

Brian Hollenden
All right and this quarter marks sort of the first unfavorable reserve development in a number of quarters, would you expect additional unfavorable reserve developments?

Randy Ramlo
That's a tough one. I hope not. We always think that we've been diligent in getting caught up, but a lot of this came, obviously, from the commercial auto line. So, more to follow, but we hope that we've got everything in the third quarter that belongs there.

Brian Hollenden
And then the last one for me, just the new technology platform that you're implementing, can you just talk about perhaps the new features that this platform has that your old platform did not? Just any additional capabilities.

Michael Wilkins
This is Mike Wilkins. I'll try to tackle that one. And I think probably the big transformational pieces that we think will come with this is just better analytics, insight, better access to data from our underwriters in decision-making. Of course, we think productivity gains will come. There'll be more things automated, less manual entry, more straight through process. But where we really think the advantages will come to UFG, the things that will really help transform our business, are the ability to make better underwriting decisions and improve the profitability through better use of data.

Brian Hollenden
That's helpful. Any way to kind of quantify that in terms of impact to combined ratio, all else equal?

Michael Wilkins
I don't think that's probably anything that we're willing to talk about at this time. There's probably a long timeframe on this project. We would not expect to implement the first states for a couple of years. And probably, by the time the whole project is wrapped up, it'll be more like five-year timeframe. Part of the, it's not just the policy processing. So it's also the data structure, analytics, and access to that data for the underwriters. So I don't think it's anything that we'd want to talk about quantifiable numbers yet.

Brian Hollenden
Thank you.

Operator
Again, if you have a question, please press star (*), then one (1). We will pause momentarily to assemble our roster.

And as we have no further questions, I would like to turn the conference back over to Randy Patten for any closing remarks.

CONCLUSION

Randy Patten
This now concludes our conference call. As a reminder, a transcript of this call will be available on the company website at ufginsurance.com. On behalf of the management of the UFG, I hope you all have a great day.

Operator
Thank you. Ladies and gentlemen, this concludes today's program. You may disconnect your lines at this time.