United Fire Group, Inc.

2018 Q4 and Year-End Conference Call

February 20, 2019 at 10:00 AM Eastern

CORPORATE PARTICIPANTS

Randy Ramlo – *President and Chief Executive Officer*

Michael Wilkins - *Chief Operating Officer*

Dawn Jaffray – *Chief Financial Officer*

Randy Patten – *Assistant Vice President of Finance and Investor Relations*

PRESENTATION

Operator
Good morning. My name is Brandon, and I'll be the operator on today's call. Welcome to the United Fire Group Inc.'s 2018 Fourth Quarter and Year-End Conference Call. All participants will be in 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). Please note, this event is being recorded.

I would now like to turn the conference over to Randy Patten, AVP 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 and 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, CEO of UFG Insurance.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to the UFG Insurance Fourth Quarter and Year-End 2018 Conference Call. Earlier this morning, we reported a consolidated net loss of $1.17 per diluted share, an adjusted operating loss of $0.30 per diluted share, and a GAAP combined ratio of 108.5% for the fourth quarter of 2018. This compares with a net income of $1.81 per diluted share, adjusted operating income of $1.78 per diluted share, and a GAAP combined ratio of 93.8% for the fourth quarter of 2017.

For the full year of 2018, we reported net income of $1.08 per diluted share, adjusted operating income of $0.67 per diluted share, and a GAAP combined ratio of 104%. This compares with full-year 2017 net income of $1.99 per diluted share, adjusted operating income of $1.79 per diluted share, and a GAAP combined ratio of 104%.

The fourth quarter of 2018 was a challenging one. During 2018, we made steady progress, improving profitability on our commercial auto line. However, during the fourth quarter, we experienced an increase in severity of losses in both our commercial auto and general liability lines of business from auto-related claims due to several factors, including a trend toward higher court awards.

In response to this setback to profitability, we are taking several initiatives in pricing, underwriting, and claims. All year, we have been working on initiatives to achieve pricing adequacy, focusing on risk control, and took tough underwriting actions on underperforming accounts. Going forward, we will add initiatives to improve the profitability of our West Coast operation, incorporate analytically determined technical pricing at a more granular level, and will implement several new claims initiatives. Mike will address these initiatives and our strategy going forward in more detail in a few minutes.

To assist in implementing our new initiatives in our West Coast region is Jeremy Bahl, who has assumed responsibility for leading our West Coast region. Jeremy has done a terrific job advancing culture, profit, and production in our Rocky Mountain region, and we look forward to seeing similar progress in the West Coast region in the coming months.

Also, to assist with our new claims initiatives, we appointed Corey Ruehle as our new Chief Claims Officer. Corey succeeds Dave Conner, who will begin his retirement in April 2019. First and foremost, we thank Dave Conner for his successful 20-year career at UFG and congratulate him on his retirement.

Prior to his appointment, Corey was the vice president and manager of our Midwest region. Corey has served UFG in various capacities, including as an underwriting supervisor and manager. Corey has a proven record of leading one of our most successful regions. With nearly two decades of underwriting experience, Corey offers a combination of deep insurance knowledge, strong leadership, and a fresh new perspective on claims management, which will benefit him greatly in his new role. Building off Dave's success, Corey has an exciting vision for the claims department at UFG, enhancing its ability to contribute to our profitability, and he will work to develop a strong and cohesive tie between claims and underwriting.

I will wrap up my discussion today on our quarterly results. The change in adjusted operating income from the fourth quarter of 2017 to an adjusted operating loss in the fourth quarter of 2018 was $2.08. This change was primarily driven by a deterioration in our core loss ratio, an increase in catastrophe losses, less favorable reserve development, lower investment income, and the prior-year one-time tax benefit from the Tax Cuts and Jobs Act. These were all partially offset by an increase in net premiums earned.

During the fourth quarter of 2018, the deterioration in our core loss ratio was primarily driven by an increase in the severity of losses in our commercial auto and general liability lines of business, which accounted for $0.59 per diluted share of the decrease in adjusted operating earnings. All year, we made steady progress, reducing our frequency of losses and the number of insured commercial auto units. However, in the fourth quarter, severity increased driven by social inflation of bodily injury claims from umbrella losses caused by commercial auto accidents.

In the fourth quarter of 2018, we experienced an increase in catastrophe losses, which was primarily due to $9.2 million of losses from the California wildfires. As a reminder, the losses from the California wildfires were from our commercial lines of business; we do not write personal lines in California. In the fourth quarter of 2018, cats added 5.9 points to our combined ratio and $0.50 per diluted share as compared to 2 points on the combined ratio and $0.13 per diluted share for a change quarter-over-quarter of $0.37. Although we saw an increase in cats in the fourth quarter of 2018, for the full year of 2018, our cat losses were well below our 10-year historical average.

Cats only added 4.5 points to the combined ratio as compared to our 10-year historical average of 6.4 points, which we attribute to the successful management of our geographic exposures to cats.

In the fourth quarter of 2018, we had lower favorable reserve development compared to the fourth quarter of 2017, which accounted for $0.22 per share of the change. Although we recorded less favorable reserve development in the fourth quarter of 2018, full-year 2018 reserve development was flat compared to 2017. Dawn will discuss favorable reserve development in more detail later in this call. Also, contributing to the change in adjusted operating income was the prior year one-time benefit from the Tax Cuts and Jobs Act in the fourth quarter of 2017, which added $0.86 per diluted share to adjusted operating income in 2017. The remaining difference is primarily due to a number of offsetting items, including lower investment income, due to volatile equity markets in the fourth quarter of 2018 and an increase in net premiums earned.

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

Michael Wilkins
Thanks, Randy, and good morning everyone. As Randy mentioned, the fourth quarter of 2018 was a challenging quarter and a setback to the progress that we have had on improving profitability of our commercial auto book of business. In response to this setback in profitability, we are responding with a number of strategic initiatives in addition to the initiatives we have been working on this year. As always, these initiatives take time to implement and therefore, may take some time to have an impact on our financial results.

One area we are addressing is our West Coast operation, which has been a significant contributor to our adverse results. As Randy mentioned, we made a leadership change by appointing Jeremy Bahl to lead our West Coast operation. Jeremy will focus on a number of strategic initiatives, which include a review of certain classes of business which do not align with UFG's risk appetite, such as residential construction, habitational, fast food restaurants, and certain classes of heavy-wheeled commercial vehicles. Over time, we will improve the West Coast mix of business and position United Fire & Casualty as the lead company for preferred business. Also, we recognize we have a number of opportunities to create efficiencies in our underwriting and claims teams to make cross-regional policies simpler to underwrite and improve claims administration, which will position UFG to compete for more attractive classes of business. Finally, in our West Coast operation, we see an opportunity to improve profitability by strengthening our marketing plan and our agency plant.

Our second major initiative to improve profitability is to incorporate analytically determined technical pricing at a more granular level into our underwriting processes with the assistance of our Enterprise Analytics team. In the fourth quarter, our renewal pricing increases for commercial lines remained in the mid-single digits with pricing varying depending on the region and size of account. Renewal pricing increases continue to be driven by commercial auto pricing. Filed commercial auto rate increases during the fourth quarter 2018 averaged in the low double digits. We will continue to focus on monitoring effective rate changes in targeted areas with our commercial auto book of business, seeking double-digit rate increases not only in the West Coast but other geographic locations, such as Florida and Texas. We now realize that our rate increases have not been aggressive enough, given the increasing severity of losses.

We will also expand our enforcement of vehicle use policies and the use of technologies such as LifeSaver app, along with continued education of our insureds on distracted driving through our successful Worth It campaign. Finally, with the successful implementation of our commercial auto analytics model, our Enterprise Analytics team has moved to development of a commercial property model.

In addition to these underwriting initiatives, we will be implementing several new claims initiatives under the direction of our new Chief Claims Officer, Corey Ruehle. These new initiatives are aimed at improving claims service, including shortening cycle time and reducing claims cost, attorney involvement, and the impact of litigation from seemingly increasing social inflation of jury awards, especially in our auto liability book.

With that, I'll let Dawn Jaffray discuss our fourth quarter financials. Dawn?

Dawn Jaffray
Thanks, Mike, and good morning everyone. As Randy and Mike both mentioned, the fourth quarter of 2018 was challenging. We reported a consolidated net loss of $29.3 million in the quarter compared to net income of $46 million in the fourth quarter of 2017. Net income in the fourth quarter of 2018 was impacted by volatile equity markets. This resulted in a decrease in the value of equity securities recognized in the income statement in the amount of $21.7 million after tax. During the fourth quarter of 2017, UFG benefited from a one-time tax change of $21.9 million associated with re-measuring deferred taxes under the new lower corporate tax rate. The remaining change in net income in the comparable fourth quarter was combination of an increase in severity of losses in our commercial auto and general liability lines stemming from auto-related claims, a decline in favorable reserve development, and lower net investment income. All partially offset by an increase in net premiums earned.

For the full-year 2018, consolidated net income was $27.7 million compared to $51 million in 2017. 2018 net income was also impacted by the decrease in the fair value of equity securities as of the end of the year. As a result, we had an after-tax loss of $17.4 million associated with these changes in value.

Also contributing to the change in net income year-over-year were some one-time items. In 2018, we recognized the $27.3 million gain on sale of United Life and in 2017, we recognized a one-time tax benefit of $21.9 million. The remaining change in net income for the full year of 2018 as compared to 2017 was due to an increase in expenses offset by an increase in net premiums earned.

In the fourth quarter and full-year 2018, our net premiums earned increased 4.1% and 4% respectively over 2017. These increases were within management's expectations. Commercial auto continues to be our line of business with the most premium growth, but the increase in this line is driven primarily by rate increases.

2018 net investment income decreased 29% in the fourth quarter and increased 3.3% compared to the same periods in 2017. The decrease in net investment income for the quarter was driven by a $5.9 million decrease in the value of our investments in limited liability partnerships due to the volatility in equity markets specifically related to financial institutions. For the full year of 2018, the increase in net investment income is due to an increase in invested assets.

Moving on to reserve development, we recognized favorable reserve development of $6.5 million in the fourth quarter of 2018 compared to favorable reserve development of $16.3 million in the fourth quarter of 2017. For the fourth quarter of 2018, the biggest driver of our favorable reserve development was in our workers' compensation and assumed reinsurance lines, partially offset by unfavorable development in general liability and commercial fire and allied.

For the full year of 2018, we recognized favorable development of $54.2 million, which was flat compared to $54.3 million in the full year of 2017. The impact to the combined ratio was 5.2 percentage points in 2018 compared to 5.4 percentage points in 2017. As a reminder, we continue to maintain a conservative reserving philosophy with annual favorable reserve development every year since 2009. Favorable reserve development varies year-to-year. At December 31, 2018, total reserves remained within our actuarial estimates.

The combined ratio in the fourth quarter and year-to-date in 2018 was 108.5% and 104% respectively compared with 93.8% and 104% for the same periods in 2017. Removing the impact of catastrophe losses and reserve development, our 2018 core loss ratio deteriorated 7.1 percentage points in the quarter and 0.4 percentage points for the full year as compared to the same periods of 2017. Referring to slide 9 in the slide deck on our website, we've provided a detailed reconciliation of the impact of catastrophes and development on the combined ratio.

Moving on to expenses. Our expense ratio was 33.1% in the fourth quarter of 2018 with a slight decrease compared to 33.3% in the fourth quarter of 2017. For the full-year 2018, our expense ratio was 33.5% compared to 31.2% for 2017. The increase is primarily due to our continued investments in upgrading our OASIS underwriting technology and analytics platform. As a reminder, we anticipate the OASIS Project will add approximately one to two points annually to the expense ratio for the duration of the project.

Continuing to proactively manage our tax position, we contributed an additional $10 million to our pension plan during 2018 to take advantage of the benefit of the deduction at the 35% corporate income tax rate for the prior year. We've made similar contributions over the preceding three years, which along with good pension portfolio returns, have improved our funded status and reduced future pension expenses. In addition, we undertook amending certain aspects of our post-retirement medical plan benefits to take effect in 2019. These changes combined with other changes in assumptions will result in a reduction to our annual pension and post-retirement benefit expenses of approximately $7 million during 2019.

I will end today's portion of our prepared remarks with a short discussion on capital management matters. With no debt in our capital structure, our annualized return on equity was 3% in 2018, compared to 5.3% in 2017. The decrease in return on equity year-over-year is primarily due to the decrease in the fair value of equity securities offset by the recognition of the gain on sale of United Life in the first quarter of 2018 and the one-time tax benefit associated with the Tax Act changes recognized in 2017. For the full year of 2018, we have returned a total of $111 million in the form of regular and special dividends and share repurchases. During the first quarter, we repurchased shares totaling $5.4 million, and for the year we paid dividends of $4.21 per share through the regular quarterly cash dividend and the $3 special dividend paid in August of 2018. And lastly, as a point of reference, over the last five years we have returned over $250 million to shareholders through cash dividends and share repurchases.

And with that, I will now open the line for questions. 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 telephone keypad. 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.

Our first question comes from Paul Newsome with Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning, everyone. Thanks for the call. I guess, could you give us a little bit more detail about the tie between the, I guess, you said umbrella losses that were also caused by the commercial losses? Are you just simply talking about umbrella insurance that was written on the same account as the commercial auto?

Randy Ramlo
Paul, this is Randy. That's exactly it. We had quite a few losses that went through the underlying policy limits and got solidly into the umbrella coverage that we provided. So, in part some of those were court awards, but a lot of them involved severe bodily injury and oftentimes fatalities. So, you're exactly right.

Paul Newsome
So, would your, was there reinsurance that would cap some of that or does that just--is that kind of a...

Randy Ramlo
Yes, we retain $2.5 million of each loss. So, if we had a $3 million, $4 million loss, some of that would be--we'd get some relief from the umbrella.

Paul Newsome
And, then could you reconcile kind of a more general comment, you said that you're making progress on the commercial auto business, but the results actually got worse. So, is that purely a mechanical process or is it--I'm just having a little, struggling with that a little bit.

Michael Wilkins
Paul, this is Mike Wilkins. If you look at the results for the year, auto did improve about 11 points from 106 to 95, and as we look at progress, we try not to focus on a quarter. We've made improvements in our moving average auto loss ratio four consecutive quarters prior to the fourth quarter. The fourth quarter, I would say, was disappointing and unexpected that we took a step backwards. So, we're re-calibrating a little bit the steps that we're taking. I think we are still making progress, maybe just not at the pace that we had thought we were making progress prior to the fourth quarter.

Paul Newsome
Mm-hmm.

Randy Ramlo
And Paul, this is Randy. You know, some things like the number of insured vehicles we track, and that is down, so that means our exposure, it should be moving in the right direction. We're starting to see some improvement in frequency of losses and even, other than the fourth quarter, we've seeing some improvement on the severity side. So, normally in underwriting, you focus on frequency and not so much on severity, but in a given quarter severity can make some material result. So, those are some of the areas that we do think we were making some good progress and then in the fourth quarter, as we said, a bunch of big severity losses kind of took it all back.

Paul Newsome
Mm-hmm.

Michael Wilkins
Paul, this is Mike again. Maybe just to elaborate a little bit further. The other thing I would say is our results in the fourth quarter were lumpy across regions. So, while we had some regions that continue to make good progress, like our Midwest region, which is one of our largest regions. We had other regions that took a big step backwards, particularly our West Coast, which had just a really bad fourth quarter; also, our Gulf Coast was disappointing, driven by states like California and Texas, where we've seen more challenging issues to address on the auto side.

Paul Newsome
So, I guess then last question and then I'll let somebody else ask. The personal auto seems to be having the same--the private passenger auto seems to be having some of the same underwriting issues as the commercial auto, but I haven't seen that in most other companies. Is something else going on in the private passenger auto that's different, that is also--I know it's a…it's a smaller business, but that also seemed to be a bit of issue?

Michael Wilkins
I would say same drivers. This is Mike again. You know, the distracted driving, the mileage being up. You know, we saw a bigger improvement on the personal auto side than we did on the commercial auto side, but I think a lot of the same drivers are at play there. We have looked at the industry and seen maybe more significant improvement for the industry on the personal line side. I think we also saw more significant improvement but maybe started at a worse place than some others in the industry.

Paul Newsome
So are you still seeing higher frequency in private passenger auto?

Michael Wilkins
We are. Randy mentioned we have started to see that turn, so that is encouraging. It's only been a quarter or two, so I'm not sure I would call it a long-term trend yet, but maybe an encouraging first step in our battle to improve auto results.

Paul Newsome
Because I think frequency has been favorable in '17 and '18 for the industry. So, that would suggest that for some reason, there's something different between your book and the rest of the industry. Is there any thoughts on why that might be different?

Michael Wilkins
Well, on the personal side, I don't have an answer for you why that would be different. I think on the commercial side, if you look at some of the areas that we write a lot of our business, primarily in the construction industry, I think a lot of that brings tough auto with it. We're evaluating our portfolio approach to the business and how we might need to change that portfolio going forward to write segments of business that are not so heavy in the auto. We're pushing hard on small commercial, which is a segment where the auto has been performing better and tends to come with less auto. So, we're evaluating things beyond just the auto line of business to try to solve this problem.

Paul Newsome
Okay. Thank you very much.

Randy Ramlo
Thank you, Paul.

Operator
As a reminder, if you would like to ask a question please press star (*), then one (1).

It appears there are no further questions. This concludes our question-and-answer session. I would like to turn the conference back over to Randy Patten, AVP of Finance and Investor Relations, for closing remarks.

CONCLUSION

Randy Patten
This now concludes our conference call. Thank you for joining us and have a great day.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.