United Fire Group, Inc.

2019 Q3 Conference Call

Wednesday, November 6, 2019, 10:00 A.M. Eastern

CORPORATE PARTICIPANTS

Randy Ramlo - *Chief Executive Officer*

Dawn Jaffray - *Chief Financial Officer*

Randy Patten - *Assistant Vice President and Controller*

Barrie Ernst - *Chief Investment Officer*

Corey Ruehle - *Chief Claims Officer*

PRESENTATION

Operator
Good morning. My name is Keith and I will be your conference operator today. At this time, I would like to welcome everyone to the UFG Insurance Third Quarter 2019 Financial Results Conference Call.

You will be in-listen only mode. After the presentation, there will be an opportunity to ask questions. When the question session begins, you may ask a question by pressing star (*) then one (1) on your touchtone phone. To withdraw your question, please press star (*), then two (2). Thank you.

I will now turn the call over to Randy Patten, Assistant Vice President and Controller. Please go ahead, Sir.

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 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 am pleased to present Mr. Randy Ramlo, CEO of UFG Insurance.

Randy Ramlo
Thanks Randy. Good morning everyone and welcome to our third quarter conference call.

Earlier this morning, we reported our third-quarter 2019 results, including a consolidated net loss of $0.09 per diluted share, an adjusted operating loss of $0.40 per diluted share and a GAAP combined ratio of 110%. This compares with net income of $0.43 adjusted operating income of less than $0.01 and 105.5% for the GAAP combined ratio in the third quarter of 2018.

Catastrophe losses, an increase in severity of losses, and current accident year reserve additions in our commercial auto and liability lines of business, are the primary drivers for the net loss reported in the third quarter of 2019. Increased catastrophe losses are not uncommon for third quarters, which, along with second quarters, are historically our most volatile quarters. In the third quarter of 2019, we incurred $19.3 million of catastrophe losses compared with $12.3 million in the same period of 2018. Dawn will discuss catastrophe losses in more detail in a few minutes.

In the third quarter, we also incurred an increase in severity of losses and added additional reserves in the current accident year in our commercial auto and liability lines of business. This reserve strengthening is due to an increase in losses from a continuation of the challenging litigious environment, particularly in commercial auto and liability lines of business in the States of Texas and Florida. As a reminder, commercial auto is our largest line of business, with Texas being the state with our highest concentration of commercial auto business.

Similar to our peers and as mentioned on prior conference calls, we continue to experience the impact of what our industry has termed “social inflation” with higher than expected legal settlements associated with bodily injury claims in our umbrella, commercial auto, and liability lines.

With the respect to claims – we continue to implement new initiatives aimed at shortening cycle time and reducing claims costs and the impact of litigation in our auto liability book. These enhancements will allow us to speed up the process of establishing reserves, improve our response time in handling claims, and efficiently assign adjusters to claims.

On the subject of analytics, our Enterprise Analytics team has delivered an improved commercial auto predictive model, which was first used with the June 2019 renewals. We continue to closely monitor the effectiveness of the model in our underwriting decisions. The team will implement a commercial property analytical model in the 4th quarter of this year to help improve technical pricing in that line. The schedule for developing an updated workers’ compensation model and small commercial model has also been accelerated, with plans to begin use in the first half of 2020.

Although the reported results do not yet reflect our strategic initiatives to improve profitability, it remains our primary focus and we are encouraged by the continued improvement we are experiencing in our underlying operations. However, these positives in our operations come with a word of caution, as commercial auto remains an industrywide challenge, with the social inflation of jury awards, higher annual miles driven, higher repair costs, distracted driving, and skilled driver shortages.

The key metrics we focus on that are showing operating improvement include declining frequency of auto claims; a decrease in claim counts, despite the increase in catastrophe claims; strong commercial pricing increases that are outpacing the industry; and an improvement in the core loss ratio of 3.1 points year-to-date.

Although we have seen an increase in severity of losses, we are pleased with the decline in the frequency of losses, especially in our commercial auto line. The third quarter marks the fourth consecutive quarter of flat or declining frequency of auto claims. In addition, we have had a decrease in claim counts despite a 25 percent increase in catastrophe claims year-to-date in 2019.

Another key metric for UFG is pricing increases. Last quarter, we mentioned that our average renewal pricing change for commercial lines was the highest we have seen in over two years at 6.6 percent. In the third quarter of 2019, our average renewal pricing change for commercial lines topped this mark, rising to 7 percent. Renewal pricing increases continue to be driven by commercial auto pricing. The effective rate change for commercial auto was 12.2 percent in the third quarter of 2019 compared with 10.9% in the second quarter of 2019, and 9.5% in the third quarter of 2018. These pricing increases in the third quarter are significantly outpacing the industry average of 4%, which was recently reported by *MarketScout*.

This increase in rates is attributable to the aggressive initiatives we have put in place at the end of 2018, as we continue to focus on reviewing the bottom 30% of our commercial auto book, non-renewing underperforming accounts, advocating for and verifying stronger insured vehicle-use policies, and declining new business opportunities that do not align with UFG's risk appetite. Over the past year, the number of commercial auto exposure units has been flat, but premiums earned has been increasing. This increase is being driven by our aggressive rate increases.

I will wrap up my portion of our prepared remarks with a mention of our surety operations. Although we rarely discuss our surety operations, this line of business continues to provide strong and steady performance year after year. This is an area of our business that we plan to expand in the future, given surety's continued outstanding performance.

With that, I will turn over the discussion over to Dawn Jaffray, Dawn.

Dawn M. Jaffray
Thanks Randy and good morning everyone. In the third quarter of 2019, we reported a consolidated net loss of $2.3 million compared to net income of $11.1 million in the third quarter of 2018. Year-to-date, consolidated net income was $38 million compared to $57 million in 2018.

As Randy mentioned, the net loss in the third quarter of 2019 was driven by catastrophe losses, an increase in severity of losses, and current accident year reserve additions in our commercial auto and liability lines of business.

Benefiting the third quarter and year-to-date 2019 was continued strong equity market performance. This increased the value of our investments in equity securities, resulting in an after-tax gain of $7.7 million in the quarter and $37.0 million year-to-date.

Also positively impacting results were higher net premiums earned with the quarter increase of 3.9% and 6.1% for the 9-month period of 2019. Premium growth has been primarily driven by an increase in rates, with the largest rate increases occurring in our commercial auto line of business.

2019 net investment income was basically flat at $13.3 million for the third quarter and $43.9 million year-to-date compared with 2018.

In the third quarter of 2019, we recognized favorable reserve development of $5.5 million compared to unfavorable reserve development of $700 thousand in the third quarter 2018. Year-to-date in 2019, we experienced favorable development of $800 thousand, compared to favorable development of $47.7 million in the same period for 2018. Year-to-date changes in prior year reserve development are primarily from reserve strengthening in our commercial auto and liability lines of business in our Gulf Coast region.

At September 30, 2019, our total reserves remained within actuarial estimates.

As Randy mentioned, in the third quarter of 2019, we had $19.3 million of CAT losses from 17 events, four of which accounted for the majority of our losses. These events included a hailstorm in Wyoming and a tornado in South Dakota. CAT losses added 7 points to the third quarter combined ratio, which is slightly below what we typically see, having a 10-year historical average of 7.3 points.

Looking ahead to the 4th quarter, our preliminary loss estimates from the October tornado in Dallas are in the $5 to $6 million range. With respect to the ongoing wildfires, it is too early to estimate losses. However, as a reminder, we have limited property exposure, we do not write personal lines in the State of California, and we have catastrophe reinsurance in place with retention of losses from a single event of up to $20 million.

The combined ratio in the third quarter and year-to-date in 2019 was 110% and 106%, respectively, compared to 105.5% and 102.5% for the same periods in 2018. Removing the impact of catastrophe losses and reserve development, our core loss ratio in 2019 deteriorated 3.7 percentage points in the quarter, and improved 3.1 percentage points year-to-date.

Referring to slide 9, in the slide deck on our website, we have provided a detailed reconciliation of the impact of catastrophes and development on the combined ratio.

The expense ratio for the third quarter of 2019 was 33%, compared with 32.3% for the third quarter of 2018. Year-to-date, the expense ratio was 32.7%, compared to 33.7% in the same period of 2018. The increase in the expense ratio during the third quarter is primarily due to quarterly fluctuations in expenses for our Oasis project, extensively upgrading our underwriting technology platform. In addition, we continue to benefit from a decrease in employee benefit expenses with the changes we made at the end of 2018 to our retirement benefits plan.

Moving on to capital matters – annualized return on equity was 5.5% during the first nine months of 2019, compared to 7.3% in the same period of 2018.

During the third quarter, we declared and paid a $0.33 per share cash dividend to shareholders of record as of August 30, 2019. We have paid quarterly dividends consecutively for the past 206 quarters since March 1968.

We also repurchased 177,249 shares totaling $8.1 million in the third quarter. We are authorized by the Board of Directors to purchase an additional 1.9 million shares of common stock under our share repurchase program, which will expire in August of 2020, and with the closing of prepared remarks, I will now open the line for questions. Operator…

QUESTIONS AND ANSWERS

Operator

Yes. Thank you. We will now begin the question-and-answer session. If you would like 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 questions, please press star (*), then two (2). At this time, we will pause a moment to assemble our roster.

And the first question comes from Paul Newsome with Sandler O'Neill.

Paul Newsome
Good morning. I was hoping you could talk a little bit about how the severity issues that you have experienced in commercial auto have expanded into the sort of noncommercial auto areas and kind of what were you seeing outside of commercial auto.

Randy Ramlo
Paul, this is Randy. Number one, also in umbrella, so some of these losses have -- went through the underlying policy and gotten into the umbrella. So that is number one. But we are also seeing kind of, I do not know if I like always using the term social inflation, but just court and jury awards have shown a pattern of increasing on all bodily injury situations and particularly in situations where there are severe or semi-severe bodily injuries, but little or no negligence. And yet courts and juries are overlooking that negligence aspect of it. And that is really where we are seeing, it is still predominantly in the commercial auto line, leaking a little bit into the general liability line, but also hitting the umbrella.

Paul Newsome
Is the umbrella principally just the commercial auto access?

Randy Ramlo
Yes. Principally, yes.

Paul Newsome
OK, and then I was -- wanted to talk about the increased speed-to-claim process. So, I certainly understand why you would want to do that to lower the ultimate claim cost, but is there a possibility that an accelerated claim process will have an accelerated recognition of claims themselves in the fourth quarter or beyond?

Randy Ramlo
So, this is -- we have Corey Ruehle here, our chief claims officer, and I will let him if he has any comments. That is possible in the short term. Long term, I mean, all studies have shown that if you can settle a claim quicker, you can usually settle it at lower dollar amounts. But you are right, as you implement this, there is a possibility of some acceleration of claim payments, maybe for a quarter or two.

Corey, do you have any other comments other than that?

Corey Ruehle
I would agree with what Randy says. We are working pretty feverishly to speed up that process, and we are keeping an eye on whether or not that will have an impact in the short run or not.

Paul Newsome
But are you -- you do not plan to make any adjustments, assuming the reserving process, if you do see increased frequency of claims because of the speed to reduced IBNR, because you think ultimately the claims will be less?

Randy Ramlo
I would say no, not at this point. As I said, that always could be possible if the actuaries see some of that coming through. But at this point, we do not have any plans to do that, no.

Paul Newsome
And then finally, how different will the fourth-quarter reserve process be for the -- between the -- from the quarterly ones?

Randy Ramlo
How do you mean, Paul?

Paul Newsome
Well, sometimes it is much more involved, sometimes it ends up being just a more careful recognition of trends, where sometimes the quarterly is just really a recognition of what you have seen just in that quarter.

Dawn Jaffray
Hi Paul, this is Dawn. With respect to the reserving process, we have both an internal actuarial review and an external actuarial review. We have that done at each of the quarter ends. So we feel our process throughout the year is consistent and robust, so I do not foresee us changing any of our approach in that regard.

Certainly, if other things develop, there could be potential for more items, more reserve changes, etc., but the overall process will remain consistent.

Paul Newsome
Great, thank you very much.

Randy Ramlo
Thank you, Paul.

Operator
Thank you, and once again please press star (*) and then one (1) if you would like to ask a question.

As there is nothing more at the present time, I would like to return the floor to Randy Patten for any closing comments.

CONCLUSION

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

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