United Fire Group, Inc. Management Discusses Q1 2015 Results – Earnings Call Transcript (Prepared Remarks with Attached Q&A Transcription)

United Fire Group, Inc. (NASDAQ: UFCS) 1Q2015 Earnings Call May 5, 2015 10:00 am EST

Executives

Randy A. Ramlo, President and Chief Executive Officer

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Kevin W. Helbing, Interim Principal Financial Officer, Assistant Vice President, and Controller

David E. Conner, Vice President and Chief Claims Officer

Barrie W. Ernst, Vice President and Chief Investment Officer

Michael J. Sheeley, Vice President and Chief Operating Officer of United Life Insurance Company

Operator

Good morning. My name is Kevin and I'll be your conference operator today. At this time I would like to welcome everyone to the United Fire Group 2015 first quarter financial results conference call. (Operator Instruction). Thank you. I will now turn the call over to Anita Novak, Director of Investor Relations.

Anita Novak, Director of Investor Relations

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 www.unitedfiregroup.com. Press releases and slides are located under the Investor Relations tab.

Our speakers today are Randy Ramlo, President and Chief Executive Officer, Michael Wilkins, Executive Vice President and Chief Operating Officer, and Kevin Helbing, Interim Principal Financial Officer, Assistant Vice President, and Controller. Other members of our executive team are also available for the question-and-answer session that will follow our prepared remarks.

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, President and Chief Executive Officer of United Fire Group.

Randy A. Ramlo, President and Chief Executive Officer

Good morning, everyone, and welcome to United Fire's 2015 first quarter conference call.

I am very pleased to report that 2015 is off to a strong start. Earlier this morning we reported operating income of $0.92 per share and a GAAP combined ratio of 89.7 percent for the quarter. Our book value was $33.76 per share, and our return on equity was 11.4 percent. Not every quarter will be as strong due to the nature of our business and the volatility of claims experience from quarter to quarter, but it is the level of performance we seek. Strong quarterly performance like this will help to offset those quarters when the wind blows.

During the first quarter, we continued to benefit from modest rate increases, a lack of catastrophic events, favorable claim activity and favorable reserve development on prior accident year claims. With the Mercer Insurance integration for all practical purposes behind us, our primary objective remains organic growth in alignment with our 2020 vision. We believe that with a disciplined approach we will achieve our expected underwriting results and expansion. Our organic growth initiatives include adding additional producers, expanding our geographic reach, enhancing our product offerings and appropriately pricing our existing products. Key initiatives such as our addition of our specialty division and expansion of our program business have also contributed to our organic growth. We have grown in the past through M&A activity and that has expanded our footprint, however, we believe commitment to our operational initiative as previously indicated is the appropriate path towards achieving our desired growth. However, if the right deal came along we would certainly consider it, but to be clear, our focus is on organic growth. In future quarters we will do our best to keep you abreast of our progress.

Speaking of future quarters, this seems like a good time to introduce the newest member of our executive team. Dawn Jaffray is with us this morning and is eager to assume her role as our new CFO in a few weeks. In the meantime, Dawn will continue to acclimate herself to United Fire's business and culture. I believe with her background, Dawn can be an important contributor to our strategic and organic growth objectives supporting our 2020 Vision.

With that, I'll turn this morning's discussion over to Mike Wilkins.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Market Conditions

Thanks Randy and good morning everyone.

Competitive market conditions during the quarter persisted on both renewals and on new business.

Commercial lines renewal pricing varied by region, with average percentage increases in the mid low-single digits on most small and mid-market accounts. Larger accounts remain more competitive with only small increases obtainable. This is the fourteenth consecutive quarter of commercial lines pricing increases.

Personal auto renewal pricing increases during the quarter remained modest and in the low-single digits. The homeowners pricing experienced average percentage increases in the mid-single digits during the quarter. Overall, personal lines renewal pricing increased slightly during the first quarter.

Premium written from new business remained strong, up from the prior quarter but down slightly when compared to the same quarter a year ago. This does not surprise us given the exceptionally large volume of new business written in first quarter 2014. Our success ratio on quoted accounts decreased slightly but remained strong. New business discretionary pricing was unchanged.

Current rate increases continue to meet or exceed loss cost trends depending on the line of business. We continue to believe loss cost trends will remain at low levels in 2015 but the gap between loss costs and rate increases will narrow as 2015 progresses.

Policy retention remains strong at 82 percent, decreasing slightly from the prior quarter for the group and most regions. Premium retention was down only slightly from the previous quarter and remained strong at 86 percent. Policies in force were down slightly in personal lines and workers' compensation but up in all other lines. New policies written were sufficient to offset policies lost or non-renewed.

The U.S. economy continues to grow at a slow rate. Premium from endorsements and premium audit continue positive trends, up from the same quarter a year ago.

During the first quarter premiums written increased 10.1 percent --- about half that amount is attributed to rate change, endorsements and audits. The other half is attributable to net new business.

Our expectations for 2015 continue to be premium rate increases in the mid-single digits range at the beginning of the year, but tapering to low single digits by the end of the year.

<u>Catastrophes and Other Losses</u>

First quarter was a benign catastrophe loss quarter with losses of approximately $200 thousand compared to $3 million in first quarter 2014. These losses had almost no impact on the combined ratio for first quarter.

<u>Large Losses</u>

Large losses, which we define as losses greater than $500 thousand, totaled $22 million in first quarter and impacted the combined ratio by approximately 11 percentage points. This compares to $23 million in first quarter 2014, which impacted the combined ratio by 13 percentage points. First quarter 2015 large losses is within our expectations, which means we are not seeing a continuation of the large loss trend we experienced in 2014, particularly in the third quarter of 2014.

<u>Life Company</u>

Sales of our single premium whole life policies have lagged due to our efforts to maintain price diligence on our single premium whole life product. Enhancements for our single premium whole life product are near completion.

Universal life first year policy premiums and traditional life policy premiums other than single premium whole life increased during the quarter.

Deferred annuity deposits decreased 31.8 percent for the quarter due to a gradual lowering of the credited rate offered on our deferred annuity products during the low interest rate environment, which has resulted in a decrease in deferred annuity deposits for the quarter compared to first quarter 2014.

Losses and loss settlement expenses increased $500 thousand for the year due to corresponding increases in death benefits paid. Fluctuations in the timing of death benefits occur from quarter-to-quarter and year-to-year.

Interest credited decreased $1.4 million for the year due to net annuity withdrawals decreasing the base on which interest is paid along with the periodic reduction in the interest rate credited on annuity products throughout 2014 and continuing into 2015.

Net income for the life insurance segment declined significantly for the quarter compared to the same quarter in 2014.

With that, I'll turn the financial discussion over to Kevin Helbing.

Kevin Helbing, Principal Financial Officer, Assistant Vice President, and Controller

Thanks Mike.

Consolidated net income, including net realized investment gains and losses, was $23.7 million or $0.94 per share for the quarter compared to $13.3 million or $0.52 per share last year.

Losses and loss settlement expenses increased by $1.2 million, or less than one percent, during the first quarter compared to the first quarter of 2014.

As Mike indicated, pre-tax catastrophe losses for the quarter totaled $0.2 million or less than $0.01 per share after tax, compared to $3.3 million, or $0.08 per share after tax. These losses had nearly no effect on our combined ratio for the quarter. Our expectation for catastrophe losses in any given year is six percentage points of the combined ratio. It's important to note, however, that our book of business remains primarily in regions of the country that are susceptible to seasonal weather events such as winter and spring convective storms, which will likely result in volatility in our results from quarter to quarter, especially during second and third quarters. As a company we don't get too excited about this volatility since our final analysis is based on annual results.

Favorable reserve development for the first quarter was $16.7 million compared to $14.5 million in the first quarter of 2014. The positive impact on net income for the quarter was $0.43 per share compared to $0.37 per share in 2014. As we have stated on many occasions, reserve development will vary from quarter-to-quarter and year-to-year due to the number of claims settled and the settlement terms. During the first quarter, the increase in favorable reserve development is attributable to the timing of paid claims. The largest single contributor was workers' compensation with $5.8 million of favorable development followed by long-tail liability with $4.9 million. Commercial auto liability contributed $3.0 million of favorable development and auto physical damage contributed $2.3 million. The majority of the releases were from accident years 2011 to 2014. I will remind our audience that we have historically reserved on a conservative basis and continue to do so. At March 31, 2015 our total reserves remained relatively flat and within our actuarial estimates.

<u>Investments</u>

Consolidated net investment income was $24.4 million for the first quarter, which was a decrease of 9.0 percent as compared $26.8 million in first quarter 2014. The decreases are due to the decline in the reinvestment interest rates from the continued low interest rate environment and changes in the value of our investments in limited liability partnerships, and are recorded on the equity method of accounting.

Because the equity method of accounting is based on changing market conditions, the results can be volatile from period to period.

We continue to feel the impact of lower investment yields on the majority of our investment portfolio and we expect a continuation of low interest rates as 2015 progresses. The weighted average effective duration of our fixed maturity securities portfolio at March 31, 2015 was 4.4 years. Our overall portfolio yield was 3.2 percent.

Consolidated net realized investment gains, for the quarter were $0.9 million compared to net realized investment gains, of $2.2 million in 2014.

Consolidated net unrealized investment gains, net of tax, totaled $156.9 million as of March 31, 2015, which is an increase of $7.3 million or 4.9 percent from December 31, 2014. The majority of the increase in net unrealized gains is a result of an increase in the fair value of the fixed maturity investment portfolio due to interest rate declines at March 31, 2015.

Expense Ratio

The expense ratio for the first quarter was 30.1 percentage points, compared to 33.5 percentage points for the first quarter of 2014. The expense ratio continues to improve. As we indicated in our earnings release this morning, we are now seeing improvement from reduced expenses associated with the Mercer Insurance integration along with investments in core development and technology over the last few years. I would like to caution our audience that we do expect the 2015 expense ratio to be somewhat impacted by pension and postretirement benefit costs as the year progresses.

Balance Sheet Highlights

Our stockholders' equity increased 3.3 percent to $844.2 million at March 31, 2015 from $817.4 million at December 31, 2014. The increase was primarily attributable to net income of $23.7 million and an increase in net unrealized investment gains of $7.3 million, net of tax. These increases were offset by shareholder dividends of $5.0 million and share repurchases of $1.1 million. At March 31, 2015 the book value per share of our common stock was $33.76 compared to $32.67 at December 31, 2014.

Capital Management

During the first quarter, we declared and paid a $0.20 per share cash dividend to shareholders of record on March 1, 2015.

In addition, during the first quarter we repurchased 37,637 shares of United Fire common shares at an average price of $28.78.

As a reminder, under our current share repurchase program, we may purchase United Fire common stock on the open market or through privately negotiated transactions. The amount and timing of any purchases will be at management's discretion and will depend upon a number of factors, including the share price, general economic and market conditions, and corporate and regulatory requirements. We are authorized by the Board of Directors to purchase an additional 1.6 million shares of common stock under the new program which expires August 31, 2016.

With that, I'll open the lines for questions.

Operator

Thank you. At this time, we'll be conducting a question and answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. Once again, if you'd like to ask a question today, please press star, one at this time.

Our first question today is coming from Paul Newsome from Sandler O'Neill. Please proceed with your question.

Paul Newsome

Good morning. Congratulations on the quarter.

Randy A. Ramlo, President and Chief Executive Officer

Thanks Paul.

Paul Newsome

I wanted to ask about expense ratio guidance. Obviously you're down a point, but you mentioned that pension can hurt you on the remainder of the year. My understanding is the pension expense essentially gets set at the beginning of each year and should be largely unchanged quarter to quarter. Am I wrong on that?

Kevin Helbing , Principal Financial Officer, Assistant Vice President, and Controller

No, you're correct, Paul. Our impact over the course of the year will be $7 million gross of tax.

Paul Newsome

Okay, so —

Kevin Helbing , Principal Financial Officer, Assistant Vice President, and Controller

We had a good favorable quarter in relation to our losses, and with the GAAP results, we had a great quarter with less premium deficiency in our back (phon) calculation.

Paul Newsome

So should there be—I mean, is this is a good run rate for the expense ratio prospectively?

Kevin Helbing , Principal Financial Officer, Assistant Vice President, and Controller

We expect it to be close to 31% for the year. We just had a really good quarter.

Paul Newsome

Okay, terrific. Maybe you could talk a little bit about the combined ratio, excluding reserves and catastrophe losses, and how that—whether or not that's a good run rate for the remainder of the year as well.

Randy A. Ramlo, President and Chief Executive Officer

Mike will take that one, Paul.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Good morning, Paul. How are you?

Paul Newsome

I'm very good, thank you.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

I think the run rate, we hope to do a little better than that during the year. We in the first quarter had some IBNR adjustments based on actuarial calculations that impacted particularly our commercial auto line business. But if you look at the direct numbers, they improved quite a bit from a year ago, so we're encouraged by that and optimistic going forward.

Paul Newsome

Well, I'll re-queue and see if there's anybody else that wants to ask questions.

Operator

Thank you. As a reminder, if you'd like to be placed in the question queue, please press star, one at this time.

Our next question is coming from Joab Dempsey from KBW. Please proceed with your question.

Joab Dempsey

Hi, good morning everyone, and thanks for taking my questions in Vince's absence. I know he certainly wishes he could have been on the call today. But with that, I just had a couple questions. The first is on the core loss ratio. With non-existing cats this quarter, are there any considerations that should be made for elevated winter weather losses that fell into the core loss ratio for the quarter?

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

This is Mike again. You know, there is probably some of that in the core loss ratio, particularly from the East Coast with some winter storm activity out there, some freeze losses and that type of thing that don't get captured in the cat loss numbers. We don't quantify that or have that number available, but I'm sure it had an impact.

Joab Dempsey

Okay, great. Then the second is around workers' comp. We've seen workers' comp claim ratio fall a little bit each of the last three years, and so I'm curious if you attribute this to some of the workers' comp initiatives or if there is anything going on from, say, a mix or an actual settlement speed issue that could account for the numbers.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Mike again here. The improvement we think is a result of our initiatives. We worked very hard on that line of business over the last couple of years, in particular trying to reduce the high hazard classes in that book and target lower hazard classes, make sure the pricing was appropriate in the higher hazard book of business. The second part of your question, our Chief Claims Officer is here. I'll let Dave take a shot at that.

David E. Conner, Vice President and Chief Claims Officer

Hi, this is Dave Conner. That timing corresponds directly with our consolidation of the work comp unit at the corporate headquarters here, and in what was not an insignificant upgrade in our operations. So I think from both angles, you're recognizing that improvement.

Joab Dempsey

Yes, we can certainly see that improvement coming through. So if we could maybe stick with workers' comp for a second, did the maturation of any of these initiatives drive any additional reserve releases this quarter?

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

No, I don't think so.

Joab Dempsey

Okay, okay. Then just my last question was on commercial auto. What the industry has been seeing, I was hoping to get maybe an update from what you're seeing between loss cost trends and rate increases with the slight uptick on the loss ratio this quarter.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Yes, that's a line we're paying close attention to. We are able to get still solid rate increases in that line, particularly if it's an auto-driven line. If it's just a small part of the package, the auto, maybe the increases aren't quite there; but if it's an auto-driven line, we're getting good mid, upper single-digit increases on the auto. I guess it's a line we're keeping a close eye on. We've seen a couple point deterioration here in the first quarter on the line (phon), a direct basis too, and then also on the IBNR side, we strengthened it a little bit.

Joab Dempsey

Okay, great. Well, that's all I had, and thanks again for taking my questions in Vince's absence. Best of luck, guys.

Randy A. Ramlo, President and Chief Executive Officer

Thank you.

Operator

Thank you. As a reminder, it's star, one to be placed in the question queue. Our next question is a follow-up from Paul Newsome from Sandler O'Neill. Please proceed with your question.

Paul Newsome

I have to ask about the life operation and the prospects there.

Randy A. Ramlo, President and Chief Executive Officer

Well, as you know—this is Randy—we've had this conversation a couple times, but the annuity business is really difficult right now, so our annuity deposits, as you can see, are down quite a bit. That affected our net investment income, and we don't like to see the annuity deposits leave but unfortunately the only way to stop that is to offer higher rates, and we don't really want to do that either, or materially change the way we invest that book of business. So we're kind of de-emphasizing the annuity business and trying to push the life business, which is more profitable, and we think this is—it's a cyclical thing if you kind of look back at a 15-year look at our life business. There's been terrific years, but unfortunately, the last four or five have been pretty difficult.

Paul Newsome

Fantastic, thank you.

Operator

Thank you. We've reached the end of our question and answer session. I'd like to now turn the floor back over to Ms. Novak.

Anita Novak , Director of Investor Relations

Thank you, Kevin. This now concludes our conference call. As a reminder, a transcript of this call will be available on our Company website at www.unitedfiregroup.com. On behalf of the Management of United Fire Group, I wish all of you a very pleasant day.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your lines at this time, and have a wonderful day. We thank you for your participation today.