United Fire Group, Inc.

2018 Third Quarter 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*

Barrie Ernst – *Chief Investment Officer*

PRESENTATION

Operator
Good morning and welcome to the UFG Insurance 2018 Third Quarter Earnings 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. After today's presentation, there will be an opportunity to ask questions. To ask a question you may press star then one on your telephone keypad. To withdraw your question, please press star then two. Please note that 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 third quarter 2018 conference call. Earlier this morning we reported consolidated net income of $0.43 per diluted share, adjusted operating income of less than $0.01 per diluted share and a GAAP combined ratio of 105.5% for the third quarter of 2018. This compares with a net loss of $0.72 per diluted share, and adjusted operating loss of $0.73 per diluted share, and a GAAP combined ratio of 118.1% for the third quarter of 2017.

In the third quarter 2018, net income was $1.15 per diluted share higher compared to the same period of 2017, which was impacted by Hurricanes Harvey, Irma and Maria. The current quarter's net income benefitted from a $14.4 million increase in the value of our investments in equity securities along with catastrophe losses continuing to be below our ten-year historical average. Removing the impact of the change in the value of our investments in equity securities, we recorded a small net gain for the quarter.

We continue to make progress on improving our core loss ratio and believe this improvement especially in commercial auto is the result of our strategic initiatives. We know we are moving in the right direction to improve profitability, but at a slower pace than we would like. One example of our progress in commercial auto is that we have seen a decrease in claim counts and the number of insured units in 2018.

Overall, looking across all of our major lines of business, this quarter's improvements in the core loss ratio was driven by a decrease in the frequency of claims which was somewhat muted by an increase in severity of losses, partially due to an adverse litigious environment. We will continue with our strategic plan to improve profitability which includes aggressively seeking rate increases, focusing on risk control initiatives and taking action on underperforming accounts with rate increases, risk control measures or non-renewing underperforming accounts.

With our focus on profitability and these initiatives, we expect our growth to slow this year. Therefore, we are satisfied with the growth in premiums this quarter. Our expectation for premium growth for 2018 will be in the range of 3% to 4%. Mike will discuss our operational results and strategy in more detail in a few minutes.

Moving on to expenses, our expense ratio was 32.3% in the third quarter of 2018, an increase of 1.5 points as compared to 30.8% in the third quarter of 2017. The increase in third quarter 2018 as compared to the same period in 2017 is primarily due to our continued investment in our multi-year Oasis project to upgrade our underwriting technology and enterprise analytics platform. I might note that our Oasis project is running on time and on budget although we have a few years to go until the project is completed. 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.

I will wrap up my portion of today's call with catastrophe losses. As I mentioned, catastrophe losses have been abnormally low this year and considerably lower than the prior year. In the third quarter 2018, cats added 4.6 percentage points to the combined ratio compared to 12 percentage points in the third quarter of 2017. The cat load for the third quarter 2018 is significantly lower than our 10-year historical average for the third quarter at 7.5 percentage points.

Year-to-date in 2018, cats added 4 points to the combined ratio compared to 9.3 points year-to-date in 2017. It is worth noting that we have not received any claims from Hurricane Florence and looking forward to the fourth quarter, we have only received a dozen or so claims from Hurricane Michael, which we expect to be a very insignificant event for us.

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

Mike Wilkins
Thanks, Randy and good morning, everyone.

As Randy mentioned, we continue to make progress on improving our core loss ratio. However, we remain committed to our profit driven strategies to improve profitability through aggressive rate increases, risk control initiatives and taking action on underperforming accounts.

As for rate increases, the average renewal pricing increases for commercial lines remained in the mid-single digits during the third quarter 2018. The rate increases continue to be driven by commercial auto pricing. Filed commercial lines pricing increased from the second quarter 2018 with pricing varying depending on the region and size of accounts. The average quarterly increase in filed rates during the third quarter 2018 was the highest in the last 10 years averaging in the mid-single digits. This increase was primarily driven by low double-digit increases in commercial auto pricing where we were getting up to a 15% increase in rates in territories with the highest loss ratios and taking other actions such as reducing commissions in regions where warranted.

In personal lines filed rate and renewal pricing increases also remained in the mid-single digits. Looking ahead, we will continue to be aggressive in seeking rate increases.

Moving on to risk control initiatives. Over the last few quarters we have outlined our enhanced risk control initiatives. One of these initiatives is expanding our reach with risk control requirements. Many of you are already aware of our “Worth It” campaign, a comprehensive educational and marketing program to remind drivers that life is worth it, driving distracted is not. We began the campaign with an initial rollout in the Midwest, now we are sharing our message more broadly beyond our home office region.

Targeted communication to employees and partner insurance agencies nationwide as well as social media posts are intended to increase awareness with the aim of presenting on the topic more frequently and garnering more pledges to drive distraction free. In addition, digital advertising is running in UFG branch office regions which include the metro areas near Trenton, New Jersey; Denver, Colorado; Houston, Texas; and Sacramento, California. The “Worth It” campaign has generated more than 2,500 signed pledges, 30,000 website visits and more than 160 presentations on the issue. This work has been recognized by the Insurance Marketing and Communications Association and the National Association of Broadcasters among others for our efforts.

Finally, our third strategy to improve profitability is taking action on underperforming accounts with rate increase, risk control measures, our non-renewing where none of the foregoing actions are anticipated to achieve our goal of underwriting profitable risks. Our enterprise analytics team has been developing predictive models to provide enhanced risk segmentation in commercial auto targeting profitability. We expect to deploy our first internally developed production model by year-end 2018 to replace our existing externally developed model.

We have had favorable impacts with culling our book of business through the use of enterprise analytics and supporting our underwriting process. For example, we are encouraged that we are seeing a slight decrease in severity in our commercial auto line of business even in light of seeing an increase in severity across other lines of business. We believe the increase in severity is partially due to an increasingly litigious environment much like the industry is experiencing.

With that, I’ll let Dawn Jaffray discuss our third quarter financials. Dawn?

Dawn Jaffray
Thanks, Mike and good morning everyone.

For the third quarter of 2018 consolidated net income was $11.1 million compared to a net loss of $17.9 million in the third quarter of 2017 which included net income from discontinued life operations of $1.2 million. Year-to-date consolidated net income was $57 million compared to $5 million year-to-date 2017.

As a reminder, year-to-date consolidated net income includes a one-time after tax gain of $27.3 million associated with the sale of our life business and the $1.9 million net loss in the first quarter from life operations.

Looking only at property and casualty insurance operations results, for the third quarter of 2018 net income was $11.1 million compared to a net loss of $19.1 million in the third quarter of 2017. Year-to-date in 2018 net income increased to $31.6 million compared to a net loss of $0.4 million year-to-date 2017. In the third quarter and year-to-date in 2018 our net premiums earned increased 3.5% and 4% respectively compared with 2017.

Our commercial auto line of business continues to be our line of business with the most premium growth, but the increase in this line is driven primarily by rate increases. Net investment income decreased 4.4% to $13.2 million in the third quarter of 2018 and increased 13.9% year-to-date 2018 to $44 million compared to the same periods in 2017. The decrease to net investment income for the quarter was driven by a change in the value of our investments in limited liability partnerships and not due to a change in our investment philosophy. The valuation of these investments in limited liability partnerships varies from period-to-period due to current equity market conditions specially related to financial institutions.

We reported net realized investment gains of $14 million and $7.4 million in third quarter and year-to-date 2018 compared with net realized investment gains of $67,000 and $3.4 million in the same periods in 2017. Included in that realized investment gains in 2018 is the change in value of equity securities which are now required to be recognized in the income statement. For the third quarter 2018 the change in value of equities securities resulted in a gain of $14.4 million and a gain of $5.5 million year-to-date.

Moving on to reserve development, we experienced minimal unfavorable reserve development of $712,000 in the third quarter of 2018 compared to unfavorable reserve development of $3.2 million in the third quarter of 2017. Year-to-date 2018 we experienced favorable development of $47.7 million compared to $38 million in the same period of 2017.

The impact on net income for the third quarter and year-to-date in 2018 was a decrease of $0.02 and an increase of $1.47 per diluted share, respectively, compared to a decrease of $0.08 and an increase of $0.96 per diluted share in the same periods of 2017.

During the third quarter of 2018 the biggest driver of our unfavorable development was in our other liability and commercial automobile lines of business partially offset by favorable development and assumed reinsurance and workers compensation.

On a year-to-date basis, favorable reserve development was primarily driven by four lines of business; workers compensation, commercial auto, assumed reinsurance and other liability. The impact to the combined ratio was 6.2 percentage points in the first 9 months of 2018 compared to 5.2 percentage points in the same period in 2017.

We continue to maintain a conservative reserving philosophy. We have had annual favorable reserve development every year since 2009. At September 30, 2018 total reserves remained within our actuarial estimates.

The combined ratio in the third quarter and year-to-date in 2018 was 105.5% and 102.5%, respectively, compared to 118.1% and 107.6% for the same periods in 2017. Removing the impact of catastrophe losses and reserve development, our core loss ratio in 2018 improved 5.8 percentage points in the quarter and 2 percentage points year-to-date 2017.

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

Annualized return on equity was 7.3% during the first 9 months of 2018 compared to 0.7% in the same period in 2017.

I will end my portion of our prepared remarks today with a discussion on dividends paid to shareholders. First, during the third quarter we declared and paid a $0.31 per share regular cash dividend to shareholders of record as of July 31, 2018. Year-to-date through September 30, 2018 we have paid a total of $22.5 million in regular quarterly dividends along with a $3 per share special cash dividend paid in August. Thus, we have returned $3.90 per share or a total of $103 million in the form of cash dividends and share repurchases to our shareholders through the third quarter of 2018.

And lastly, we did not repurchase any shares in the third quarter of 2018. Year-to-date we have repurchased approximately 120,000 shares for $5.4 million. We purchased United Fire common stock from time-to-time on the open market or through privately negotiated transactions as the opportunity arises. We are authorized by the board of directors to purchase an additional 2.1 million shares of common stock under our share repurchase program.

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

QUESTIONS AND ANSWERS

Operator
We will now begin the question and answer session. To ask a question, you may press star then one 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. 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 with your question.

Paul Newsome
Good morning. I was wondering if you could talk a little bit about—before we bang on the severity and underwriting stuff—the appropriate run rate for investment income prospectively.

Barrie Ernst
Well as we stated the last time, it probably was our LLC's were up a little bit in the last quarter. This quarter as Dawn stated, again, it's the LLCs that cause it and it's mostly financial and they were down for the quarter slightly. So I think this is a more normalized investment income that we're at, slightly down from where we probably should be because of the LLCs.

Paul Newsome
Do you anticipate any issues with those LLCs given the market turmoil that we've have had in the fourth quarter?

Barrie Ernst
I don't. I think we were just in to visit the LLCs in October and I think their look going forward is quite good. So I don't envision anything good or bad in there.

Paul Newsome
So turning to underwriting, maybe start with kind of a broad question here. Could you pinpoint kind of what you think has made the turnaround slower than you anticipated? Is it just the severity question? And maybe you can talk a little more about that as well.

Randy Ramlo
This is Randy. I think maybe Mike will have some comments as well, but severity is kind of a—we have mentioned it a couple of times in the past and oftentimes the severity issue can be a couple handfuls of very large losses. So it's difficult to overreact too much to that. We do pay attention to frequency which we see some positives in that area.

We always think we should—we mentioned kind of we've have had good success with rate increases, but the market doesn't always allow us to get where we want to. A lot of times our analytics tells us what we need and sometimes we're not able to get it all at once. We mentioned litigation and it's kind of early to see a trend, but when talking with some of our reinsurers, it's kind of a theme that a lot of other people reported as well.

So a lot of these severity losses really kind of come down to cases where we feel we had little or no negligence, but the injuries or damages were severe whether it be judges or juries just kind of ignoring the principle of negligence. And we're also seeing some of these cases not only in the areas of the country of the usual suspects, but some areas that have tended to be a little bit more conservative. So we'll continue to keep an eye out on some of those things, but a lot of the severity has kind of been driven by blindsided jury verdicts. Mike, do you have anything to add?

Michael Wilkins
I would add that while we have been very successful with the rate increases, the underlying drivers and increased loss costs in commercial auto are still there. So we still have miles driven being up. We still have unemployment being very low. Commercial clients having a hard time finding qualified drivers. We have seen a lot of—some of our claims have been underinsured motorists claims, so while we're improving the value or the quality of our book, I think we still are subject to a lot of these underlying loss cost trends that are driving loss costs up. So while we have improved the underlying loss ratio, still not where we would like it to be. We kind of feel like we're about halfway to where we need to be. If we continue to make progress like we have over the last four quarters, we feel like in another four quarters we should be in pretty good shape with that line of business.

Paul Newsome
Great. I'll let someone else ask questions. Appreciate the call.

Operator
Once again, if you would like to ask a question please press star then one.

CONCLUSION

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Randy Patten for any closing remarks.

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

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