United Fire Group, Inc.

Q2 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Randy Patten - *Assistant Vice President and Controller*

Randy Ramlo - *Chief Executive Officer*

Michael Wilkins - *Chief Operating Officer*

Dawn Jaffray - *Chief Financial Officer*

PRESENTATION

Operator
Good morning. My name is Carrie and I will be your conference operator today. At this time, I would like to welcome everyone to the UFG Insurance Second Quarter 2019 Financial Results 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 (*). After today's presentation, there will be an opportunity to ask question. To ask a question, you may press star (*), then one (*) on your touchtone phone. To withdraw your question please press star (*), then two (2). Please note this event is being recorded.

Thank you. I will now turn the call over to Randy Patten, Assistant Vice President and Controller.

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 www.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 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 second quarter conference call.

Earlier this morning, we reported our second quarter 2019 results including a consolidated net loss of $0.17 per diluted share and adjusted operating loss of $0.59 per diluted share, and a GAAP combined ratio of 111.7%. This compares to net income of $0.01 and adjusted operating loss of $0.03 and 107.9% for the GAAP combined ratio in the second quarter of 2018.

This year's second quarter results were impacted by both an increase in catastrophe losses and unfavorable prior-year reserve development, partly offset by continued strong equity markets and an increase in net premiums earned.

Year-over-year we experienced the same number of catastrophe events in the second quarter of 2018 and 2019, but this year's events were more severe. The majority of the losses were from convective storms in Missouri and Louisiana and hailstorms in Texas, which is not uncommon for the second quarter.

The unfavorable prior year reserve development was primarily from reserve strengthening on commercial auto and liability claims in our Gulf Coast region. Prior year reserve strengthening was driven by continued escalation in settlements, or what has been termed “social inflation” in the industry with commercial auto and commercial liability claims, primarily in Texas.

The increase in catastrophe losses and prior year unfavorable reserve development were partially offset by an increase in the unrealized depreciation in value of our equity securities portfolio and continued increases in premiums from rate in our commercial auto book of business.

Overall, our average commercial lines renewal rates increased by 6.6% which is the highest we have seen in over two years, exceeding last quarter's average renewal rate increase of 5.9%. This increase continues to be driven by commercial auto with rate increases remaining in the low double-digits.

Similar to the first quarter, we continue to see improvement in our underlying operating profitability, which we attribute to the initiatives we put in place in 2018, to improve our commercial auto book of business. Removing the impact of catastrophe losses and prior year reserve development, this marks the second consecutive quarter of improvement in our core loss ratio. Compared with the same periods last year, our core loss ratio improved 3.5 points in the second quarter and 6.8 points year-to-date in 2019.This is summarized on slide 9 of our presentation on our website.

A good sign to report, that this is the third consecutive quarter with reduced frequency of commercial auto claims. While it may be too early to call these improvements a trend, they are encouraging. Mike will discuss this in more detail in a few minutes.

To wrap up my portion of today's call, I would like to share some additional positive developments at UFG. In mid-July, we implemented a limited launch or Phase 1 of our multiyear Oasis initiative, to upgrade our underwriting technology and enterprise analytics platform. Phase 1 of the platform was successfully rolled out in our Rocky Mountain region for two lines of business. This rollout also included a new countrywide policyholder web portal, a new billing system, and a new and improved agent web portal www.ufgagent.com. The agent portal will enhance the way our independent agents submit business, manage accounts, report claims to UFG, combined with other beneficial features that integrate with our Oasis underwriting and billing platform.

In award news, UFG earned “Five-Star Carrier” status in 2019 from the *Insurance Business America* for the fourth time. We are one of only 25 companies to make the list earning 5-star ratings on our commitment to the agent distribution channel, underwriting expertise, product training, and marketing support. UFG was also recently named to the 2019 list of super-regional property and casualty insurers by *Insurance Journal* for the 13th consecutive year ranking 26 on the list of 151 companies.

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

Michael Wilkins
Thanks, Randy and good morning, everyone. As Randy mentioned, we continue to focus on the strategic underwriting and claims initiatives that we implemented during 2018 to improve profitability. While we recognize we have more work to do, especially in our commercial auto line of business, improvements we are seeing in our core loss ratio are encouraging, in spite of the increased severity of catastrophe losses and reserve strengthening in the second quarter of 2019.

One item that I point to as the key metric for improvement and profitability is the frequency of our losses in commercial auto line of business. As Randy mentioned, the frequency of auto losses has decreased for the third consecutive quarter. A driving force behind this decrease is our continued focus on reviewing the bottom 30% of our commercial auto book of business 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, including certain classes of heavy wheeled commercial vehicles.

Another key metric for UFG is pricing increases. The average renewal pricing change for commercial lines is the highest we have seen in over two years, increasing by 6.6% in the second quarter of 2019 compared to 5.9% in the first quarter of 2019. Renewal pricing increases continue to be driven by commercial auto pricing. During the second quarter of 2019, filed commercial auto rate increases averaged in the low double-digits, marking the fourth consecutive quarter of filed double-digit rate increases in this line. Personal lines filed rate and renewal pricing increases also remained in the mid-single digits.

Another positive this quarter is the decrease in severity of non-cat losses. During the second quarter non-cat losses over $500,000 decreased by $6.6 million, primarily from improvements in workers' compensation and commercial property lines of business, partially offset by an increase in commercial liability losses.

Although catastrophe losses increased in severity in the second quarter of 2019, they did not increase in frequency as compared to the second quarter of 2018. In both periods, we incurred the same number of events. The increase in severity was primarily from tornadoes in Missouri and Louisiana along with hailstorms in Texas. In the second quarter 2019 catastrophe losses added 8 points to the combined ratio compared to 5.9 points in the second quarter 2018. This is below our 10-year historical average of 10.9 points for second quarters.

In looking ahead to the third quarter, we expect any losses from Hurricane Barry to be insignificant, at less than $500,000. As of today, total catastrophe losses for the third quarter are within our expectations.

Finally, as we have mentioned previously, our enterprise and analytics team delivered an improved commercial auto predictive model at the end of 2018, and we continue to closely monitor its impact on our underwriting decisions. We are cautiously optimistic that the decrease in frequency of commercial auto losses and the improvement in our core loss ratio are early signs of its effectiveness. The team is still on-track to finish development of a commercial property predictive model during the third quarter and complete data mining for claims analytics by year-end.

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

Dawn Jaffray
Thanks, Mike and good morning everyone.

In the second quarter of 2019, we reported a consolidated net loss of $4.2 million compared to net income of $157,000 in the second quarter of 2018. Year-to-date with the previous strong first quarter, consolidated net income was $40.3 million compared to $45.9 million in 2018. As Randy and Mike mentioned, the net loss in the second quarter of 2019 was driven by catastrophe losses and prior year reserve strengthening in our Gulf Coast region.

In the second quarter of 2019 we recognized unfavorable reserve development of $9.4 million compared to a favorable reserve development of $10.3 million in the second quarter of 2018. Year-to-date in 2019, we experienced unfavorable development of $4.7 million compared to favorable development of $48.4 million in the same period of 2018. The change in prior year reserve development in the quarter and year-to-date is primarily from prior year reserve strengthening in our commercial auto and commercial liability lines of business in our Gulf Coast region, as Randy had mentioned.

As a reminder, our approach to reserving continues to remain conservative and we have had annual favorable reserve development every year since 2009. At June 30, 2019, our total reserve position remained within actuarial estimate.

Benefiting the second quarter and year-to-date 2019 was continued strong equity market performance, which increased the value of our investment in equity securities resulting in an after-tax gain of $9.9 million and $29.3 million respectively, recognized in the income statement.

Also positively impacting the second quarter and year-to-date 2019 results were higher net earned premiums with increases of 7.6% and 7.3% respectively. The growth in both periods was primarily driven by an increase in rates with the largest rate increases occurring in our commercial auto line of business, as Mike has mentioned.

Net investment income was $14.1 million for the second quarter of 2019, a decrease of 18.1% as compared to net investment income of $17.2 million for the same period in 2018. Year-to-date net investment income was $30.6 million flat compared to net investment income of $30.7 million for the same period in 2018. The change in net investment income for the quarter was due to lower appreciation in the value of our investments and limited liability partnerships in 2019 as compared to 2018. The valuation of these investments in limited liability partnerships varies from period-to-period, due to equity market conditions specifically related to financial institutions.

The expense ratio for the second quarter of 2019 was 32.1 percentage points compared with 34.3 percentage points for the second quarter of 2018. Year-to-date, the expense ratio was 32.6 percentage points compared to 34.4 percentage points in the same period of 2018. The decrease in the expense ratio during the second quarter is primarily due to a decrease in employee benefit accruals and expenses caused by post-retirement benefit plan changes we made at the end of 2018. In addition, we are capitalizing a portion of the expenses associated with the Oasis project related to development in accordance with accounting rules for a project like this.

Moving on to annualize return on equity, it was 8.7% during the first six months of 2019, compared to 6.9% in the same period of 2018.

With respect to capital management, during the second quarter, we declared and paid a $0.33 per share cash dividend to shareholders of record as of May 31, 2019. We have paid quarterly dividends consecutively for the past 205 quarters since March of 1968.

We did a small amount of share repurchasing totaling 69,000 in the second quarter. We are authorized by the Board of Directors to purchase an additional 2.1 million shares of common stock under our share repurchase program, which will expire in August of 2020.

And with closing of prepared remarks, I will now open the line for questions. Operator.

QUESTIONS AND ANSWERS

Operator
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 key. To withdraw your question, please press star (*), then two (2). At this time, we will pause momentarily to assemble our roster.

The first question will come from Paul Newsome of Sandler O'Neill.

Paul Newsome
I would like to maybe get a little bit more details about the nature of the reserve development. Things like, it was specific to particular accident years. I know you did say, it was sort of social inflation, which sounds like it is mainly at upper end of the severity. And maybe it looks like it is just one office. Is there something to the fact that it may have been an office issue or is it really just a Texas issue kind of those--things along those lines?

Randy Ramlo
Paul, this is Randy. I admire you for not asking if all the reserve development is all done, because I have seen a lot of CEOs declare that they are completely done and then they were not. So I am not going to say that, but we are not looking at multiple other offices, and we had a leadership change there, and I think that is part of it-–it is mostly Texas. It has been mostly confined to commercial auto.

We have kind of talked--Dawn talked a little bit about our reserving success in the past. We have been pretty redundant and pretty consistently so. The accident years were mostly 2017 and 2018. I do not know exactly, which mix of those are, but that office is growing pretty substantially, and it could be a little bit of a result of that. So, I am not going to say, we will never have any more deficiencies, but right now it seems to be pretty isolated.

Paul Newsome
So given the charge, why would not the accident year rise for your business? I assume that when you have development like this, you incorporate that into how you think of your current profitability and future profitably, given your pricing?

Michael Wilkins
Paul, this is Mike. I would say we have incorporated social inflation and things we have seen on the claims side and the reserving for current accident year. I think in our comments we mentioned that we are optimistic. We have seen a decrease in frequency. There has been some decrease in severity in portions of our book. So I think maybe some of those positives would account for why you are not seeing an increase in the current accident year loss ratio.

Paul Newsome
I guess this would be my last one. How should we think about what is going to happen on the top line? Obviously, you are getting overall price increases across the board, but are you seeing changes in your retention that might lead you to, and new business, that might lead you to a change in the top line that is different than what the price increases are? So I mean essentially, what is going to happen with growth in your view?

Michael Wilkins
Paul, this is Mike again. If you look at this year's growth, it is down a little bit from what we have been in the previous few years. I think that is due to more focus on profitability within our operation and I think that will continue for the immediate future. So I do not think you will see the top line growth that we have seen in the last few years at UFG.

If you look at retention, especially within, as we segment our auto book, especially within the segments that have been less profitable, our retention has dropped quite a bit, and that is a good thing. We have encouraged our regions to take tough action on underperforming portions of that book and we have got more than a 10-point difference in retention for those worse parts of the book versus the better performing parts of the book, and now we would like that to continue until we get the profitability numbers to where we want them.

Paul Newsome
Great. Thank you.

Michael Wilkins
Thank you, Paul.

Operator
Once again if you have a question, please press star (*), then one (1). This concludes our question-and-answer session. 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. Thank you for joining us and have a great day.

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