United Fire Group Inc.

Q1 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Randy Patten - *Assistant Vice President and Controller*

Randy Ramlo - *Chief Executive Officer*

Mike Wilkins - *Chief Operating Officer*

Dawn Jaffray - *Chief Financial Officer*

PRESENTATION

Operator
Good morning, and welcome to the United Fire Group Inc. 2020 First-Quarter Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) and then one (1). To withdraw your question, you may press star (*) and two (2). Please also note, today's event is being recorded.

At this time, I'd like to turn the conference call over to Randy Patten, Assistant Vice President and Controller. Sir, please go ahead.

Randy Patten
Good morning, everyone and thank you for joining this call. Earlier today, we issued a news release on the 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; Mike Wilkins, 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 our first-quarter 2020 conference call.

I'll start off our call today with a discussion on the COVID-19 pandemic and the incredible resiliency of our UFG employees during this worldwide health crisis. The COVID-19 pandemic has had a profound impact on day-to-day life, financial markets and the economy beginning in mid-March. In response to the challenges presented by COVID-19, we activated our pre-existing business continuity pandemic plan. With the exception of our essential services employees, we have dispatched our staff to work remotely for the safety, health and well-being of our employees, which is our top priority. Thanks to our past experience in personally dealing with catastrophes, including the floods of 2008 and 2016 at our corporate headquarters, we were well prepared to have the technological infrastructure in place for a seamless transition to work from home for most of our employees.

We were fully operational from day 1, but we modified certain routine work completed by our field claims and loss control representatives such as premium audits and inspections to comply with social distancing recommendations for the safety of our employees, agents and policyholders.

Nearly all of the policies we have issued contain contract language, which specifically excludes business interruption coverage losses attributable to viruses such as COVID-19 pandemic, but we continue to carefully scrutinize each claim and will be affording coverage when appropriate. At this time, we expect the effect of COVID-19 on claims currently under our coverages to be manageable. However, the effects of the COVID-19 pandemic continue to evolve, and we cannot predict how future legislation, regulation or court actions that could act to void our written contracts or how these actions could affect us.

We anticipate that the larger impact on our financial conditions and results of operations will likely result from development in the economy as a whole, including the effect on financial markets and the investments we hold in our investment portfolio, premiums and demand for our products and our ability to collect premiums or the requirements to return premiums to our policyholders.

Much like many of our industry peers have experienced, the COVID-19 pandemic has significantly impacted the financial markets and in turn, the value of our investment in equities. However, through the first quarter, there was not a significant impact on our core insurance operations. The most significant impact to our reported net loss in the first quarter of 2020 was the sharp decline in equity markets due to the COVID-19 pandemic, which decreased both the value of our investments in equity securities and our net investment income from the decline in the fair value of our investments in limited liability partnerships.

Operationally, our first-quarter results were impacted by an increase in severity of catastrophe and non-catastrophe losses. During the first quarter of 2020, we reported $15.3 million of catastrophe losses or 5.7 percentage points of the combined ratio, compared to $3.6 million or 1.4 percentage points in the first quarter of 2019. Our historical average for catastrophe losses in the first quarter is 2.9 percentage points. Our higher catastrophe loss results stemmed from two events: First, a large explosion in January at a manufacturing business in Houston, Texas, classified as a catastrophe by the Insurance Service Office; second, a hailstorm in Jefferson City, Missouri during the last week of March.

The increase in severity in non-catastrophe losses was in our other liability, commercial property and workers' compensation lines of business. Dawn will discuss our quarterly financial results later during the call.

I will end my portion of the call with an update on our progress to improve the profitability of our commercial auto book of business. In the first quarter of 2020, we reported an improvement in our commercial auto loss ratio of 10.1 points with a decrease in the frequency of commercial auto claims and a reduction in commercial auto exposure units compared to the first quarter of 2019. Although we saw improvement, our loss ratio for commercial auto remains at a higher-than-acceptable level, primarily the result of continued severity of commercial auto claims.

During the COVID-19 pandemic, there has been a decrease in miles driven and fewer vehicles on the road, but this has not led to the same level of decline in the severity of commercial auto accidents. This fact continues to reinforce that we must continue to aggressively move forward with our strategic plan to improve the profitability in our commercial auto book of business.

Mike will now discuss our operational results in more detail, including the progress we have made with our strategic plan to improve profitability. Mike.

Mike Wilkins
Thanks, Randy, and good morning, everyone.

As Randy mentioned and as we have discussed on previous calls, our focus remains on improving profitability. During the first quarter of 2020, we continued to see progress with our portfolio management strategy to improve our commercial auto book of business. This quarter marks the fifth consecutive quarter of flat or declining frequency of commercial auto claims with 4% decline in the first quarter of 2020.

Our moving average auto claims frequency is now at its lowest point in the past seven years. Slide 6 in our slide deck on our website presents this decline, along with the decline in the number of commercial auto exposure units. The 12-month moving average number of commercial auto exposure units decreased 4% from December 31, 2019, and 9% since March 31, 2019.

A combination of the reduction in commercial auto claims frequency, number of commercial auto exposure units and the prior-year reserve strengthening in the Gulf Coast region during the first quarter of 2019 resulted in an improvement of 10.1 points in our commercial auto loss ratio during the first quarter of 2020.

As Randy mentioned, the decrease in the number of miles driven and vehicles on the road during the COVID-19 pandemic has not resulted in the same level of decrease in severity of commercial auto claims. Therefore, during the first quarter of 2020, we have expanded our targets, setting renewed retention and rate increased goals for the bottom half of our business. We will continue with our plans to be aggressive with nonrenewals throughout 2020, where allowed. Our focus continues to be on poor-performing segments and not writing new accounts that are heavy in auto.

By taking these actions, we're confident we'll achieve our goal of a better balance in our overall book of business, which has become too heavily weighted in commercial auto in recent years. As a consequence of this, we know we stand to lose entire accounts since we have traditionally been a package writer. For the second consecutive quarter, we experienced a decrease in both policy and premium retention. Although both premiums written and premiums earned increased this quarter, which was primarily due to rate increases, premium audits and endorsements, we do not expect any premium growth in 2020.

As for rate increases in the first quarter of 2020, the average renewal pricing change for commercial lines increased 7.6%, compared to 6.6% in the fourth quarter of 2019. The renewal pricing increases continue to be driven by commercial auto rate increases. During the first quarter of 2020, commercial auto effective rate change remained in the low-double digits. Personal lines renewal rate increases remained in the mid-single digits.

With overall claims frequency down significantly in the first quarter of 2020, with a decrease of 18% on a new claim basis and 23% on a written-premium basis, the story this quarter is definitely claims severity. As Randy mentioned, operationally, our first-quarter 2020 results were impacted by an increase in severity of both catastrophe and non-catastrophe losses, primarily in our commercial fire, other liability and workers' compensation lines of business. The increase in severity of catastrophe losses is primarily from two events, as Randy mentioned, the increase in severity in non-catastrophe losses in our commercial fire line of business is due to an increase in large fires. During the first quarter of 2020, there were 11 large fire losses compared to five large fire losses in the first quarter of 2019. The increase in severity in our workers' compensation line of business is due to one large claim. Our workers' compensation line of business continues to perform within our expectations with a net loss ratio of 39.7%. With that, I'll turn over the discussion to Dawn Jaffray. Dawn.

Dawn Jaffray
Thanks, Mike, and good morning, everyone.

In the first quarter of 2020, we reported a consolidated net loss of $72.5 million, compared to net income of $44.5 million in the same period for 2019. The net loss was primarily the result of the change in the value of our investments in equity securities, which declined by $90.6 million in first quarter 2020. This compared to an increase in the value of equity investments of $24.6 million during the first quarter of 2019, thus, representing a change of $115.2 million between these comparative quarters.

It is important to note that our investments in equity securities remain in a gain position of $140 million at March 31, 2020, despite the nearly $91 million decrease in value in the first quarter. In addition, we recognized an after-tax unrealized gain of $4.5 million in our bond portfolio in the first quarter of 2020.

Operationally, we reported adjusted operating income of $1.3 million or $0.05 per share in first quarter 2020, compared with $23.4 million or $0.91 per share in the same period of 2019. Our operational results were impacted by an increase in both catastrophe losses and non-catastrophe losses, as Randy and Mike mentioned, along with this decrease in net investment income. The decrease in net investment income was due to volatility in the equity markets and the change in the value of our limited liability partnerships or what we refer to as our bank funds.

Moving on to operating metrics, the combined ratio in the first quarter 2020 was 105.2%, compared to 95.6% in the first quarter of 2019. Slide 8 in our presentation on our website contains a reconciliation of the components of our reported combined ratio.

Referencing the adjusted combined ratio, which removes the impact of catastrophe losses and reserve development, our core loss ratio deteriorated 5.8 percentage points in the quarter, primarily due to an increase in severity of losses in our other liability, commercial fire and workers' compensation lines of business, as Mike has mentioned.

We recognized more favorable reserve development with $13.7 million in first-quarter 2020, compared to $4.6 million in the first quarter of 2019. Higher prior-year favorable reserve development was primarily in our workers' compensation and commercial fire lines of business. Our total reserve position remains with an actuarial estimate.

The expense ratio increased 2.8 points in first quarter of 2020 as compared to the same period in 2019, although we've seen improvement in our commercial auto book of business, the loss ratio remains at a higher-than-acceptable level, which impacts the amount of acquisition expenses we can defer during the quarter, resulting in an increase in the expense ratio. Also contributing to an increase in the expense ratio, but to a much lesser extent, is the continued investment in our multiyear OASIS Project and upgrade to our technology platform designed to enhance core underwriting decisions, selection of risks and productivity.

I will end my portion of the call discussing capital matters. First, as we have consistently done for the past 208 quarters since March of 1968, we declared and paid a $0.33 per share cash dividend to shareholders of record as of March 6, 2020.

During the quarter, we repurchased just over 70,000 shares for $2.7 million. In mid-March, we made the decision to suspend share repurchases for the time being. We remain authorized by our board of directors to purchase an additional 1.8 million shares of common stock under our share repurchase program, which will expire in August of 2020.

As previously announced, we signed a new credit agreement with Wells Fargo Bank in first quarter. This revolving credit facility has similar terms to our prior credit facility, which expired in February 2020. At this time, UFG has no intention to draw funds from this current credit agreement, and once again, the entry into the credit agreement was completed as part of our regular course of financial planning and was not initiated as a result of market conditions resulting from the COVID-19 pandemic. We believe our current capital and liquidity position are adequate. The credit agreement with Wells Fargo demonstrates our continued focus on maintaining access to additional liquidity in the event such need should ever arise.

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

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, at this time we will begin the question-and-answer session. To ask a question, you may press star (*) then one (1). To withdraw you question, you may press star (*) and two (2). If you are using a speakerphone, we do you ask you please pick up the handset before pressing the numbers to enure the best sound quality. Once again, in order to ask a question that is star (*) and then one (1). Our first question today comes from Marla Backer from Sidoti. Please go ahead with your question.

Marla Backer
Thank you. So, I'm just wondering if we could get a little bit more color on how the renewals process is proceeding? In this environment, is it making it easier or a little bit easier for you to raise rates or drop policies that you had already planned to drop?

Randy Ramlo
Thanks, Marla. This is Randy. One of the things that's kind of happening with regards to renewals is we're actually working more days out. We have a lot less new business coming in, so we're processing renewals out a bit further. I don't know rate increases; we went over what we've been getting for rate on an aggregate basis in the transcript. I don't know if it's necessarily easier or harder. There are a lot of insureds that are in difficult financial position.

We don't write like a lot of bars and restaurants, but we have seen a lot of the claims that we've gotten in on the business income side or obviously, some of those businesses are hit the hardest. So, we haven't seen a huge amount of cancellations coming, but the renewal process is going very well. It looks like most insureds are kind of staying put for the most part. We write a lot of construction and construction throughout the country has pretty much been open for business, so things are going fairly well, and we've been pretty satisfied with the level of rate increase that we're getting. I think if we asked our agents, is it easy to sell rate increases at these times, they would probably say, not really, but so far, we've done pretty well with it.

Marla Backer
Okay, that makes sense. So, you touched upon another question I had, which is about new business. How, in this environment where people are working remotely, has [unintelligible] given a lot of your activity is with other customers who initiate [unintelligible] prior to this stay-at-home

orders or existing customers -- how are your agents [unintelligible] initiate conversations with the potential customers?

Randy Ramlo
I'm sorry, Marla, you really broke up there. I didn't really catch the gist of that.

Marla Backer
Okay, I apologize. The gist of the question is about new business. In this environment [unintelligible] in your previous remarks. How do you see all your agents [unintelligible] to try to reach out to potential new customers? Or has that sort of [unintelligible] at the moment?

Randy Ramlo
So unfortunately, you're breaking up a little bit there again, Marla. I kind of maybe caught that how are agents able to kind of solicit new business and I haven't talked to a lot of our agents about that. I get the impression that a lot of them are working from home as well, and you don't just see -- a lot of insurers aren't moving around right now, opportunities to quote new business. New business applications are very down, but also, we're not seeing a lot of cancellations from people moving to other competitors, so I apologize if I totally missed what you're asking there.

Operator
And ladies and gentlemen, our next question comes from Paul Newsome from Piper Sandler. Please go ahead with your question.

Paul Newsome
Good morning. A little bit of an uptick in the expense ratio. I was hoping you could talk about the outlook for the expense ratio perspectively.

Dawn Jaffray
Hey, Paul. It's Dawn. Thanks so much. We're running historically somewhere in the roughly 32% range, and that's what we would expect under normal circumstances. With the commercial auto loss ratio, producing a total combined ratio of over 100, we did have to recognize about 1.6 points of additional deferred acquisition costs that we were unable to defer, so, I would suggest somewhere in that 32% range because of both the OASIS project and where we've been historically.

Paul Newsome
Would the deferral continue? How long is the acceleration deferral last? Is it just a full year? Or is it just a quarterly impact?

Dawn Jaffray
You know we have to evaluate it based on the actuarial estimates every quarter, and because -- and it's somewhat of a look-back scenario, so we did have to look back to fourth quarter, which had a large uptick in the commercial auto loss ratio. We evaluated over number of quarters, but there are some good signs of things like Mike had mentioned about frequency, etc., that we're able to consider.

So, every quarter, we have to evaluate it, and we'll do that again in the second quarter with our actuaries.

Paul Newsome
Does your thoughts on the top-line growth also include some factor for the effect of the higher -- low level of employment, higher levels unemployment that possibly could reduce revenues for workers' comp and other lines where they're tied to the economic activity?

Randy Ramlo
Well, we did grow a little bit in the first quarter. I don't anticipate that that is going to continue, and if you kind of even look at the last two weeks of March, things really -- we had some good momentum going. The economy was working well. Then, when the pandemic hit, things changed a lot. So, I think we're already seeing a lot of reductions. We've been pretty open to reductions in payroll and sales, so insurers are calling in and we're being pretty liberal with doing as they ask and lowering sales and payroll-premium basis.

Our thought is that those policies will be audited and if anybody is playing any games, we'll be able to catch up on those, but normally, we would -- if someone called in and wanted to lower their payroll, we would just say, well, let's wait until the audit is done and then we'll true things up then, but we realize that a lot of people are in difficult cash flow situation. So, we've been pretty liberal in making those changes as they're requested. So, I think second quarter is going to look quite a bit different for the whole rest of the industry because of that.

Paul Newsome
No doubt, but I think you mentioned about keeping premiums flat, and I was just wondering if that also included the impact of what could be a fairly significant decrease in the -- well, change in the auto premiums? That sounds like that is not the case.

Randy Ramlo
Rates are going up. So, that's a positive, but I think endorsement premium and cancellations, we're going to see premiums. Certainly, right now, they're headed substantially lower. Now when some of the economy gets opened back up in maybe late May or early June, maybe things will rebound a little bit, but what we're seeing right now in the second quarter, premiums are down pretty substantially.

Paul Newsome
Great. Thanks. Hope you stay safe.

Randy Ramlo
Thank you. You, too, Paul.

Operator
Once again, if you would like to ask a question, please press star (*) and one (1). Our next question comes from Ron Bobman from Capital Returns. Please go ahead with your question.

Ron Bobman
Hi. Thanks a lot. Seems like a lifetime since I saw you last, Randy. It was just two months ago.

Randy Ramlo
Well, we were shaking hands and eating in the buffets. That looks like a longtime ago.

Ron Bobman
Yeah, although I wasn't touching the buffet even then in any event.

Randy Ramlo
You were smarter than I was.

Ron Bobman
Yeah. Well, hopefully, we both dodged trouble. So, I had a question, and I'm sorry if I'm reading your comments in the press release too literally, and I'm sort of the question is sort of misplaced, but I want to ask it anyway. The BI reference and the sentence or the two that touched on BI in the press release about virus not being covered in your property BI coverages. I just want to make sure that I'm not reading it too liberally. Do your commercial property policies have explicit virus exclusion? And is it near -- the reference to nearly every policy has an explicit virus wording exclusion? Or are you making a slightly different communication in the words you chose?

Randy Ramlo
Well, our lawyers have to approve what we put out, and we struggled with -- we started with most, and that to be seemed not enough. We talked about 99.9%, and we have very few policies that don't have that exclusion, and most of our -- not most, nearly all, I think, is the best way to term it. We have a couple of isolated types of policies in a couple of states that don't have that exclusion on it, but far and away, most of our policies have that virus exclusion. So, we don't anticipate any issues with claims from the virus, apart from if some courts makes some goofy decisions or there's still talk from legislation, not too much from regulators, but there's still some talks of making -- voiding that exclusion and making retroactive business income. I don't think those things had a lot of momentum, but I think we said in the transcript that we feel that BI losses will be very manageable, for example, we don't write a lot of work comp. We don't write work comp, hardly any healthcare workers, but we do have injured workers that have, say, carpal tunnel, low back issues or shoulder injuries that are waiting for surgeries, and all those surgeries are considered elective. So, we do have indemnity payments that are having to be made until those elective surgeries can be done. Normally, these are not very serious injuries and can be repaired pretty quickly, but until the operating rooms are opened up for elective surgeries, these people are not going to be able to have their procedures with Iowa as our largest work comp state and this week, Iowa did open up for elective surgery. So hopefully, we'll kind of see that trend. So, it's difficult for us to say that there's not going to be any effect from this COVID incidents, but we think it will be extremely manageable for UFG.

Ron Bobman
Thanks. That was quite helpful. I appreciate that. That is it for my questions. Thanks. Good luck. All the best.

Randy Ramlo
Yeah. Thank you and stay healthy yourself.

Ron Bobman
Thanks.

Operator
Once again, if you would like to ask a question, please press star (*) and then one (1). To remove yourself from the question queue, you may press star (*) and two (2), and ladies and gentlemen, I'm showing no additional questions, I'd like to turn the conference call 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
Ladies and gentlemen, with that, we will conclude today's presentation. We thank you for joining. You may now disconnect your lines.