United Fire Group, Inc.

Fourth Quarter and Year-End 2019 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Randy Ramlo - *Chief Executive Officer*

Mike Wilkins - *Chief Operating Officer*

Dawn Jaffray - *Chief Financial Officer*

Randy Patten - *Assistant Vice President & Controller*

Corey Ruehle - *Chief Claims Officer*

PRESENTATION

Operator

Good morning and welcome to the UFG Insurance Fourth Quarter and Year-End 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 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, this event is being recorded.

I would now like to turn the conference over to Randy Patten, Assistant Vice President and Controller. 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 am pleased to present Mr. Randy Ramlo, CEO of UFG Insurance.

Randy Ramlo

Thanks, Randy. Good morning, everyone, and welcome to our fourth quarter and year-end 2019 conference call. Earlier this morning, we reported our fourth quarter 2019 results, including a consolidated net loss of $0.93 per diluted share and adjusted operating loss of $1.04 per diluted share and a GAAP combined ratio of 117.9%. This compares with a net loss of $1.17 and adjusted operating loss of $0.30 and a GAAP combined ratio of 108.5% in the fourth quarter of 2018.

For the full year of 2019, we reported net income of $0.58 per diluted share and adjusted operating loss of $1.08 per diluted share and a GAAP combined ratio of 109%. This compares with full year 2018 net income of $1.08 per diluted share, adjusted operating income of $0.67 per diluted share and a GAAP combined ratio of 104%.

Our 2019 results continued to be negatively impacted by commercial auto losses and prior year reserve strengthening in our Gulf Coast region with the majority of this strengthening occurring in the first half of 2019.

From a profitability standpoint, the fourth quarter was disappointing and an unacceptable end to a year in which we failed to meet expectations and failed to make an operational profit. Commercial auto losses continued to be the main driver of the net operating loss in the fourth quarter. We know we have work to do and we are focused on moving forward with our strategic plan to improve profitability.

As part of our strategic plan, we have several initiatives underway in underwriting, claims, analytics, portfolio management and technology innovation to name some of our focus areas. Mike will discuss our strategy in more detail, but one example of a noteworthy development at UFG is within our portfolio management strategy, specifically related to our commercial auto book.

Despite our best efforts to manage poor performing commercial auto accounts with double-digit rate increases and nonrenewals, these efforts proved to be insufficient to return this line of business to underwriting profitability in 2019. With the continued escalation of commercial auto loss industry-wide and no signs of improvement in the key metrics we track such as miles driven, driver shortages, distracted driving and social inflation, we decided to take several difficult, but necessary actions beginning in the fourth quarter.

Our plans include being even more aggressive with nonrenewals in 2020, which will reduce our commercial auto unit counts especially in poor performing segments and we won't write new accounts that are heavy in auto. By taking these actions, we are confident we will achieve a better balance in our overall book of business, which has become too heavily weighted in commercial auto in recent years. Although we stand to lose some of our commercial package policy business as a consequence of this action, we believe it will have the most immediate and profound impact on our profitability.

Part of our strategic plan has been to increase rates which we have been more aggressive than the rest of the industry the past two years. Commercial lines average renewal pricing increases remained in the mid-single digits again in the fourth quarter. However, it is clear to us that our commercial auto issue cannot be solved with rate increases alone. As we enter 2020, we are more determined and prepared than ever to take stronger action to turn around this unprofitable line of business. We realize that it is even more important to focus on the bottom 30% of our book; underperforming accounts and accounts that our model has identified as having characteristics that are predictive of adverse future loss experience.

There were definitely positive signs of progress in our commercial auto line in 2019 including a decreased frequency in commercial auto claims, a decline in policy retention, and a decrease in our number of insured commercial auto units. But these positives were not significant enough to offset the continued rise in severity of commercial auto claims. Again, this quarter we continued to see an increase in severity of commercial auto claims. This increase in severity has been a common theme all year. This along with prior year reserve strengthening in our Gulf Coast region are the main drivers of our disappointing results in 2019.

In the fourth quarter of 2019, we had $19.4 million of CAT losses, which included tornadoes in Dallas, Texas and Alexandria, Mississippi. CAT losses for the fourth quarter of 2019 added 7.1 percentage points to the combined ratio, which is above our 10-year historical catastrophe load of 4.8 percentage points for the fourth quarter. For the full year of 2019 catastrophe losses added 5.9 percentage points to the combined ratio, which is below our 10-year historical catastrophe load of 6.4 percentage points.

I will end my portion of our prepared remarks with reporting some good news. As we first reported in our press release in December of 2019, AM Best had affirmed the financial strength rating of “A”, Excellent, for the property and casualty subsidiaries of United Fire Group Inc. The outlook of these credit ratings remains stable. This is the 26th consecutive year we have earned an “A” financial strength rating from AM Best. AM Best ratings are a meaningful measure in the insurance industry with an “A” rating given to companies that have an excellent ability to meet their ongoing insurance obligations.

Second, *Business Insurance*, an industry news and information source, has named UFG in its annual list of Best Places to Work in Insurance. The list honors workplaces for exceptional performance in establishing environments where employees can thrive, enjoy their work and help their companies grow which is important to us.

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

Mike Wilkins
Thanks Randy and good morning everyone.

As Randy mentioned our focus remains on improving profitability. Our strategic plan contains some very ambitious initiatives in several areas, including underwriting, claims, analytics, portfolio management, and innovation. The three I will focus on today are portfolio management, underwriting initiatives and claims.

First, our portfolio management initiative focuses on balancing the portfolio of our various lines of business, targeting profitable geographies, classes of business and products to optimize profitability. Today with the exception of commercial auto, the majority of our book of business is performing within our expectations from a profitability standpoint. The portfolio management initiative will increase the percentage of our business written in profitable lines and reduce the percentage of business written in the auto line.

With most key metrics showing no improvement for commercial auto, it is clear we need to reduce the size of our commercial auto book of business. The performance of our commercial auto book of business has failed to meet our expectations and is a drag on profitability. We will accomplish this by being more aggressive with nonrenewal of underperforming accounts focusing on the bottom 30% of our book and we will not write new accounts that are heavy auto. As a consequence of this, we stand to lose entire accounts since we have traditionally been a package writer, providing an insured all of their commercial insurance needs. But we feel this is a necessary step to balance our book of business and improve profitability.

In the fourth quarter of 2019, we began to see this initiative take hold with a reduction in policy and premium retention and a reduction in insured auto units of approximately 15%. Our expectation for 2020 is that policy count, premium retention and insured auto units will continue to decline with no expected premium growth in 2020.

The second initiative that I will discuss is our underwriting initiative. This initiative consists of several tactics including a continued focus on rate increases, a quality program consisting of targeted file reviews designed to both identify ongoing performance trends and provide coaching and feedback for frontline underwriters, an underwriting best practice guide to promote consistency in the underwriting process across all regions, as well as other professional development initiatives across the underwriting operation.

In the fourth quarter the average renewal pricing change for commercial lines increased 6.6% compared to 7.0% in the third quarter of 2019. The renewal pricing increases continued to be driven by commercial auto rate increases. During the fourth quarter of 2019 commercial auto renewal rate increases averaged in the low double digits. Over the past three years, we have achieved a cumulative renewal rate increase of almost 30% in our commercial auto book. These increases were targeted towards the worst performing segments of our book. Personal lines rate increases remained in the mid-single digits.

Finally, our gold standard claims initiative began in the second half of 2019 and will continue to be implemented throughout 2020 and beyond. This initiative began with the development of a target operating model whereby we analyze the entire claim cycle from beginning to end, evaluating each step from both the external and internal customer experience perspective. From our target operating model, we formed multiple work streams which include claims excellence, litigation management and data analytics.

Our mission with gold standard is to create a seamless customer experience while creating consistency and stability in our reserving practices. A few examples that have come from gold standard include a defined set of best practices to operate as the foundation that every claims employee, in every region, will utilize.

Our goal with data analytics is to assist us in identifying severity and claims quicker, setting accurate reserves more timely and shortening the claims cycle time leading to a reduction in legal expenses. Our data scientists are currently in the text mining phase of this process. We anticipate our first claims model focused on severity in our casualty lines to be launched in the second half of 2020.

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

Dawn Jaffray
Thanks Mike and good morning, everyone.

In the fourth quarter of 2019, we reported a consolidated net loss of $23.2 million compared to a net loss of $29.3 million in the same period for 2018. For the full year 2019, consolidated net income was $14.8 million compared to $27.7 million in 2018.

As Randy mentioned 2019 results were negatively impacted by an increase in severity of commercial auto losses and prior year reserve strengthening in our Gulf Coast region and these were the main factors contributing to our disappointing loss ratio for the year.

Our investment portfolio continued to benefit during 2019 from the strong equity markets. We reported an after-tax gain of $40.5 million for the full year 2019 with the increases in the value of our equity securities. For comparison purposes in 2018, we had a decrease in the fair value of equity securities with an after-tax loss of $17.4 million. However last year's decrease was offset by the $27.3 million gain on the sale of our life company in March of 2018.

Our investment in limited liability partnerships or what we refer to as our bank funds also benefited from the strength of the financial markets and were a positive contributor to our 14% increase in net investment income for 2019. Specifically, during the fourth quarter of 2019 we reported net investment income of $16.5 million and $60.4 million for the full year. For 2018, we reported $9 million in the fourth quarter and $52.9 million for the full year.

We recognized slightly less favorable reserve development quarter-over-quarter $4.6 million in the fourth quarter of 2019 compared to $6.5 million in the fourth quarter of 2018. However, for the entire 2019 year there was a more significant year-over-year impact with a $49 million reduction in reported favorable development. The difference is due to reserve strengthening in our commercial auto and liability lines of business in our Gulf Coast region, as we have been reporting all year. We did end the 2019 year with aggregate favorable development of $5.3 million versus $54.2 million for 2018. This continues our historical trend of having overall favorable development every year since 2009, and lastly our total reserve position remains within actual estimates.

Moving on to operating metrics; the combined ratio in the fourth quarter at 117.9% compared to 108.5% in Q4 of 2018, and for the full year 2019 it was 109% compared to 104% for 2018. We have work to do to improve our operating performance. Each of us at UFG are engaged in driving the success of the initiatives Randy and Mike have discussed in detail, and collectively we are all committed to improve our long-term profitability.

For reference of what we term the adjusted combined ratio which removes the impact of catastrophe losses and reserve development, our core loss ratio in 2019 deteriorated 8.4 percentage points in the quarter, however, it improved very slightly by 0.2 percentage points on a year-to-date basis. For a breakdown of the components of the adjusted combined ratio, please see slide 9 in the slide deck we presented on our website.

The expense ratio has improved almost one point in the quarterly and annual comparative periods. For the fourth quarter of 2019, we reported 32.2% compared to 33.1% in the fourth quarter of 2018. For the full year, the 2019 expense ratio was 32.6% compared with 33.5% for 2018. The decrease in the expense ratio in both periods is primarily due to a decrease in employee benefit expenses. As a reminder, the changes we made during 2018 to our retirement benefits plan continued to take effect in our results.

Moving on to a discussion of capital matters, our annualized return on equity was 1.6% in 2019 compared to 3% in 2018.

And as we have consistently done for the past 207 quarters since March of 1968 we declared and paid a $0.33 per share cash dividend to shareholders of record as of November 29, 2019. With the UFG stock price of $46 that translates to an annual dividend yield of approximately 2.9%,

And the last item I will speak to is the UFCS share repurchases we have made for the year. During 2019, we repurchased just over 250,000 shares for $11.7 million. We believe that share repurchases can be a good use of our capital subject to certain conditions, however, we are also limited in the number of shares we can repurchase by the rules of the stock exchange based on our daily trading volumes. We remain authorized by our 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 that, the closing of our 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 on your telephone keypad. If you are using a speakerphone, please pick up your handset

before pressing the keys. To withdraw your question, you can press star then two. Our first question will come from Paul Newsom with Piper Sandler O'Neill.

Paul Newsome
Good morning. Could you give me a little bit more detail about the components of the reserve development between what was the impact of issues in your Gulf Coast operation versus commercial auto versus everything else? Just to get a sense of what may or may not persist?

Mike Wilkins
Paul this is Mike Wilkins. I will take a stab at it. We have Corey Ruehle here our Chief Claims Officer too. He may have some additional information on that. The components would be heavily weighted towards commercial auto, but most of that commercial auto impact is coming from our Gulf Coast office. It is focused in both of those areas commercial auto but out of the Gulf -- primarily out of the Gulf Coast office. Corey anything to add there?

Corey Ruehle
I will just add to that, that the deficiency in the Gulf Coast was roughly $40 million last year and about $32 million to $33 million of that was commercial auto.

Paul Newsome
Is there significant reserve issues outside of the Gulf Coast with commercial auto?

Randy Ramlo
No.

Paul Newsome
Okay, and then I was a little bit surprised to see that incrementally the rate increases had decelerated slightly fourth quarter versus third quarter. Maybe you could talk about the components of that change?

Mike Wilkins
Yes. This is Mike again. First the reduction was primarily driven by less rate increase in the auto line of business. That surprised us a little bit at first. As we dug into it, two comments I will make. One it seemed to rebound in January; and two I think what may have driven that we really took a lot more aggressive nonrenewal actions, and a lot of those accounts that we nonrenewed would have been accounts where we would have been able to achieve the largest rate increases.

I think that would have moved the average auto rate increase down just the fact that a lot of the accounts prior to our more aggressive nonrenewal we would have got the biggest increases on.

Randy Ramlo
Paul, we mentioned a couple of times that we are focusing on the bottom 30%, and we have found ourselves now to the point where the top 70% is actually pretty close to where we want it to be priced. As Mike said, we are leaning more toward nonrenewal in that bottom 30% simply because some of those accounts are so far off, we cannot get there with rate. Instead of last year or previous quarters, we may have raised something 25% 30%. Now we are just not renewing it. We lose that big impact on the overall rate increase.

Paul Newsome
And my final question. I do not know if – it is not ever easy to answer this, but do you have any sense of what is the all-in claims inflation for the book? Obviously, there are some negatives in

workers' comp and deposits in commercial auto, but we are all trying to figure out whether or not net for the entire book we need more rate or less rate than you are currently achieving?

Randy Ramlo
Paul this is Randy, and I wish I could help you, but we are struggling with that too. We see evidence of the inflation every day, but to try to put a number on it we have not really been able to do that either.

Paul Newsome
Do you have a sense of what it was last year?

Randy Ramlo
No.

Paul Newsome
Okay. Thanks.

Randy Ramlo
Thanks Paul.

Operator
Again, if you have a question, you can press star then one.

At this time, I am showing no questions. This will conclude our question-and-answer session. I would like to turn the conference back over to Randy Patten for any closing remarks.

CONCLUSION

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

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