United Fire Group, Inc.

Q3 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*

Bob Cataldo – *Chief Investment and Strategy Officer*

PRESENTATION

Operator
Good morning. My name is Kate, and I'll be your conference operator today. At this time, I would like to welcome everyone to the UFG Insurance Third Quarter 2020 Financial Results Conference Call. [Operator Instructions] Please note this event is being recorded. Thank you.

I will now turn the call 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 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 Relation's 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 that are not a guarantee of future performance. These forward-looking statements are based on management's current expectations. 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 third quarter 2020 conference call.

As we previously announced on October 29, 2020, the largest impact on our financial results during the third quarter of 2020 was catastrophe losses. This marks the second consecutive quarter in which we have experienced a historically high level of catastrophe losses. Based on our historical experience, we typically only experience a quarter similar to this once out of every 10 years. However, we have now had two quarters in a row.

In the third quarter of 2020, we recorded $55.4 million of catastrophe losses, or 21.4 percentage points of the combined ratio compared to $19.3 million, or 7 percentage points in the third quarter of 2019. Our historical average for catastrophe losses in the third quarter is 8.9 percentage points.

The catastrophe losses were from 25 events with the most notable catastrophe event being the August Midwest derecho. The August Midwest derecho exceeded our $20 million reinsurance retention. We also recorded $9 million of reinsurance reinstatement premium related to this event in the third quarter of 2020. In addition to the derecho, we experienced a number of other cat events with the most significant being Hurricane Laura with losses of $12.3 million. The remaining cat losses in the third quarter were from severe convective storms, none greater than $5 million individually.

Cedar Rapids, Iowa, the location of our corporate headquarters, experienced some of the most severe damage from the August Midwest derecho. Nearly every structure in the 75 square mile city limits of Cedar Rapids sustained at least some damage. This massive thunderstorm covered over 53,000 square miles and a distance of nearly 800 miles throughout the Midwest, flattening crops, destroying trees and homes and knocking down power lines, which left hundreds of thousands of people without power for up to two weeks. The storm at its full strength in Eastern Iowa was equivalent to an EF3 tornado or a Category 4 hurricane with estimated peak wind gusts of up to 140 miles per hour. According to the National Oceanic and Atmospheric Administration, the losses from the Midwest derecho are second only to Hurricane Laura in 2020, and it ranks as the most costly thunderstorm in U.S. history. Slide 9 in our slide deck on our website, presents a comparison of the derecho and Hurricane Laura.

Many of our employees dealt with personal losses to their homes and vehicles from the derecho, including myself. Despite dealing with personal losses, once again, UFG employees came together to help take care of customers, who were impacted by the same devastation. Our employees assisted policyholders with nearly 2,800 claims following the derecho. I continue to be amazed by the dedication of our employees, most of whom are working from home, due to the ongoing pandemic. One thing is for certain, when catastrophes hit, our people rise up to do extraordinary things, even while dealing with their own personal crisis.

In regards to the ongoing pandemic, our employees continue to work remotely and continue to deliver outstanding service to our agents and policyholders. We continue to assess the current situation with the safety, health, and well-being of our employees being our top priority.

As we mentioned during the last two quarterly calls and as a reminder, nearly all of the policies we have issued contain contract language that specifically excludes business interruption coverage losses attributable to viruses, such as the COVID-19 pandemic. At this time, we expect the effect of COVID-19 on claims currently under our coverages to be manageable. However, the impact of the COVID-19 pandemic continues to evolve, and we cannot predict how future legislation, regulation, or court actions will impact us. Although we are still in the midst of the pandemic, the litigation process and court decisions remain favorable for the insurance sector thus far, with contract law being upheld in the courts.

Before turning the call over to Mike, I will highlight our operational results, starting with our core book of business. Excluding the impact of catastrophe losses and favorable prior year reserve development, our core loss ratio improved slightly in the third quarter and year-to-date 2020 with improvements of 0.4 and 0.3 percentage points, respectively, to the combined ratio. Year-to-date, our commercial auto loss ratio improved 4.8 points compared to the same period in 2019. This improvement is being driven by continued decreases in the frequency of commercial auto claims and our intentional reduction in the number of commercial auto exposure units, both positive signs of progress in our strategic initiatives. However, we know we have work to do as our commercial auto loss ratio remains higher than acceptable with severity of commercial auto losses and reserve strengthening continuing in the third quarter.

With respect to premiums, last quarter we forecasted an overall reduction in net premiums earned in the range of 6% to 8% in the second half of 2020. We still believe this forecast is accurate, due to a combination of underwriting and business factors, including the renewal rights agreement for our personal lines business, which we signed in May with Nationwide Insurance Company and became effective with renewals beginning on September 1.

The premiums earned decreased 5.8 percentage points in the third quarter of 2020 as compared to the third quarter of 2019. On a positive note, we are experiencing growth in our profitable E&S and surety business and also with our MGA agreement with Arrowhead Insurance.

I will now turn the call over to Mike to discuss our operational results in more detail. Mike.

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

We continue to make progress on improving the profitability of our commercial auto book of business in 2020. In the third quarter, we again saw a decline in the frequency of commercial auto claims. Since September of 2019, commercial auto frequency is down 13%. Additionally, our 12-month moving average of insured commercial auto units has declined 16% since September 2019. Slides 6 and 7 in the slide deck on our website present these declines. As a reminder, the decline in both frequency and the number of insured units began prior to the ongoing pandemic.

The reduction in commercial auto claims frequency and number of commercial auto exposure units resulted in an improvement of 4.8 points in our commercial auto loss ratio year-to-date. However, we did experience an increase in our commercial auto loss ratio in the third quarter, as Randy mentioned. There were three factors contributing to this increase. First, we added IBNR reserves of $6.7 million. Second, the third quarter included prior accident year reserve strengthening. And finally, in the third quarter, there was an increase in severity of commercial auto losses, primarily in our Great Lakes and Gulf Coast regions. Excluding the impact of prior accident year reserve strengthening and IBNR reserve additions, the commercial auto loss ratio would have improved 5.2 points in the third quarter of 2020, despite the increase in severity.

As Randy mentioned and as highlighted in Slide 10 in the slide deck on our website, our core loss ratio, which removes the impact of catastrophe losses and prior accident year reserve development, improved in both the third quarter and year-to-date 2020 as compared to the same periods in 2019. Our core loss ratio improved 0.4 percentage points and 0.3 percentage points, respectively. We are pleased with this continued improvement.

We remain focused on our pricing and retention strategy, specifically on our commercial auto, property, and umbrella books of business. As previously mentioned, our commercial auto strategy is unit reduction through non-renewing underperforming accounts, limits reductions on commercial umbrella, and rate increases. During the third quarter of 2020, the average renewal pricing increases were driven by commercial auto and commercial property. The commercial auto average renewal rate increase remained in the double-digits at 11.5% in the third quarter of 2020. The commercial auto average 12-month rate increases have been in the low double-digits since the beginning of the year. We continue to get the most rate in our bottom 30% of our retained commercial auto book. As a reminder, we are non-renewing a large percentage of our underperforming commercial auto business in the bottom 30% of our book.

We believe there is an opportunity with our commercial property book to be more aggressive with rate increases and reduce undesirable exposures. The average renewal rate increase was 5.8% for commercial property, remaining in the mid-single digits again in the third quarter of 2020. There are signs that the commercial property market is hardening, and we believe we should be able to get more rate in this book.

I will wrap up my portion of the call with a few comments on our workers' compensation performance. In the third quarter and year-to-date in 2020, our workers' compensation loss ratio increased as compared to the same periods in 2019. The increase in 2020 is from eight large claims. It is important to note that 2019 was an exceptional performance year for our workers' compensation book with loss ratios of 14.0% and 27.7% in the third quarter and year-to-date 2019, respectively. Our expectation for this book of business is loss ratios in the low 60s. Therefore, 2020 is performing better than our expectations with loss ratios of 53.3% and 41.8% in the third quarter and year-to-date 2020, respectively.

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

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

The significant catastrophe experience driving results during 2020. In the third quarter, we reported a consolidated net loss of $37.2 million compared to a net loss of $2.3 million in the same period for 2019. Year-to-date, we reported a consolidated net loss of $103.8 million compared with net income of $38 million in the same period of 2019.

Partially offsetting the quarterly catastrophe losses we've discussed was the increase in the fair value of our investments in equities or what I refer to as phantom gains, of which $22 million in pretax income was added to our resolves.

Net investment income decreased $6 million and $21.6 million in the third quarter and year-to-date 2020, respectively. The decrease in both periods was primarily the result of a change in the value of our limited liability partnerships, our bank funds. These investments do tend to fluctuate with market volatility. Also contributing to the decline was an overall decrease in invested assets.

As of the end of third quarter, our equity portfolio remains in a $137 million unrealized gain position. For the first nine months of 2020, we further recognized an after-tax unrealized gain of $35 million in our bond portfolio. We sold some equity securities in the third quarter, recognizing a pretax loss of $6.8 million. Note, we did have a gain, when measured against our actual cost basis for these securities.

We undertook a quantitative analysis of our goodwill as a result of the disruptions in the equity markets from COVID-19 and in consideration of the fact that our stock has been trading below book value this quarter. As a result of this quantitative analysis, we recorded a onetime write-off of our remaining goodwill balance of $15.1 million in the third quarter. This goodwill was related to the acquisition of Mercer Insurance Group in 2011.

Moving on to operating metrics - with significant impacts from catastrophes, the year-to-date combined ratio was 113.5% compared to 106% in the same period of 2019.

We have recognized more favorable prior year accident reserve development during the first three quarters of 2020 at $30 million, when compared to 2019 at $800,000. The favorable prior year reserve development in 2020 has been primarily from our workers' compensation and commercial property lines of business.

The expense ratio for the third quarter of 2020 was 0.8% higher, compared to third quarter 2019. Our year-to-date expense ratio was 34.4%, compared to 32.7% for 2019. The increase in the year-to-date expense ratio during the comparable three- and nine-month periods is primarily due to our continued investment in technology initiatives.

I will end my portion of the call by discussing capital matters.

As of September 30, 2020, we continue to maintain a healthy balance sheet and good liquidity with $100 million available to seek investment income opportunities.

During the third quarter, we declared and paid a $0.33 per share cash dividend to shareholders of record as of September 4, 2020, marking our 210th consecutive quarter of consistently paying dividends.

Lastly, during the quarter, we did not repurchase any UFCS shares. We made the decision in mid-March to suspend share repurchases. 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 at the end of August 2022.

And, with 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 (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw from the question queue, please press star (*), then two (2).

The first question is from Paul Newsome of Piper Sandler. Please go ahead.

Paul Newsome
Hopefully, you're safe and sound. I wanted to ask you if you could talk to what the loss ratio sort of the underlying loss ratio would be if you exclude the personal lines business. Does that have a material impact on the comparison that we see and the improvement that we see here on a quarterly or year-to-date basis?

Randy Ramlo
Paul, this is Randy. I don't know if we have that in front of us. The Midwest ratio is a big factor, and though we don't write a lot of personal lines as a percentage of our total book, we do have a lot of personal lines in Cedar Rapids area. So, the ratio did hit the personal lines pretty hard, again, we've got reinsurance contributions too.

So, we could probably look to see if we could find that. But I have a feeling that our personal lines was more of a contributor to our overall loss ratio than we would normally expect.

Paul Newsome
I'm just curious if there's actually more improvement there than we would expect. The other thing I wanted to ask goes to the run rate for investment income and whether or not you could help me with that. It's a little bit of a head scratcher relative to other companies, because we're pretty used to having a three-month lag between venture capital hedge funds, alternative asset results, which would have suggested actually an improvement for most companies in their alternatives in the third quarter?

But it looks like that didn't happen to you guys. Could you talk about why that may or may not happen? Are you accounting for you a little bit differently or just give us any color that gives us a sense of where we should think about the run rate for investment income?

Bob Cataldo
Hi Paul, this is Bob. I can't really speak to the accounting of our equity exposure or limited partnerships. But I could say, just with the general level of interest rates, we are experiencing an overall decline in investment yields, which is not atypical of our peers. But again, I'll have to defer to either Dawn or our accounting folks to really walk through the accounting treatment of our equities and unlimited partnerships.

Dawn Jaffray
So, I apologize Paul, I was looking at the number for the personal lines ex loss--commercial lines--personal lines loss ratio. Are we talking about the investment income, the straight investment income or the treatment of what I call phantom income?

Paul Newsome
No, the straight investment income and I understand equities obviously have been and always--have been for a long time, mark-to-market and report as the quarter progresses. But other alternatives, hedge fundamentally, technology stuff, as some companies report them with a quarter lag. And I'm just wondering if you were doing the same here or something different and whether or not that had an impact on the third quarter results?

Dawn Jaffray
Yes, we book everything in the current quarter. There is no lag for us on the bank funds--is the largest component of that.

Paul Newsome
OK, that's great. And then just real quick, the goodwill write-down, was that mostly a function of profitability of the entire firm or is that a function of the Mercer operations in a particular? I would have thought by now, Mercer was pretty well integrated with the rest of the firm. But just curious as to how that works through the process?

Dawn Jaffray
Yes, it's a really formulaic-driven calculation. It's related to the entire company, and as our stock price has been trading significantly below book value. So, it's a combination of looking at the stock price as well as projections to future performance from a--excuse me, a quantitative basis, the calculation dictated that we had an impairment. So, unfortunately, it's aggregating it in the $15.1 million is a very small number compared to many others. So, the Mercer is fully converted with current operations.

Paul Newsome
Any other intangibles that we need to think about actually, I think the only thing left would be maybe the tax--any tax assets. But I would guess, no but just checking?

Dawn Jaffray
We have a very small amount associated with agent licenses excuse me, state licenses, which obviously carry value. And then, some portion with agent relationships, but it's very, very small. It's $6 million or so.

Paul Newsome
Well, anything to worry about a DTA?

Dawn Jaffray
No, not at this point.

Operator
Next question is from Marla Backer of Sidoti. Please go ahead.

Marla Backer
Thank you. So, given how high the cap contribution was during the quarter and given that we've seen two back-to-back quarters with severe weather and the fourth quarter is looking like. It also has some severe weather events. Is this impacting in anyway, the way you're thinking about your reinsurance approach?

Randy Ramlo
Marla, this is Randy. One way to look at it is we had an extremely severe event really right in our backyard, probably arguably our top two or three levels of exposure we have countrywide. And the reinsurance really held up very well. And we got into it, but a long, long ways from the maximum. So, I think it's kind of a testament that--we're pretty good position from where we bought.

We will probably evaluate some of the upper layers, after our personal lines book runs off. That's a big contributor to some of our probable maximum losses in some areas. So, but really, right now, going into next year, I think we're pretty comfortable where we are. But we may reevaluate like I said, after the personal lines are rolled off. Mike, you got anything else to?

Mike Wilkins
Yes, I would just add that every year, when we evaluate reinsurance, we try to optimize the coverage that we get in the program against what we spend for the coverage. And I think we have great relationships with brokers that help us with that analysis. And I think, we've always had reinsurance programs that have helped us through big cat events like the derecho.

And I would just second what Randy said about the derecho---we look at an event like that, which is very much a tail event for UFG, something that we would not expect to occur, even in every decade, it would be much longer out on the tail than that and we had coverage that really only went through about more than half of our cat program. So, I feel like we're well protected against future events like this.

Marla Backer
And then just switching gears a little bit in the past, I know I've asked about what the industry terms social inflation. So, can you address a little bit what you're seeing in terms of any changes there or any improvement trends in social inflation, or is it likely that right now the pandemic is sort of masking any possible changes in the way people are approaching litigation and the way litigation might be trending?

Randy Ramlo
Marla, this is Randy. Good question. I'll give my $0.10 worth and see if anyone has anything else to offer. A couple of things that we seem to see over and over again first is, the court so judges ignoring actual negligence. And so, if you find yourself in a court case and you happen to have

large limits with little or no negligence, that is really ignored. Also, like post-traumatic stress syndrome or traumatic brain injuries were something you saw maybe a couple of times a year on claims.

And now you see that almost constantly, even on--especially in car accidents that have - we've had car accidents that literally were below the deductibles with regards to damage to the two vehicles, yet either post-traumatic stress syndrome or traumatic brain injuries were claimed. And so, we have to do--we don't see this necessarily changing overnight. So, I think Mike talked a little bit about in the transcript, we have to be much more stingy with large liability limits, especially umbrella over $5 million.

And we have to do everything we can to stay out of court, because we don't see a lot of these things changing. We also see more of these judgments in more jurisdictions. It used to be we could keep track of a dozen or so places around the United States that you really wanted to try to stay out of court at all costs of those businesses--are many, many more in some areas that we consider pretty conservative in the past.

Operator

[Operator Instructions] There are no other questions at this time. Ladies and gentlemen, this concludes today's program. Thank you for joining us and have a great day. You may disconnect your lines.