United Fire Group, Inc.

2016 Third Quarter Earnings Conference Call

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CORPORATE PARTICIPANTS

Randy Patten - *Assistant Vice President, Finance and Investor Relations*

Randy Ramlo - *President and Chief Executive Officer*

Michael Wilkins - *Executive Vice President and Chief Operating Officer*

Dawn Jaffray - *Senior Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good morning. My name is Nan and I'll be your conference operator today. At this time, I would like to welcome everyone to the United Fire Group Third Quarter 2016 Financial Results Conference Call. All participants will be in listen-only mode today. 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 and then one on your telephone keypad. To withdraw your question, please press star then two. These instructions will be repeated. And please note this event is being recorded.

Now, I would like to turn the conference over to Randy Patten, Assistant Vice President of Finance and Investor Relations. Please go ahead, sir.

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 that are not a guaranty 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, Chief Executive Officer of United Fire Group.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to UFG Insurance third quarter 2016 conference call.

Earlier this morning, we reported net income of $0.48 per diluted share, operating income of $0.41 per diluted share and a GAAP combined ratio of 100.9% for the third quarter. This compares with net income of $0.77 per diluted share, operating income of $0.75 per diluted share and a GAAP combined ratio of 94.1% in the third quarter of 2015. Dawn will address the quarterly and year-to-date financial results later in a few minutes.

The third quarter results were within our expectations and were highlighted by continued organic premium growth, increased investment income, and catastrophe losses below our ten-year historical average for third quarters.

On a less positive note, our quarterly results were impacted by an increase in large commercial fire losses and an increase in commercial auto losses. I will let Mike discuss losses and the impact of our loss ratio in a few moments.

In the property and casualty segment, we continue to meet our organic growth objectives, with expansion in targeted geographical locations. Net premiums earned increased 9% during the third quarter and 11% year-to-date in 2016 as compared to the same periods in 2015. We anticipate continued momentum from our expansion initiatives for the remainder of 2016 and remain focused on maintaining underwriting discipline as we grow the top line.

As a reminder, some of our growth initiatives are targeted geographic expansion include expanding into the State of Ohio in the fourth quarter of 2015 and recently the State of Kentucky in the third quarter of 2016, along with adding our workers' compensation product in the State of Texas in the fourth quarter of 2016.

I am pleased to report that with the State of Ohio, we are off to a good start, with written premium within our expectations. In the State of Kentucky, we began selling our commercial lines and products in the third quarter of 2016, which will be followed with personal lines in 2017. In the State of Texas, we added our workers' compensation line, with the first premium received in October of 2016.

Renewal rate increases for both commercial lines and personal lines averaged in the low single digits in the third quarter. This is our 20th consecutive quarter of renewal pricing increases in our commercial auto and commercial property lines of business. However, the rate increases are not matching the increase in loss cost.

For new business, the rate increases for commercial lines of business were in commercial auto and commercial property lines of business. We did not seek any rate increases on new business for personal lines in the third quarter. Mike will provide more specifics with respect to the P&C market conditions and performance in a few moments.

As we discussed in prior quarters, the current interest rate environment has presented challenges during 2016 in our life segment. Although we had net income in the third quarter of 2016 as compared to a net loss in the second quarter of 2016, our expectation is that profitability in this segment will be difficult the remainder of the year. We are aggressively making changes to our strategy in the life segment, with life product pricing adjustments and restructuring our commission structure in 2017.

We are also working on creating efficiencies in our life segment, such as our recent automation of our deferred annuity application process, by implementing e-application and e-signature in the third quarter. We believe these actions will result in reductions in operating expenses and an increase in profitability in our life insurance segment.

Our expense ratio for the third quarter was 30.2 percentage points of the combined ratio compared to 31.2 percentage points in the same period in 2015. We are pleased with the progress we are making in reducing our expense ratio. We are continually looking for efficiencies to manage our expenses as we strive to reach our ultimate goal of an annual expense ratio of 30.0 percentage points.

I am pleased to report that, on September 15, 2016, A.M. Best affirmed our financial strength, A, excellent rating, for the property and casualty subsidiaries of United Fire Group, collectively known as United Fire & Casualty Group, and also affirmed the financial strength rating of A-, or excellent, for United Life Insurance Company, both with a stable outlook.

Finally, I'll end this morning with an update on UFG's exposure to Hurricane Mathew. To date, we have only received a few claims related to this catastrophe, with estimated losses less than $100,000. We have contacted the majority of our policyholders and are not yet expecting any further material developments from this event.

With that, I'll turn the discussion over to Mike Wilkins, our Chief Operating Officer.

Michael Wilkins
Thanks, Randy. And good morning, everyone. As Randy indicated, our catastrophe losses' impact to the combined ratio in the third quarter was 5.2 percentage points as compared to our ten-year historical average for third quarters of 7.8 percentage points. While the impact is below our ten-year historical average, we believe further geographical diversification will contribute to lowering our catastrophe loss impact in the future.

On a year-to-date basis, for the first nine months of 2016, catastrophe losses' impact to the combined ratio was 7.6 percentage points compared to our ten-year historical average for the first nine months at 7.0 percentage points. The increase is primarily due to weather-related catastrophe losses incurred during the second quarter of this year.

As a reminder, our expectation for catastrophe losses in any given year is 6 percentage points for the combined ratio, with the second and third quarters being the most significant quarters with storm and catastrophe events in geographic areas where we conduct much of our business.

In the third quarter of 2016, we experienced an increase in large losses, which we define as losses greater than $500,000. Large losses totaled $30 million in the third quarter of 2016 compared to $19 million in the third quarter of 2015. Year-to-date, large losses totaled $67 million in 2016 compared to $62 million in 2015. The increase in large losses is primarily due to an increase in commercial fire losses.

During the third quarter, we incurred five large commercial property losses for a total of $9.6 million. These fires were geographically spread out, with no recurring patterns. However, we are in the process of completing audits and identifying changes that are needed to reduce commercial property losses.

Commercial auto losses continued to deteriorate in the third quarter of 2016 due to an increase in frequency and severity of claims. Our experience is similar to what we are seeing throughout the industry right now, which we believe is attributable to an increase in miles driven, a reduction in the unemployment rate, and distracted driving.

We are currently asking for and receiving rate increases on our commercial auto, new business and renewal premiums. We are currently asking for and receiving rate increases between 5% and 10% depending on the region.

Along with implementing these rate increases in many of the states we write, we've also taken several initiatives to reduce commercial auto losses, including re-underwriting several of our accounts, lowering some of the limits we offer, and expanding into new initiatives in the areas of predictive analytics and telematics.

Similar to the second quarter, our loss ratio on workers' compensation deteriorated in the third quarter. In the third quarter, our loss ratio on workers' compensation increased 22 points over an unusually low loss ratio in the third quarter of 2015. We attribute this change to an increase in severity of claims over $100,000. Despite the increase, the loss ratio continues to be within our expectations for this line of business. Our workers' compensation losses can be volatile quarter-over-quarter. Therefore, we will continue to monitor this line of business.

During the third quarter, we continued to see competitive market conditions for both renewals and new business. Renewal pricing for both commercial lines and personal lines averaged in the low single digits. We had the most success with increases in commercial auto and commercial property lines of business, offset by a decrease in workers' compensation rates. This is the 20th consecutive quarter of commercial lines pricing increases on our overall book of business. The increases in our personal lines continue to be in homeowners and personal auto lines of business.

Premium and policy retention remained strong at 85% and 83% respectively, with changes from the prior quarter of less than 1% respectively. Our success ratio on quoted accounts was down 1% from the prior three quarters, but remains at an acceptable level. We continue to be most successful on accounts with premiums less than $25,000.

During the third quarter, property and casualty premiums written increased 8% as compared to the third quarter of 2015; 3% is attributed to new business and the remaining increase is due to rate changes, endorsements, audits and exposure increases.

Year-to-date, property and casualty written increased 10% as compared to the same period of 2015; 3% is attributable to new business. The remaining increase is due to rate changes, endorsements, audits, and exposure increases.

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

Dawn Jaffray
Thanks, Mike, and good morning. For the third quarter of 2016, we reported consolidated net income of $12.4 million or $0.48 per diluted share compared to $19.5 million or $0.77 per diluted share in the third quarter of 2015.

Through nine months 2016, year-to-date, consolidated net income was $37.9 million and $1.47 per diluted share as compared to $58.2 million and $2.31 per diluted share in 2015. The decrease in net income in the third quarter and year-to-date as compared to 2015 is primarily due to an increase in large losses and an increase in catastrophe losses previously discussed by Randy and Mike.

Our shareholders' equity increased 9% to $959 million at September 30, 2016 from $879 million at December 31, 2015. Book value increased $2.89 to $37.83 at September 30, 2016 from $34.94 at December 31, 2015. The increase in shareholders' equity and book value are primarily due to net income of $37.9 million and an increase in unrealized investment gains of $51 million.

Consolidated unrealized investment gains were $179.8 million at September 30, 2016.

Return on equity was 5.5% in the first nine months of 2016 compared to 9.3% in the first nine months of 2015. The decrease in ROE as compared to the same quarter last year was primarily due to a combination of decrease in net income and increase in shareholders' equity.

Losses and loss settlement expenses increased by $32 million or 22% during the third quarter 2016 as compared to the third quarter of 2015. On a year-to-date basis, losses and loss settlement expenses increased by $78 million or 18% compared to the same period of 2015. The primary driver of the increase in third quarter is large losses and catastrophe losses, as we previously mentioned.

As has been historical reserving practice at UFG, we set initial reserves conservatively. As a result, we often have favorable reserve adjustments that vary from year-to-year across our book of business.

Favorable reserve development for the third quarter 2016 was $0.7 million, which was flat as compared to the third quarter of 2015. The impact on net income for the third quarter in 2016 was $0.02 per share, which is flat as compared to the third quarter of 2015.

On a year-to-date basis, favorable reserve development for 2016 totaled $27.1 million compared to $24.1 million in 2015. The impact on net income in 2016 was $0.68 per share compared to $0.62 per share in 2015.

Two lines together provide the majority of the favorable reserve development in the first nine months of 2016. The largest contributors to our favorable development were commercial liability, with $16.4 million, and workers' compensation with $11.5 million. All of these lines benefited from successful claims management and continued successful management of litigation expenses. The favorable development is attributable to reductions in reserves for loss adjustment expenses, which continue to benefit from continued successful management in our litigation area. These lines were slightly offset by $6.9 million of adverse development in the commercial fire line of business which experienced an increase in paid claims.

The combined ratio in the third quarter 2016 was 100.9% and 99.5% year-to-date; 2015, comparative, were 94.1% for the third quarter and 93.9% year-to-date. Removing the impact of catastrophe losses in reserve development, our core loss ratio deteriorated 5.8 percentage points in the third quarter and 1.9 percentage points year-to-date when compared with 2015 results.

The primary drivers of the deterioration in the core loss ratio are an increase in large commercial fire losses, increase in commercial auto and workers' compensation losses, as previously mentioned.

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

Moving on to investments, consolidated net investment income was $26.7 million for the third quarter of 2016 or an 11% increase as compared to $24.1 million in the third quarter 2015. Year-to-date 2016 consolidated net investment income was $73.4 million, which represents a 1% decrease when compared to 2015.

The increase in net investment income for the quarter was primarily driven by the change in value of investments in limited liability partnerships as compared to the same period of 2015, and not due to a change in our investment philosophy. This resulted in $3.8 million increase in investment income during the third quarter 2016 as compared to the same period of 2015. Year-to-date, the decrease in investment income is primarily due to a declining reinvestment interest rate in our life portfolio.

With respect to capital management activity, during the third quarter, we declared and paid a $0.25 per share cash dividend to stockholders of record on September 1, 2016. I emphasize that we have consistently paid a quarterly dividend every quarter since March of 1968.

Under our share repurchase program, we may purchase United Fire common stock from time to time on the open market or through privately negotiated transactions. The amount and timing of any purchases will be at management's discretion and will depend on a number of factors, including the share price, general economic and market conditions, and corporate and regulatory requirements.

During the third quarter, we repurchased 67,492 shares of our common stock at an average price of

$42.48 and a total cost of $2.9 million. We are authorized by the board of directors to purchase an additional 2,961,394 shares of common stock under our share repurchase program, which expires in August 2018.

And with that, I'll 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 touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star and then two. At this time we will pause momentarily to assemble our roster.

Our first question comes from Paul Newsome of Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning. Could you walk through the loss ratio deteriorations for property, auto and workers' comp and talk about the prospects of whether or not those loss ratios will improve prospectively, given what you're doing at the moment, and how quickly you think that could change?

Randy Ramlo
Well, the tough part of that question is how quickly that can change.

On the workers' compensation part, we had some deterioration, but we're far from a disaster. That line was pretty good last year, better than, I think we said better than we probably expected it to be. Commercial auto, I think the good news there is it's kind of an industry problem. So, I think a problem is always easier to cure if everybody's kind of feeling the same pain.

So far, I think this is still something we can cure through rate increases and we've filed for rate increases already and those rate increases are going in fairly successfully. We also have had a lot of really large losses and have had to change our stance on providing large umbrellas on some heavier fleets on commercial auto. I think that'll help very quickly because I think we're pretty much around the horn on reducing the umbrella coverage on a lot of the auto fleets.

Mike mentioned that we have some analytics projects underway, specifically a pilot program. And I think that will have some pay off, certainly within 12 months. And then the commercial fire, the couple areas there that we did an audit and took a look at our property book. A couple of things that we found is not always having diligent implementation of loss control recommendations, and not on large accounts, but more on medium-size accounts. So, a lot of times, small insureds aren't able to implement loss control recommendations. So, we have to do a better job of making sure that if we have loss control recommendations, we get them implemented or get off the account.

And then the last thing we found is that we probably have to do a little bit better job of underwriting older buildings. Specifically, we have a church program that inherently—churches are often very old. So, we have to, again, make sure loss control recs implemented. But, hopefully, we can see some improvement in these loss ratios certainly by the first part or the second quarter of next year.

Paul Newsome
And then maybe a broad question here. Your slides that came out about the same time of the call talked about a 2020 goal of increasing the return on equity. Maybe you could just walk through what

the levers you're going to pull to achieve that goal?

Randy Ramlo
First of all, we have to get the three lines we talked about earlier under some better control. We probably have some branches that need to become a little bit more profitable. We're having good success with growth, and kind of interestingly, the branches that are growing the least actually have some of the more elevated loss ratios.

So, we'll continue to be diligent on rate. We think that's always a way to help things. We think property diversification, which part of our Mercer acquisition, we hope that we can continue to see the contribution of cat losses slowly coming down in years to come. So, hopefully, growing property in especially the western states and parts of the Northeast can help with those things. Those are some of the levers that we will continue to pull.

Paul Newsome
Great. Thanks. Appreciate it.

Randy Ramlo
Thank you, Paul.

Operator
Again, to ask a question please press star then one.

There being no more questions, this concludes our question and answer session. I would like to turn the conference back to Randy Patten for any closing remarks.

CONCLUSION

Randy Patten
This now concludes our conference call. As a reminder, a transcript of this call will be available on the company website at ufginsurance.com. On behalf of the management of United Fire Group, I wish all of you a pleasant day. Thank you.

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