United Fire Group

Q4 and Full Year 2017 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Randy Ramlo, *Chief Executive Officer*

Michael Wilkins, *Chief Operating Officer*

Dawn Jaffray, *Chief Financial Officer*

Randy Patten, *Assistant Vice President, Finance & Investor Relations*

PRESENTATION

Operator
Good morning. My name is Brandon, and I'll be your conference operator today. At this time, I would like to welcome everyone to the United Fire Group Fourth Quarter and Full Year 2017 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 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

I would now like to turn the call over to Randy Patten, AVP of Finance and Investor Relations. 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. The press releases and slides are located under the Investor Relations tab.

Our speakers today are Chief Executive Officer Randy Ramlo; Michael Wilkins, our Chief Operating Officer; and Dawn Jaffray, Chief Financial Officer.

Please note that our presentation today may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The company cautions investors that any forward-looking statements include risks and uncertainties and are not a guarantee of future performance. These forward-looking statements are based on management's current expectations, and we assume no obligation to update them. The actual results may differ materially due to 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 UFG.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to the UFG Insurance Fourth Quarter and Full Year 2017 Conference Call.

Earlier this morning, we reported consolidated net income of $1.81 per diluted share, adjusted operating income of $1.78 per diluted share, and a GAAP combined ratio of 93.8% for the fourth quarter of 2017. This compares with net income of 46 cents per diluted share, adjusted operating income of 46 cents per diluted share, and a GAAP combined ratio of 102.6% for the fourth quarter of 2016.

For the full year 2017, we reported net income of $1.99 per diluted share, adjusted operating income of $1.79 per share, and a GAAP combined ratio of 104%. This compares with full year 2016 net income of $1.93 per diluted share, adjusted operating income of $1.78 per diluted share, and a GAAP combined ratio of 100.3%.

Our fourth quarter and year-end 2017 results benefited from the Tax Cuts and Jobs Act which passed into law on December 22, 2017. The impact of this change added 86 cents per diluted share to adjusted operating earnings in the fourth quarter. Removing the impact of the tax law change, adjusted operating earnings were 92 cents per diluted share for the fourth quarter, which is an increase of 46 cents per diluted share compared to the fourth quarter of 2016. Dawn will be providing additional details on the financial impact of the tax changes later in this conference call.

During the fourth quarter of 2017, we began to see improvements in our core loss ratio, including a decrease in our commercial auto and commercial property losses. As a company, we have several initiatives in place to return our auto line of business to the acceptable level of profitability, which includes continuing to aggressively increase pricing on our auto business. We believe we are gaining traction in our auto lines and will continue our initiatives to improve profitability going forward.

During the fourth quarter of 2017, catastrophes were manageable, with CATs adding 2 percentage points to the combined ratio compared to 3.6 percentage points in the fourth quarter of 2016. The CAT load for the fourth quarter of 2017, is lower than our ten-year historical average of 6 percentage points. For the full year 2017, CATs added 7.4 percentage points to the combined ratio, up from 6.5 percentage points in 2016. The ten-year historical average for CATs has been 7.3 percentage points, so 2017 was right in line with our historical performance.

For the full year 2017, the hurricanes during the third quarter had the most significant impact, accounting for $22 million, or approximately 30%, of our total 2017 CAT losses. The wildfires in California accounted for $2 million of our CAT losses in 2017.

Moving on to expenses, our expense ratio increased to 33.3% in the fourth quarter of 2017 as compared to 30.2% in the fourth quarter of 2016. This increase is primarily due to the deterioration in profitability of our auto lines of business, which accelerates the amortization of our deferred acquisition costs. For the year, our expense ratio was 31.2% compared to 30.6% in 2016. So despite the increase in the fourth quarter, our full year 2017 expense ratio continues to meet our expectations at around 31 percentage points.

2017 was a year that definitely had its up and downs. UFG, like the industry overall, continued to battle a deterioration in performance in our commercial and personal auto lines of business. We expect to return these lines back to our desired level of profitability with aggressive rate increases and other initiatives. In 2017, UFG also incurred losses from three powerful hurricanes and devastating wildfires in California. The diligence and proactive efforts of our claims staff allowed us to minimize the impact on our policyholders and agents and return them to a sense of normalcy as quickly as possible.

In addition to these large catastrophes, in 2017, the industry endured the second most costly severe connected storm season in the US in a decade. UFG was no different than the industry. The majority of our remaining catastrophe losses in 2017 were from severe connected storms. I believe it is worth noting that in both these cases, our selective underwriting minimized our losses from any individual CAT event. Finally, signs of improvement in our underlying core loss ratio in our commercial auto and commercial property lines, has us headed in the right direction.

Looking forward to 2018, we are still on track to close our previously announced sale of our life insurance business in the first half of 2018. As we stated previously, the proceeds from the sale will be used for various capital initiatives, which may include share repurchases, regular and extraordinary dividends, and potential future acquisitions.

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

Michael Wilkins
Thanks, Randy, and good morning, everyone. As Randy indicated, we had some improvement in our core loss ratio in the fourth quarter of 2017, driven by a decrease in severity in our commercial auto and commercial property lines of business. We are making progress in our ongoing efforts to improve profitability in our commercial and personal auto lines of business, with the initiatives we have discussing all year, and we will continue to push rate increases, while keeping a close eye on these lines during 2018. All of our agents will also be reviewing our underperforming accounts and taking appropriate rate and underwriting actions necessary to return these lines to profitability.

In the fourth quarter of 2017, we had 18 large commercial auto claims compared to 24 large commercial auto claims in the fourth quarter of 2016. For the full year, we had 63 large commercial auto claims compared to 45 large claims in 2016. This reduction in frequency of large losses during the fourth quarter is encouraging, and we look forward to seeing the benefits of our auto initiatives carry on into 2018. On Slide 10 of our slide deck, we have provided a breakdown of the geographic distribution of the large commercial auto claims received for the full year 2017.

Our risk control representatives are continuing to focus their efforts on accounts with significant auto exposure. These efforts include ensuring that our commercial policyholders have acceptable hiring practices, driver screening practices, vehicle use policies, and vehicle maintenance policies in place and that they are being enforced. Also recently, we began working with selected automobile accounts to implement an app-based telematic solution to monitor and prevent distracted driving practices by insured drivers. The new app will provide information on miles driven, hours driven, number of drives, drive times a day, drive durations, drive locations, routes, mobile distractions, and also will provide data on hard stops, acceleration, and speed.

We are also continuing to grow our Enterprise Analytics Department and look forward to the additional capabilities this department will provide to our underwriting teams in both risk selection and pricing. Enterprise Analytics is also directly involved in our OASIS Initiative, which is a multiyear project to modernize our policy processing system and transform the way we do business, allowing us to incorporate data and analytics into our daily decision-making. The initial phase of this project is complete, and we expect to make substantial progress in the year ahead, with support and guidance from over 50 employees serving on the OASIS Team.

For commercial property, similar to our commercial auto initiatives, we implemented several strategies in 2016 to address our underperforming commercial property book. In the fourth quarter of 2017, we began to see some improvement in this line due to these initiatives. In particular, we have seen significant reduction in fire losses during 2017 as compared to 2016. We believe the fire results are benefiting from an increased focus on loss control in this line, including the use of infrared imaging technology. Additionally, there has been an increased focus on underwriting discipline for older buildings and certain classes of business.

Moving on to market conditions, during the fourth quarter of 2017, market conditions were competitive on both renewal and new business across all regions. The average renewal pricing change for commercial lines increased by low-single digits, primarily driven by an increase in commercial auto pricing. Filed commercial auto rate increases processed during the quarter averaged in the low-double digits and commercial property increases averaged in the mid-single digits. Filed workers got some compensation rate decreases averaged in the mid-single digits.

Personal line's renewal pricing also increased with average percentage increases in the low-single digits, and filed rate increases processed during the quarter averaged in the upper-single digits. All regions continued to aggressively address our poor performing accounts through non-renewal of significant rate increases.

During the fourth quarter of 2017, premium and policy retention remained strong at 84% and 81%, respectively. Our success ratio on quoted accounts decreased 1 percentage point from the prior quarter, to 27 percent. This decrease, similar to the third quarter, was largely driven by a significant drop in the success rate of our Specialty Division, resulting from a large increase in quote requests for this division, again in the fourth quarter. As we continue to address the deterioration in our book of business, our expectation is that premium and policy retention may be negatively impacted.

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

Dawn Jaffray
Thanks, Mike, and good morning. For the fourth quarter of 2017, we reported consolidated net income of $46 million compared to $12 million in the fourth quarter of 2016. For the year ended 2017, consolidated net income was $51 million, compared to $49.9 million in 2016. The increase in net income in the fourth quarter and full year over the comparable period is due to prior year favorable reserve development, improvement in our core loss ratio, as Randy and Mike have discussed, and changes in the corporate tax rate resulting in a one-time adjustment to net income.

UFG realized the tax benefit of $21.9 million associated with remeasuring our deferred tax liability under the new lower corporate rates that will be in effect in 2018 and beyond. In simple terms, the deferred tax asset on the balance sheet reflects an opportunity for our future tax deduction, and our deferred tax liability reflects the future taxable income amount. However, I note it is not as simple as just applying a rate change from 35% to 21%, as various other tax rules create permanent and temporary timing differences between accounting for income taxes and actual corporate income tax payments.

UFG's effective rate, which can vary as a function of the amount of pre-tax income or loss, has historically been in the range of 21%. Although subject to variability in any year, we anticipate our effective tax rate will approximate 15% to 17% on average under the new tax code. One of the more significant items potentially impacting property and casualty companies will be the requirement to discount loss reserves based solely on IRS factors, and using company payment patterns will no longer be permitted. With bonus depreciation being increased to a 100% write-off for assets with a depreciable life of 20 years or less, we may see capital investments increase across our commercial client base. So, in analyzing the impact of the new tax bill, we view it as a positive development for UFG as well as for our commercial policyholders. We will continue to refine our calculations as more definitive guidance is issued.

Moving on to premiums, consolidated net premiums earned increased 2.6% in the fourth quarter of 2017 as compared to 2016, while total revenues were flat. Year-to-date consolidated net premiums earned increased 3.5%, total revenues increased 2.8% as compared to 2016, with resulting increases in property and casualty continuing operations premium being offset by decreases in discontinued life insurance business premium.

Consolidated net investment income of $25.1 million for the fourth quarter 2017, a decrease compared to fourth quarter 2016, was $33.4 million. For the full year 2017, investment income was $100.9 million, or a 5.5% decrease over 2016. The decrease in net investment income in the fourth quarter and full year 2017 was primarily driven by the change in value of our investments in limited and liability partnerships as compared to the same periods in 2016, and not due to a change in our investment philosophy.

In looking at only our property and casualty insurance business or our continuing operations, we reported consolidated net income of $1.78 per diluted share and $1.75 per diluted share in the fourth quarter and full year 2017, respectively, as compared to net income of 46 cents per diluted share and $1.90 per diluted share in the same periods of 2016.

Net premiums earned from our continuing P&C operations grew by 6.5% and 6.6% in the fourth quarter and full year 2017 as compared to the same periods in 2016. As we have discussed in our previous conference calls, our expectation for premium growth in 2017 was 4% to 6%. We will emphasize profitable growth initiatives along with continued rate increases, expecting year-over-year growth rates to remain in a similar range for 2018.

We experienced favorable reserve development of $16.3 million in the fourth quarter of 2017 compared to $4.2 million of favorable development in the fourth quarter of 2016. For the full year 2017, favorable reserve development was $54.3 million, compared to $31.2 million for the same period 2016. The impact on net income for the fourth quarter and full year in 2017 was an increase of 42 cents and $1.38 per diluted share compared to an increase of 10 cents and 79 cents per diluted share in the same periods of 2016.

To expand further on our reserve development in the fourth quarter of 2017, the biggest driver was favorable development in our fire and allied line of business. For the full year 2017, a majority of the favorable development was from other liability lines and worker's compensation, partially offset by reserve strengthening in our assumed re-insurance line. Our full year reserve development of 5.4 percentage points of the combined ratio is slightly below our five-year and ten-year averages of 5.8 and 5.7 percentage points. At December 31, 2017, total reserves were within our actuarial estimates.

The combined ratio in the fourth quarter 2017 was 93.8% compared to 102.6% for the fourth quarter 2016. For the full year 2017, combined ratio was 104% compared to 100.3% for the same period in 2016. Removing the impact of catastrophe losses and reserve development, our core loss ratio improved by 5.7 percentage points in the fourth quarter and deteriorated 4.3 percentage points for the full year of 2017 as compared with 2016. The primary driver of the deterioration in the core loss ratio is an increase in the number of severe commercial auto losses in the first three quarters of 2017, as previously discussed. Referring to Slide 9 in the slide deck on our website, we have provided a detailed reconciliation of the impact of catastrophes and development on the combined ratio.

Return on equity was 5.3% in 2017 compared to 5.5% in 2016. Even though net income was slightly higher in 2017 compared to 2016, the decrease in ROE is attributed to a higher denominator equity base.

During the fourth quarter, we declared and paid a 28 cent per share cash dividend to stockholders of record on December 1, 2017. We have paid quarterly dividends every quarter since March of 1968.

During the fourth quarter, we did not repurchase any shares of our common stock. For the full year 2017, we repurchased 701,899 shares of our common stock for a total cost of $29.8 million. We purchase United Fire common stock from time to time on the open market or through privately negotiated transactions as the opportunity arises. The amount and timing of any purchases is at management's discretion and depends on a number of factors, including the share price, general economic and market conditions, and corporate and regulatory requirements. We are authorized by the Board of Directors to purchase an additional 2.2 million shares of common stock under our share repurchase program which expires in August 2018.

And, with that, 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 1 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, then 2. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Brian Hollenden with Sidoti. Please go ahead.

Brian Hollenden
Good morning, and thanks for taking my questions.

Randy Ramlo
Hi, Brian.

Brian Hollenden
Yes, commercial auto, you know, the large losses from commercial auto by region, any—I guess why is the West Coast and Great Lakes regions so much worse than, let's say, the East Coast and Gulf Coast? Can there any—can there by anything done there to improve those results? You know, what's going on particularly in the West Coast?

Randy Ramlo
Well, maybe I'll let Mike answer in more detail, but I think there's kind of a lot of factors. It's a little bit the type of books of business differ slightly by the branches. I mean, a little bit of it's underwriting. Some of it is a little bit more heavy vehicles written, and then, you know, court jurisdictions are part of the factor too. Mike, you got some things to add to that maybe?

Michael Wilkins
Yes, Brian, one thing I'd say is for a lot of these regions, correlations are based on how much premium they write, so, for example, Great Lakes is our second largest auto region, and the East Coast is by far our smallest, so that's part of the reason—the difference there—the one outlier would be West Coast office, and, you know, a couple things play into that. One, they tend to write more heavy wheel exposures, which tend to generate more severe losses. And then the second thing, as Randy mentioned, is jurisdiction. And just that state, if you look at

national statistics, there have been a lot more auto issues in that state, a lot of congestion, just tend to see higher frequency and severity in the state of California than a lot of the other states.

Brian Hollenden
Thanks. And then just by segment, I mean, fire and allied lines and worker's comp, there's pretty significant improvement in the net loss ratio. Anything in particular that you guys are doing different on the underwriting side, you know, to generate those — put significant improvements?

Randy Ramlo
I think on the property, probably the biggest thing is age of building. We've kind of become a lot more strict on older buildings, and then on the work comp, we're down in that line. I think if anything else that—as premiums are going down in that line, we've probably walked away from more businesses as the pricing goes down. Mike, you got anything you want to add?

Michael Wilkins
Yes, you know, property in particular has been a line of focus for us, and we're probably most pleased with the reduction in fire loss ratio. Between 2017 and 2016, our storm losses were up quite a bit in the year but still had some improvement in the line, so we feel good about that. On the work comp side, the only other thing I'd throw in there is we've got analytics at play there, which I think is helping, so we've tried to focus on reducing the severity within that book, and I think we're making some progress.

Brian Hollenden
And then the last one for me, just to confirm, Dawn, did you mention the premium growth in '18 of 4% to 6% and effective tax rate between 15% and 17%. Did I hear that correctly?

Dawn Jaffray
Yes, Brian, that is correct.

Brian Hollenden
All right. Thank you.

Randy Ramlo
Thanks, Brian.

Operator
Our next question comes from Paul Newsome with Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning, and thanks for the call. Could you talk a little bit more about capital management and as we approach the big sale of the life operation, and, you know, the mechanics of how you'll go about that and maybe some of the specific statistics of how you look at the, you know, buyback versus special dividend?

Randy Ramlo
Yes, sure, Paul. So I think we've mentioned in the past, we've assembled a capital committee as part of our Board. We've chosen to kind of wait until after the sale to decide what the best use of the proceeds are going to be. We've listed in the conference call some of the areas that we'll consider. I think we've told you in the past, we're maybe not looking for acquisitions as we

have in the past. We're focusing more on organic growth, but we still list that as a possible use, and we continue to look for M&A opportunities, still.

Our stock price will kind of depend. You know, the share buybacks are a function of where our stock is trading, so we'll use that more heavily, obviously, if our share price stays a little bit lower, and special dividends is something we have not traditionally done, but I know that's something also we're going to be talking about going into the future. And then we're kind of continuing to refine our capital analysis and A.M. Best has a new kind of rating system that we would also like to take a look at that to see exactly where we stand capital wise from a minimum required capital, and that will help us make some of our judgments as well.

Paul Newsome
And then separately, my question, in 2018, is regulatory clawback of rates sort of related to the benefits of the corporate tax reform? You know, could you give us your thoughts as to whether or not you think they will materially impact your rate filings and particularly—the issue, I guess, is in California more than other places as well, which is obviously a problem state.

Randy Ramlo
Yes, I probably should have looked up—obviously, when we file rates, you have to load in for your tax rate, so I don't know if it's a one-year or if it's a three-year rolling, but that tax cut will be passed on to our policyholders, certainly within two or three years.

You know, it could be quicker than that, but I think there will be some benefit maybe in the shorter run, but as we continue to file new rates, that new tax rate is going to be reflected in there, so I know California has talked about mandating that the tax cut be returned to the policyholders, but I think the market is going to kind of ensure that that happens relatively quickly.

Michael Wilkins
Paul, this is Mike, I would add a couple of points there. I think there will be more pressure from regulatory bodies on personal auto, which is 3% of our book, than on the commercial side. And the second thing I would say is, you know, with the auto results that we've had, when you look at our rate calculations, the tax will be a very small part of that, and I'm confident we will still have justification for increased auto premiums going forward until we get the numbers back in line with where we want them to be.

Paul Newsome
Great. Thank you very much.

Randy Ramlo
Thank you, Paul.

CONCLUSION

Operator
As a reminder, if you have a question, please press star, then 1. This concludes our question-and-answer session. I would like to turn the conference back over to Randy Patten for any closing remarks.

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

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