United Fire Group, Inc.

2018 Q1 Earnings Conference

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CORPORATE PARTICIPANTS

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

Randy Ramlo – *Chief Executive Officer, President; Director and President, United Life Insurance Company*

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

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

Robert Cataldo – Assistant Vice President and Senior *Portfolio Manager*

PRESENTATION

Operator
Good morning, my name is Denise and I'll be your conference operator today. At this time, I would like to welcome everyone to the UFG Insurance First Quarter 2018 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 touchtone phone. To withdraw your question, please press star, then two. Please note this event is being recorded. Thank you.

I would now like to turn the conference over to Randy Patten, AVP of Finance and Investor Relations.

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 and are not a guarantee of future performance. These forward-looking statements are based on management's current expectations, and we assume no obligation to update them. The actual results may differ materially due to a variety of factors, which are described in our press release and SEC filings.

Please also note that in our discussion today, we may use some non-GAAP financial measures. Reconciliations of these measures to the most comparable GAAP measures are also available in our press release and SEC filings.

At this time, I'm pleased to present Mr. Randy Ramlo, CEO of UFG Insurance.

Randy Ramlo
Thanks Randy. Good morning everyone and welcome to the UFG Insurance First Quarter 2018 Conference Call. Earlier this morning we reported consolidated net income of $1.80 per diluted share, adjusted operating income of $1.00 per diluted share, and a GAAP combined ratio of 93.5% for the first quarter of 2018. This compares with net income of $0.77 per diluted share, adjusted operating income of $0.67 per diluted share, and a GAAP combined ratio of 96.5% for the first quarter of 2017.

On March 30, 2018, the culmination of our previously announced sale of our life company to Kuvare US Holdings was completed. On a GAAP basis, the sales generated an after-tax gain of $27.3 million, or $1.07 per diluted share. Dawn will provide further details on the financial impact of the sale later in this call. As we've stated previously, in addition to investing the proceeds, we are in the process of solidifying various capital management actions for UFG. As a reminder, United Life Insurance Company was a subsidiary of United Fire and Casualty Company, our lead insurance company. As a result, the distribution of any proceeds beyond our traditional dividend capacity limits requires regulatory approval.

In addition to share repurchases, we are pursuing the approval of an extraordinary special dividend beyond what we traditionally pay on a quarterly basis. Although subject to customary approval of the

Department of Insurance, we expect to announce both the amount and the timing of the dividend within the next three-to-six months.

Moving on to P&C operations we are continuing to see some improvement in our auto lines, due to the various initiatives we put in place over the past 18 months, although we still have work to do until these lines return to our desired level of probability. With the continued heightened focus and coordination of our efforts in underwriting, risk control, and analytics on managing our current and prospective book of business, we anticipate continued improvement throughout 2018.

I'm pleased to report that our catastrophes were $3.4 million, or 1.4 points of the loss ratio during the first quarter of 2018, which is below our historical average of 2.6 percentage points in the first quarter. Further, this also compares quite favorably to our first quarter of 2017, which was $9.7 million, or 4.1 points of the loss ratio. Notably, the majority of our CAT losses from the first quarter were from a March hailstorm in southern Texas, our largest state by premium and the remainder resulting from the winter storms in the Northeast.

Moving on to expenses, our expense ratio was elevated at 34.5% in the first quarter of 2018 as compared to 30.3% in the first quarter of 2017. The major drivers for this increase were a combination of factors. First our commercial and personal auto lines have had heightened loss experience. As a result, we must accelerate the timing of our deferred acquisition costs. This calculation uses a view of experience based on the prior quarter end and accordingly doesn't include improvements experienced in the first quarter of 2018. The second largest impact was related to our investment in our Oasis project, which is our multiyear initiative to both upgrade our technology platform, to modernize our analytics capabilities and enhance core underwriting decisions and productivity. Moving forward, we anticipate the Oasis project will add approximately 1.5 to 2 points to the expense ratio annually for the duration of the project.

During the first quarter of 2018, we are celebrating the payment of our 200th consecutive quarterly dividend, demonstrating UFG's continued financial strength and consistency. And finally, now that we've seen some signs of improvement in our commercial and personal auto lines, we are confident we are headed in the right direction and are focused on maintaining this momentum throughout 2018.

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

Michael Wilkins
Thanks, Randy and good morning, everyone. As Randy indicated, we’ve had some improvement in our auto loss ratios. Our profit initiatives targeted at improving these lines including expanded risk control practices, stricter underwriting guidelines, and making sure we're getting adequate rates for the exposure, have all led to this improvement, but we will continue to watch these lines closely throughout 2018. All of our regions continue to review underperforming accounts and are taking necessary underwriting actions and rate increases to ensure we are writing profitable business.

Our continued growth in investment in enterprise analytics is providing additional tools and insights to make better decisions. Enterprise analytics remains an important aspect of our Oasis strategic initiative and will be a key component of our modernized underwriting system. We believe this focus will help revolutionize the way we underwrite and make decisions, including risk selection, pricing, and renewal processing.

Moving on to market conditions, during the first quarter of 2018 we saw an increase in competition for both renewal and new business across all regions. Overall, the average renewal pricing change for commercial lines decreased slightly, with pricing varying depending on region and size of account. Filed commercial auto rate increases processed during the quarter averaged in the high single-digits. The workers compensation line has been very competitive over the past several quarters, our filed workers compensation rate decreases averaged in the mid-single digits during the quarter.

Our personal lines renewal pricing increased during the quarter with average percentage increases in the mid-single digits. We continue to aggressively address poor performing accounts across the country through nonrenewal or significant rate increases. Our premium retention remained strong at 83% during the first quarter of 2018. Going forward, our expectation is that we will see a decrease in our premium and policy retention as we continue to return our auto book of business to profitability.

With that I'll let Dawn Jaffray discuss our quarter one financials, Dawn.

Dawn Jaffray
Thanks, Mike and good morning, everyone. For the first quarter of 2018 we reported consolidated net income of $45.8 million compared to $19.9 million in the first quarter of 2017. The change in net income in the first quarter over the comparable period is due to the following business items: As Randy has mentioned, UFG realized a one-time after-tax gain of $27.3 million associated with the sale of United Life Insurance Company. The transaction received final regulatory approval and concluded with the closing of the sale at the end of the quarter on March 30th, 2018. Previously, on March 30th we reported in our press release and pro forma financials filed with our announcement of the closing of the sale, an estimated after tax of gain $4.5 million. The earlier estimate was based on our December 31st, 2017 issued financial statement and the carrying values of the subsidiary investment. During the first quarter, rising interest rates decreased the value of the fixed maturity portfolio, which also correspondingly decreased the book value of our investment in United Life and this resulted in an increase in the ultimate gain we achieved at March 31st, 2018.

And, as many of our peer companies have reported during the first quarter of 2018, we adopted new accounting guidance, which involves recognizing any changes in the value of equity securities as realized investment gains or losses in net income. Prior to 2018, changes in the value of equity securities were previously recorded in accumulated other comprehensive income in the equity section on our balance sheet. We anticipate that recognizing these gains or losses that have not been realized due to any sale or disposition, will add a level of reporting volatility in net income in any quarter, relative to our portfolio and market conditions. Reporting this change in accounting principles during the first quarter resulted in a net realized investment loss from equity securities of $8.1 million after-tax, or $0.32 per diluted share.

Excluding these two items adjusted operating income improved $8.1 million, or $0.32 per diluted share as compared to the same quarter in the prior year. This improvement was primarily due to a decrease in catastrophe losses and an increase in prior year favorable reserve development. These improvements were partially offset by an increase in expenses from continued investment in our multiyear OASIS project and the acceleration of deferred acquisition costs in our commercial and personal auto lines of business, as Randy mentioned at the beginning of the call.

Moving on to premiums, consolidated net premiums earned increased 1.7% in the first quarter of 2018 as compared to 2017. Our property and casualty continuing operations net premiums earned increased by 3.7%. This was offset by a 25.4% decrease in net premiums earned from our discontinued life insurance business. We continue to be focused on profitable growth initiatives, expense management, and achieving rate increases as we've previously discussed.

Consolidated net investment income was $26.2 million for the first quarter of 2018, an increase of 4.5% compared to the first quarter of 2017. The increase in net investment income for the quarter was driven by an increase in invested assets and the change in the value of our investments in limited liability partnerships and not due to a change in our investment philosophy. The valuation of these investments and limited liability partnership varies from period to period due to current equity market conditions specifically related to financial institutions.

With the new accounting requirements for reporting, as previously mentioned, with the recognition of the change in value of equity securities now flowing through revenue, total revenues decreased 2.7%. Excluding the change in net realized investment losses on equity securities, revenues increased 1%.

Taking a deeper look at only our property and casualty insurance continuing operations, we reported consolidated net income of $0.80 per diluted share in the first quarter of 2018 compared to net income of $0.72 per diluted share in the same period of 2017.

We experienced favorable reserve development of $38.1 million in the first quarter of 2018, compared with $24.9 million of favorable development in the first quarter of 2017. The impact on net income for the first quarter of 2018 was an increase of a $1.18 per diluted share, compared to an increase of $0.63 per diluted share in the same period of 2017.

Expanding further on reserve development, during the first quarter of 2018 we saw favorable development across all lines of business, except assumed reinsurance. The biggest driver of our favorable development was in our other liability line of business followed by commercial auto and commercial property. Our first quarter 2018 reserve development of 15.5 percentage points of the combined ratio exceeded the 10.6 percentage points of reserve development, we reported in first quarter of 2017. At March 31st, 2018, total reserves remain within our actuarial estimate.

The combined ratio in the first quarter 2018 was 93.5% compared to 96.5% for the first quarter 2017. Removing the impact of catastrophe losses in reserve development, our core loss ratio was up very slightly by 0.4 of a percentage point as compared with first-quarter 2017. Referring to slide nine in the slide deck on our website, we've provided a detailed reconciliation of the impacts of catastrophe and development on the combined ratio.

Annualized return on equity was 11% during the first quarter of 2018 compared to 8.4% in the first quarter of 2017. Moving on to our return to our shareholders, during the first quarter, we declared and paid a $0.28 per share cash dividend to stockholders of record on March 7th, 2018. As Randy mentioned, we have paid quarterly dividends every quarter since March of 1968 making this our 50th consecutive year of paying quarterly dividends to shareholders.

Also, of note during the first quarter, we repurchased 120,372 shares of common stock at an average price of $44.90, which totaled $5.4 million. We purchase United Fire common stock from time to time on the open market or through privately negotiated transactions as the opportunity arises. As always, the amount and timing of any purchase will remain within management's discretion and depends on a number of factors, including the share price, general economic and market conditions and corporate and regulatory requirements, including SEC rules on restricting the amount of any purchases associated with the available float, when purchasing in the open market. We are authorized by the Board of Directors to purchase an additional 2.1 million shares of common stock under our share repurchase program, which expires in August 2018.

With that, I will now open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator
Thank you. We will now being 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. If at any time your question has been addressed and you would to withdraw from the queue, you may do so by pressing star, then two.

And your first question will be from Paul Newsome of Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning. Congratulations on the bottom line number and on the sale of the Life Company. I'd like to ask about the increase in expenses, and maybe talk about expected payout for this over time. You said it was a multiyear project. Is this essentially something that's permanent that you kind of want to go from a 30 to 32 expense ratio prospectively and think that's kind of the right way to go? Just give us a little sense of what you think in terms of how that's going to return, an increase in expenses will return favorable profitability perspective and the timeframe of that.

Randy Ramlo
We are redoing our policy processing platform with that building in some more additional analytics tools with that, we mentioned it in our conference call, the Oasis project. It's required us to hire some additional IT and PMO staff, and purchase some additional hardware and software items. We do think it's going to add, 1.5 to 2 points, but not forever. This project is basically a five-year project and we're kind of one year into it. And then we think we'll be able to also see some efficiencies. It could also help the expense ratio as well. Mike do you have anything further to add there?

Michael Wilkins
I would echo Randy's comments, I think post implementation we're looking at probably a half point to a point additional expense with the new system, but as Randy said we hope to offset that with efficiencies gained and productivity.

Paul Newsome
How quickly could those productivity gains show up? Or in five years, I'd be happy if I still have a job in five years, let alone owning your stock. So, that is essentially permanent, five years is essentially permanent from our perspective, do these efficiencies show up after five years or is it something we'd see in the next year or two?

Michael Wilkins
You won't see it in the next year or two, Paul, it would be down the road. We won't implement the first parts of the system for, it's over a year away before we start implementation. And then it'll be five years before we fully implement, so we won't see the productivity gains in the short run. We also hope to see loss ratio improvements from the better analytical tools that we'll have built into the system and the underwriting dashboard that we're building and better tools for the underwriters to make their decisions.

Paul Newsome
So, second question, a different one, the conclusion I guess, is it's a permanent increase in expenses. The second question I have is on pricing. Your result of slightly down is different than every other company that I cover, and particularly in the small middle-market commercial area. What about your book makes you different from other companies that would give you that sort of adverse result? Is there something, are you more workers comp than others, or some other sort of thought here that would make you so different? I mean other companies are talking up 2% or 3%. You're down something, that's kind of a big difference.

Michael Wilkins
Paul, we did a poor job of wording that. So we were not down. We are still getting rate increases on the

commercial side. We were getting less rate increases than we got fourth quarter. So during 2017 we saw the rates pick up every quarter, so second quarter was higher than first, third quarter was higher than second, and fourth quarter was our best quarter as far as being rate increases last year. Q1 was down a little bit from Q4, but still positive, and I would say in that low single-digit range that you're talking about. We measure exposure and pricing in our system and our exposure plus pricing increase was 5% in the quarter, so you figure a couple of points of that's probably exposure growth we're probably looking at around 3%.

We still saw momentum building on the commercial auto pricing. We had pricing increases of over 9% in commercial auto line and that was up from 7.5% in the fourth quarter, so saw momentum building there. But other lines definitely saw some competition pick up, probably picked up the most in work comp, which is a small line for UFG. It's about 12% of our premiums, which is quite a bit smaller than our peer group on the work comp side, but also I would say large accounts in particular quality large accounts we saw competition pick up in the first quarter and just felt a little more competitive out there. But, still had increases, just not—decelerating from Q4.

Paul Newsome
Okay, okay that makes much more sense, thank you, I'll let some other folks ask questions.

Operator
And once again, if you would like to ask a question, please press star, then one. And we'll pause just a moment for any additional questions.

And the next question will come from Brian Hollenden of Sidoti, please go ahead.

Brian Hollenden of Sidoti
Yes, good morning and thanks for taking my question. Just wanted to follow-up on the sale just closed of the Life Insurance Company, I guess just potential timing for any one-time special dividend, any acquisitions that you're looking at, maybe you could just give us some characteristics of things you're looking at and maybe what the issue is, in terms of not being able to purchase anything to date. Is it just price, is it the book of business, maybe you can just talk broadly about your after-tax proceeds, thanks.

Randy Ramlo
Brian, thanks for the call. We do continue to look for acquisitions, prices are maybe a little bit of a factor right now. But probably more of a factor for us is just we really haven't found the exact very good fit. If you look at the publicly traded universe of insurance companies that are smaller than us, it's a pretty small group and so we've, kind of going back to 2011, made a more concentrated effort on organic growth, which has worked very well for us and we also think is a lot less risky. So we've really kind of been focusing on organic growth, even though we continue to look for acquisitions fairly regularly. We just really haven't found a lot and maybe haven't got a lot of confidence that there's a whole lot out there. So, we'll continue to grow organically.

We don't mean to be vague about the timing of a special dividend, but we are subject to regulatory approval and that can always be a little bit of a wild card, even though we don't anticipate any issues, we've been in communications with Iowa's insurance department and we feel very good but the three to six-month timeframe that we put in the transcript that's just kind of the best estimate that we have right now.

Dawn Jaffray
And Brian, for the record, our statutory gain on the sale transaction after tax is about $106 million, obviously that's different, and that's going to weigh in relative to the decision from the Department of

Insurance, Iowa, in approving any special or extraordinary dividend that we're seeking.

Brian Hollenden
Thank you. That's very helpful. And then, maybe just on the overall portfolio consolidated income yield down couple of basis points year-over-year. I guess with the questions with rising rates, at what point is sort of weighted-average income yield kind of tick up or turnaround?

Robert Cataldo
This is Bob Cataldo. I'm a Portfolio Manager within the Investment Department. We're starting to see those yields pick up now with money we're redeploying back into the market. We're still staying very liquid, same high quality and consistent with our investment philosophy, but we are experiencing an improvement in investment yields as we continue to redeploy cash.

Brian Hollenden
And then can you just remind us, what's your sort of weighted-average duration there on your fixed-income portfolio?

Robert Cataldo
Right around five years and we intend to keep it within that range.

CONCLUSION

Operator
And ladies and gentlemen this will conclude our question-and-answer session. I would like to hand the conference back over to Randy Patten for closing remarks.

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

Operator
Thank you, sir. Ladies and gentlemen, the conference has concluded. Thank you for attending today's presentation. At this time, you may disconnect your lines.