United Fire Group, Inc.

Second Quarter 2018 Earnings

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CORPORATE PARTICIPANTS

Randy Patten - *AVP, Finance and Investor Relations*

Randy Ramlo - *President, Chief Executive Officer*

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Dawn Jaffray - *SVP, CFO*

Barrie Ernst - *VP, CIO*

PRESENTATION

Operator
Good morning. My name is Stephen, and I'll be your conference operator today. At this time I would like to welcome everyone to the UFG Insurance second 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 telephone keypad. To withdraw your question please press star then two.

I will now turn the call over to Randy Patten, AVP of Finance and Investor Relations.

Randy Patten
Good afternoon, 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 second quarter 2018 conference call. Earlier this morning we reported consolidated net income of $0.01 per diluted share and adjusted operating loss of $0.03 per diluted share and a GAAP combined ratio of 107.9% for the second quarter of 2018. This compares with net income of $0.12 per diluted share, adjusted operating income of $0.05 per diluted share and a GAAP combined ratio of 107.2% for the second quarter of 2017.

Looking at just our property and casualty insurance operations, although our second quarter 2018 net income was comparable to second quarter last year with both periods earning $0.01 per diluted share, we know we need to continue our efforts at improving our core results. In both periods we had an elevated level of losses. However, the composition of these losses in each period is different. In the second quarter of 2018 losses were driven by an increase in severity of non-catastrophe losses as compared to the same period of 2017, which experienced catastrophe losses above our historical averages. Mike will discuss our operational results in more detail in a few minutes.

Moving on to expenses, our expense ratio was higher at 34.3% in the second quarter of 2018 as compared to 30.3% in the second quarter of 2017. As we mentioned in previous conference calls, the increase in the expense ratio is primarily split between two items. First, we have invested in our multi-year Oasis project to upgrade our underwriting technology platform to modernize our analytic capabilities and enhance decisions and productivity. As a reminder, we anticipate the Oasis project will add approximately 1 to 2 points to the expense ratio annually for the duration of the project. Second, since our commercial and personal auto lines have had heightened loss experience, we are required to accelerate the timing of our deferred acquisition costs, or simply, immediately expense those costs against net income. Our calculation uses a view of experience based on the prior quarter end. As we see improvement in future quarters in our auto lines of business, the acceleration of these costs through immediate expensing will decrease.

During our first quarter earnings conference call I mentioned that we were pursuing regulatory approval for a special cash dividend. As you may be aware, our Board of Directors declared a special cash dividend for $3.00 per share, which we previously announced in a press release on July 24, 2018. The dividend is payable on August 20, 2018 to shareholders of record as of August 3, 2018. We remain confident that our decision to sell United Life was in the best interest of our shareholders, agents, employees and UFG. We are now pleased to share the profits from this sale with our shareholders, returning a majority of the statutory gain from the sale through this special cash dividend. The special cash dividend benefits our shareholders while allowing UFG to continue building upon the success of our property and casualty operations together with the future strategic opportunities, share repurchases and capital initiatives.

It is also important to note the significance of the special cash dividend in our recent history. With this dividend UFG has returned over $250 million to shareholders through regular, quarterly and special dividends and share repurchases since 2013. With that, I will turn over the discussion to Mike Wilkins. Mike?

Michael Wilkins

Thanks, Randy, and good morning, everyone. As Randy mentioned, our second quarter 2018 results were impacted by an increase in severity of non-catastrophe losses, which we define as losses greater than $500,000. This increase in severity of losses was primarily in our other liability and workers compensation lines of business, of which a number of these were commercial auto liability related claims. We’ve had some improvement in our commercial auto loss ratio in the first half of 2018 compared to prior year, but we remain unsatisfied with the level of our improvement. On a positive note, we are seeing a decrease in frequency of claims in our commercial auto book and a decrease in our exposure units. However, the improvement is somewhat muted by an increase in the severity of bodily injury claims overall. We remain committed to risk control initiatives to improve the performance of our commercial auto book.

As we have discussed the past few quarters, we continue to focus on profit-driven strategies, targeted at improving the risk we underwrite, including expanding our reach with risk control requirements, stricter underwriting guidelines and ensuring we are targeting adequate rates for the exposure. Our enterprise analytics team continues to refine models designed to provide more insight into underperforming commercial auto accounts and where rate increases are needed.

In 2018 catastrophe losses for the second quarter and year-to-date were below our historical averages. During the second quarter we experienced catastrophe losses of $15.1 million or 5.9

percentage points of the combined ratio as compared to our historical average of 10.8 percentage points of the combined ratio. Year-to-date catastrophe losses were $18.5 million or 3.7 percentage points of the combined ratio. Looking forward to third quarter, we know we have exposure to two catastrophe events, the California Carr wildfire and the July 19th tornadoes in central Iowa. Our early loss estimates appear limited in these events and are less than $5 million at this point.

Moving on to market conditions, during the second quarter of 2018 the average renewal price change for commercial lines decreased slightly from the first quarter of 2018 with the average rate increases remaining in the mid-single digits. Filed commercial lines pricing increased from the first quarter 2018 with pricing varying depending on the region and size of account. The increase in filed rates during the second quarter 2018 was primarily driven by an increase in commercial auto pricing. Filed commercial auto rate increases processed during the quarter averaged in the high single digits. Consistent with the past several quarters of 2018, much like many of our peers have reported, workers compensation line remains very competitive with filed workers compensation rates continuing to decrease. Our expectation moving forward is that our workers compensation premiums will continue to decrease due to pricing and underwriting decisions, including walking away from unprofitable accounts. Our workers compensation continues to perform within our expectations with a year-to-date net loss ratio in the low 60s, which is comparable to the same period in the prior year.

Our personal lines renewal pricing increased during the quarter with average percentage increases in the mid-single digits. We continue to aggressively address our poor performing accounts across the country through nonrenewal or significant rate increases. Our premium retention and policy retention remained strong at 84% and 81%, respectively, during the second quarter of 2018.

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

Dawn Jaffray
Thanks, Mike, and good morning, everyone. For the second quarter of 2018 consolidated net income was $157,000 compared to $3 million in the second quarter of 2017, which included net income from our discontinued Life business of $2.9 million. Year-to-date consolidated net income was $45.9 million compared to $22.9 million year-to-date in 2017. As a reminder, the year-to-date consolidated net income includes a one-time after-tax gain of $27.3 million associated with the sale of United Life Insurance Company and the first quarter net loss of $1.9 million from our discontinued Life business.

Looking at only property and casualty insurance operations results, for the second quarter of 2018 net income was comparable to the second quarter of 2017 with $157,000 of net income compared to $109,000 reported in the second quarter of 2017. Year-to-date in 2018 net income increased to $20.5 million compared to $18.7 million year-to-date in 2017. In both periods of the second quarter and year-to-date in 2018 our net premiums earned increased 4.7% and 4.2%, respectively, compared with 2017.

As mentioned previously, with our continued focus on profitable growth initiatives and achieving rate increases, we estimate our growth in premiums for 2018 will be in the low end of the range of our guidance of 4% to 6% growth.

Net investment income increased 42% to $17 million in the second quarter of 2018 and increased 24% year-to-date 2018 to $31 million compared to the same period in 2017. The increase in net investment income for the quarter and year-to-date was driven by an increase in invested assets and the change in value of our investments and limited liability partnerships and not due to a change in our investment philosophy. The valuation of these investments in limited liability partnerships varies from period to period due to current equity market conditions specifically related to financial institutions.

We reported net realized investment gains of $1.3 million and net realized investment losses of $6.6 million, respectively, in second quarter and year-to-date 2018 compared with net realized investment gains of $1.1 million and $3.3 million in the same periods in 2017.

Included in net realized investment gains and losses in 2018 is the change in value of equity securities which are now recognized in the income statement due to new accounting requirements adopted at the beginning of 2018. For the second quarter of 2018 the change in value of equity securities resulted in a gain of $300,000, and for the first six months of 2018, a loss of $8.9 million.

Moving on to reserve development, we experienced favorable reserve development of $10.3 million in the second quarter of 2018 compared to $16.3 million of favorable development in the second quarter of 2017. Year-to-date in 2018 we experienced favorable development of $48.4 million compared to $41.2 million in the same period of 2017. The impact on net income for the second quarter and year-to-date in 2018 was $0.32 and $1.49 per diluted share compared to $0.41 and $1.04 per diluted share in the same periods of 2017.

Expanding further on reserve development, during the second quarter of 2018 the biggest driver of our favorable development was in our workers compensation line of business followed by assumed reinsurance. Our second quarter 2018 reserve development, up 4 percentage points of the combined ratio, was below the 6.6 percentage points of reserve development we reported in second quarter of 2017. On a year-to-date basis reserve development was primarily driven by three lines of business, other liability, commercial auto and workers compensation. The impact to the combined ratio was 9.6 percentage points in the first six months of 2018 compared to 8.6 percentage points in the same period in 2017.

As a reminder, we continue to have a conservative reserving philosophy with annual favorable development every year since 2009. At June 30, 2018 total reserves remained within our actual estimates. The combined ratio in the second quarter and year-to-date in 2018 was 107.9% and 100.9%, respectively, compared to 107.2% and 102% for the same periods in 2017. Removing the impact of catastrophe losses and reserve development, our core loss ratio in 2018 was flat compared with second quarter and year-to-date in 2017. Referring to slide 9 in the slide deck on our website, we've provided a detailed reconciliation of the impact of catastrophe and development on the combined ratio.

Annualized return on equity was 6.9% during the first six months of 2018 compared to 4.8% in the same period in 2017. I will end my portion of our prepared remarks today with a discussion on capital management activity. During the second quarter we declared and paid a $0.31 per share cash dividend to shareholders of record as of June 1, 2018. Also, as Randy mentioned, we also announced a special cash dividend, the first in the company's history, I might add, of $3.00 per share to shareholders of record as of August 3rd.

Including the regular quarterly dividend, special cash dividend and share repurchases, we've returned over $95 million to shareholders so far during 2018. Also of note during the first six month of 2018 we repurchased 120,372 shares of common stock at an average price of $44.90, which totals $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 purchases 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 on 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. With that, I will now open the line for questions. Operator?

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question you may press star then one on your telephone keypad. If you are using a speakerphone please pick up your handset before pressing the keys. To withdraw your question please press star then two. At this time we will pause momentarily to assemble our roster.

And our first question comes from Paul Newsome with Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning, everyone. I was hoping, and I apologize a little bit ahead of time. I was having some phone problems here, so I may have cut out a few times and missed some things, but I was hoping you could talk a little bit more about the products and why the business that deteriorated on the year-over-year basis outside of the commercial auto insurance business. It looks like there was net improvement in commercial auto, so that, at least on a year-over-year basis, that would suggest to me that most of the year-over-year deterioration, especially if you exclude catastrophe losses, is someplace outside of that book of business. Is that fair, and can you talk about those products a bit?

Michael Wilkins
Paul, this is Mike Wilkins. I'll take a shot at that. You know, if you look at the exhibit in our press release on the back it has the results by line, and you'll see most of the lines of business year-to-date have shown some improvement. One that hasn't is general liability, and we've had some--I think we mentioned in our comments that we've seen some severity there, a few large claims. The other thing is last year, if you look at our loss ratio, it was in the 20s both for the three-month and six-month periods. This year we were 50.5 for the three months ended June 30th, and we're 42.0 for the year, so still not a disaster, but a big increase from a year ago. And that's primarily what drove the lack of progress in our core loss ratio. I think you said we deteriorated. I think we were about flat in the core loss ratio this year to last year.

Paul Newsome
The large losses, is there anything that suggests that they are unusual in nature or not unusual in nature?

Michael Wilkins
I would say that they were random. They weren't any one class or region. We did note that we saw several of those that were commercial auto related. So even though they maybe were impacting other lines of business the root to the loss was a commercial auto accident.

Randy Ramlo
Paul, this is Randy. One other area we seem to be seeing more and more of is adverse court decisions. We've had several of the large auto losses had a distracted driver element to them, and those don't do very well if they end up going to court.

Paul Newsome
Okay, I know you touched on the investment income increase. Is this a fair run rate as we sit? Is there some further investing going to happen because of the cash flow from the Life operation, or obviously alternatives bump that around. Should we think of the [unintelligible] investment in the quarter? Is a reasonable run rate?

Barrie Ernst
Yeah, I believe that it's a reasonable run rate. This is Barrie. With the increase in the invested assets with the sale of the Life company and, you know, our LLC did a lot better this quarter, too, as Dawn pointed out. And we haven't changed our investment philosophy with that. So I think this is pretty normal.

Paul Newsome
Great. I've got a couple questions, but I'll re-queue in case there is somebody else who wants to ask a question.

Operator
Again, if you have a question please press star then one. Again, we will pause momentarily to assemble our roster.

Our next question comes from Eric Leifson with Eric Leifson Associates. Please go ahead.

Eric Leifson
Yes, good morning. This question is for Randy. He mentioned the Oasis project and the increased expenses related to that project. So my question is what is the anticipated duration of this project, and what are the anticipated long-term benefits that will be derived from this?

Randy Ramlo
So I may defer a little bit of this to Mike Wilkins. He is a lot more familiar with this than I am, but overall it's a five-year project. We have four left. We actually had one of our benchmarking people come in earlier this week, and these major legacy systems usually take 5 to 7 years, so ours is at the low end of that, which we're thankful for. It's moving along as we expected. Our past policy processing system was probably 25 years old, so it had a bit of baling wire and duct tape on it, and the new system, and Mike can add to this, is a lot more streamlined. We can add a lot more analytics features, so underwriters will have information right at their fingertips on a policy level, better management of data. Mike, you got any more comments on that?

Michael Wilkins
Yeah, just expanding on what Randy said, I think the big advantage for us--we use analytics today, but our analytics today isn't integrated into our policy processing system so the underwriters, it's a separate operation for them to go get the analytics information and then incorporate it into their underwriting process. The new system will tie it all together and provide guideposts for them on pricing and attractiveness of the business, quality of the business as they go through the process. Of course productivity is another big area that we look to improve underwriting policy processing expenses, underwriting expenses, things like that. So it's a big project and probably overdue that we tackled it.

Eric Leifson
Thank you.

Operator
And once again, if you have a question please press star then one on your telephone keypad, and we'll pause momentarily to assemble the roster.

Showing no further questions, this concludes our question-and-answer session. I'd like to turn the conference back over to Randy Patten for any closing remarks.

CONCLUSION

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.