United Fire Group, Inc.

2019 First Quarter 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 – *AVP, Finance and Investor Relations*

Corey Ruehle – *Chief Claims Officer*

PRESENTATION

Operator
Good morning. My name is Steven, and I'll be your conference operator today. At this time I would like to welcome everyone to the UFG Insurance First Quarter 2019 Financial Results Conference Call. After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your telephone keypad. To withdraw your question, please press star (*) then two (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.

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 am pleased to present Mr. Randy Ramlo, CEO of UFG Insurance.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to our first quarter conference call.

Earlier this morning, we reported our first quarter 2019 results, including consolidated net income of $1.74 per diluted share, adjusted operating income of 91 cents per diluted share, and a GAAP combined ratio of 95.6%. These results compare with last year's first quarter numbers of $1.80 for net income, $1.00 for adjusted operating income, and 93.5% for the GAAP combined ratio.

During the first quarter of 2019, UFG benefited from strong equity markets, achieving higher net investment income and an increase in net realized investment gains. This compares with net realized investment losses in the first quarter of 2018, which were offset by the one-time realized gain of $1.07 per diluted share on the sale of our Life Company. Also in the first quarter of 2019, we experienced an increase in net premiums earned, reflecting pricing increases on our commercial business, particularly commercial auto. As mentioned last year, we are focused solely on improving our profitability, with several strategic initiatives in enterprise analytics underway, which Mike will elaborate on.

On the claims side, our new Chief Claims Officer, Corey Ruehle, is working on the initiatives we announced during last quarter's call. As a reminder, these new initiatives are aimed at improving claims service, including shortening cycle time and reducing claims costs, attorney involvement, and the impact of litigation. As always, these initiatives take time to implement and therefore, will take time to show up in our financial results

This quarter's improvements in net investment income and net premiums earned were partially offset by reserve strengthening on commercial auto in our Gulf Coast region. This resulted in a decrease in the favorable prior-year reserve development from the same period a year ago. Dawn will be discussing this in more detail.

Catastrophe losses were insignificant in the first quarter of 2019 as well as in the first quarter of 2018, adding only 1.4 points to the combined ratio in both periods. This is below our 10-year historical average of 2.5 points for the first quarter. With the geographic mix of our book of business, the second and third quarters typically lead to a higher impact of catastrophes in our financial results. On a preliminary basis, we know that in April, we've experienced more CAT losses from storms than we did in the prior year, although at this point, not significantly different than our expectations of second quarter storms losses.

Without the impact of prior-year reserve development and catastrophe losses, our core loss ratio improved 10.1 percentage points quarter over quarter. We are cautiously optimistic with this improvement, but it is too early to tell if it is a trend, especially heading into the second and third quarters. Slide nine of our presentation on our website provides a detailed reconciliation of the impact of catastrophes and development on the combined ratio.

We realize as we look to the future we need to continually refine our business approach, both in our ability to adapt as well as anticipate the demands of the changing insurance marketplace. Five years ago we built our 2020 Vision to guide us to the future. We are a larger Company than we were five years ago when our stock was trading at 91% of book value, and our annual property and casualty premiums were about 30% less than today. During this time frame, our stock price has appreciated around 50%, and we've grown book value even considering returning over $250 million to shareholders through dividends and share repurchases. And, most recently UFG is trading at a stock multiple of about 115%. However, importantly, we also realize with our recent couple of years of disappointing commercial auto results, we have more work to do towards improving profitability.

With our internal leadership teams and McKinsey consultants, we have commenced a strategic review looking out to 2025. This is an in-depth review of the what, where, and how we can do things differently, or do the things we do well even better. This review will emphasize all the pillars of performance, including ways to improve our business profitability, strengthen our digital and analytic capabilities, innovate, and continue to drive the evolution of the underwriting platform through our OASIS project. Although in the very early stages of this endeavor, we will share perspectives as we progress throughout the year.

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

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

We continue to focus on the strategic underwriting and claims initiatives we discussed last quarter to improve profitability. In the first quarter, we can report that our average commercial lines renewal pricing increases are the highest in recent history, with effective rate changes remaining in the mid-single digits. The renewal pricing increases continue to be driven by commercial auto pricing, with an effective rate change in the low double digits in the first quarter of 2019. Filed commercial auto rate increases during the first quarter of 2019 continue to be in the low double digits.

We continue to aggressively push rate increases in targeted areas with our commercial auto book of business, seeking double-digit rate increases. With the assistance of our Enterprise Analytics team, we are closely reviewing the bottom 30% of our commercial auto book of business, seeking significant pricing adjustments or taking underwriting action. We are also passing on new business opportunities with commercial auto which do not align with UFG's risk appetite, including certain classes of heavy-wheeled commercial vehicles.

Our premium retention remained strong at 84% during the first quarter of 2019, primarily due to rate increases in our commercial auto book. Going forward, we expect to see a decrease in our premium and policy retention as we continue to review our book of business for profitability.

Before I turn the call over to Dawn, I'll spend a few minutes discussing a couple of additional and important initiatives we are working on, which will be instrumental in how we do business in the future.

First, over the past two years, the newly created Enterprise Analytics team has been actively pursuing the build-out of an analytics ecosystem to support data and advanced analytics capabilities at UFG. Capitalizing on the initial stages of data management solutions, the Enterprise Analytics team was able to deliver an improved commercial auto predictive model in the fourth quarter of 2018. Actual results are still pending, but the team is closely monitoring the impact of underwriting decisions for signs of effectiveness. Plans for 2019 include the deployment of a commercial property model during the third quarter and completion of data mining for claims analytics by year-end. As we look ahead to 2020 and beyond, our focus will be on enhancing claims analytics as well as completing additional lines of business that would allow for account-level predictive modeling for underwriting.

Second, we are in year two of our multi-year OASIS project to upgrade our underwriting technology and enterprise analytics platform. We are currently nearing the first rollout for this project, which is an important milestone for our Company. We expect Phase 1 to roll out on schedule in July, and it is limited to two products in our Rocky Mountain region.

Lastly, we continue to focus on our small commercial insurance operations with the continued build-out of our service center and technology platform. We are now writing approximately $100 million annually in premiums in small commercial insurance. We have seen increases in submissions, hit ratios, and percentage of policies issued without underwriter involvement.

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

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

In the first quarter of 2019, we reported consolidated net income of $44.5 million compared to net income of $45.8 million in first quarter of 2018. First quarter of 2019 net income was impacted by strong equity market performance. This included a $2.4 million after-tax increase in net investment income due primarily to an increased valuation of our bank fund limited liability partnerships and an increase in our invested assets with last year's sale of our life company. Our year-over-year increase in the value of equity securities resulted in an after-tax increase of $19.5

million recognized in the income statement.

Higher net earned premium growth quarter over quarter of 7% also contributed to net income and, as Mike mentioned, this increase was primarily driven by an increase in rates, with the largest rate increases occurring in our commercial auto line of business. Lastly, a reminder that the one-time after-tax gain on the sale of United Life of $27.3 million was previously recognized in the first quarter of 2018.

I want to highlight that the 2019 annualized return on equity is 19.3%, as compared to 11% in the first quarter of 2018. The change in valuation of our equity securities included in the income statement, or what I personally refer to as phantom gains, are impacting our first quarter annualized ROE calculation. Excluding the impact of all unrealized gains in our portfolio, our annualized return on equity would be 10.9%.

In the first quarter of 2019, we recognized favorable reserve development of $4.6 million compared to favorable reserve development of $38.1 million in the first quarter of 2018. The decrease in favorable reserve development was primarily in our general liability, commercial property, and commercial auto lines of business due to prior accident year reserve strengthening in our Gulf Coast region, as Randy mentioned. This reserve strengthening was not due to a change in reserving philosophy in the Gulf Coast region, but rather the result of our recent experience with similar claim settlements, especially with auto liability claims.

According to the U.S. Census Bureau, Texas has four of the country's 10 fastest-growing counties, and consistently leads the nation in the number of traffic accident fatalities. Texas is not only our largest state in premium; it also represents approximately 22% of our total annual Company-wide commercial auto premiums. On an annualized basis, it has also accounted for roughly 24% of our total commercial auto losses. With a growing population on the roadways, our commercial auto experience has followed suit. We believe our new predictive commercial auto model developed by our Enterprise Analytics team will assist us in refining our risk selection and underwriting decisions, not only in Texas, but Company-wide, as Mike discussed. As a reminder, our approach to reserving remains conservative. Supporting that assertion, we've had annual favorable reserve development every year since 2009. At March 31, 2019, our total reserve position remained within actuarial estimates.

Our expense ratio was 33% in the first quarter of 2019 compared to 34.5% in the first quarter of 2018, which included about 1.5 points for our OASIS underwriting initiative. The overall improvement in the ratio is due primarily to a decrease in employee benefit expenses. As we mentioned last quarter, changes we made to our post-retirement benefits along with other assumption changes have resulted in a reduction in our annual pension and post-retirement benefit expense of approximately $7 million for 2019.

Our first quarter of 2019 GAAP effective tax rate came in at 18.6%, which is higher than our expected range of 15 to 17%, primarily due to the phantom realized equity gains as previously mentioned.

Moving on to capital management matters, during the first quarter we declared and paid a $0.31 per share cash dividend to shareholders of record as of March 1, 2019. We have paid quarterly dividends consecutively for the past 204 quarters since March of 1968. We did not repurchase any shares in the first quarter. 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 will expire in August 2020.

And, with closing of prepared remarks, I will now open the line for questions. Operator?

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star (*) then one (1) on your telephone keypad. 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 like to withdraw your question, please press star (*) then two (2). And, our first question comes from Paul Newsome with Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning, everyone. Congratulations on the quarter. I was wanting to ask about the combined ratio or really the loss ratio if you exclude reserve development and the CAT, it looked like it improved quite a bit and on both a year-over-year and a sequential basis, and I was hoping you could talk about sort of the sustainability of that and whether there was something unusual or different in that particular measurement?

Randy Ramlo
Well, we sure hope that's sustainable, Paul. We think we're seeing some good progress, you know. We continually repeat that a quarter doesn't make a trend, but we had some reserve strengthening in our Gulf Coast, as we mentioned, but we are starting to see a little bit of progress. Maybe, Mike, you could add a little bit on what we're seeing on the frequency side.

Mike Wilkins
Yeah, a couple comments, Paul. First, I would say the improvement was broad based, so it's property lines, while we had a quiet CAT quarter we also had a reduction in fire losses versus prior years, so that was good to see that. Personal lines has improved quite a bit from last year first quarter. Assumed business performed better than it did last year first quarter. Work Comp, we had a good quarter. So, a lot of improvement across many different lines. Some other underlying things that maybe give us some optimism. We've had two consecutive quarters of quarterly moving average decrease in frequency in the auto lines, so while we still have work to do in that line, it's nice to see that trend reverse because we did several quarters consecutively prior to that time where we saw increases in frequency, so I think some good trends. As Randy said, it's just a quarter, so we aren't going to get too excited, but maybe some indicators of turning tide on the underwriting profitability side.

Paul Newsome
And, then maybe we could talk, turn to the reserve issues in the Gulf Region. I guess, is it, it sounds like it's just kind of commercial auto, for the most part? But, I'm surprised that Texas is the issue. I thought sort of the West Coast was the problem child area. Maybe just some more comments on that and maybe how quickly that might turn itself around?

Randy Ramlo
Well, it's, you are correct, we've had our share of issues on the West Coast, as well. We have a new branch claims manager in our Texas region. As we mentioned in the release, we don't think there's necessarily a change in philosophy, but we've probably increased our pessimism on the way some, especially bodily injury losses are settling out, especially in left turn situations or rear-end accidents. And, I think really this is kind of a reflection of a new set of eyes on some of the claims that we've had and kind of just a bit more pessimism on how these claims are settling out.

Corey, I don't know if you want to add anything to that commentary?

Corey Ruehle
Sure. Good morning, Paul, this is Corey Ruehle, Chief Claims Officer. While we're not looking to change our reserving philosophy, we are looking at refining it in ways that we can continue to evaluate that. A couple of examples would be we're looking at a quality assurance unit that will help identify trends, training gaps, and then also things, the Property Institution of Best Practices, as well, so that we can make sure that the reserving philosophy is being followed completely. The second thing, Dawn Jaffray had mentioned analytics, and we have engaged in analytics to work on developing a couple of claims models to start that will help us better identify this as well.

Paul Newsome
Okay. My final question, I wanted to talk a little bit more about the expense ratio and the outlook there. It looks like you've had a couple of quarters now of keeping it, actually more than a couple quarters of keeping it under 34%. Is that, does that look more sustainable now that it looks like you've made some efforts there? So, any thoughts on the sustainability of the expense ratio at this level?

Randy Ramlo
Well, I'll make a comment and then if Dawn or Mike want to add anything. You know, the OASIS project is kind of staying kind of where we had predicted, so that's kind of a plus. We have made some changes to our post-retirement benefits. Those benefits do run out someday, and hopefully the timing with this OASIS project ultimately is going to see some efficiency. So, there will be, I think long, long-term, yes, we'll see the expense ratio return to normal, kind of in the next three or four bumpy years, that will remain to be seen, but we sure hope so.

Dawn Jaffray
Paul, this is Dawn. The only other thing I would add is relative to the investment and enterprise analytics, obviously there's a cost of the Enterprise Analytics team, and that investment will directly pay off in the lower loss ratio, so I do think we will continue to have some additional amount than maybe we've had in the past relative to that particular group.

Paul Newsome
Great. I'll let some other folks ask questions. Thank you very much, though.

Randy Ramlo
Thank you, Paul.

Operator
And, as a reminder, if you have a question please press star (*) then one (1). And 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
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.