United Fire Group, Inc. Management Discusses Q4 and Year-End 2014 Results – Earnings Call Transcript (Prepared Remarks with Attached Q&A Transcription)

United Fire Group, Inc. (NASDAQ: UFCS) 4Q2014 Earnings Call February 17, 2015 10:00 am EST

Executives

Randy A. Ramlo, President and Chief Executive Officer (if available)

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Kevin W. Helbing, Interim Principal Financial Officer, Assistant Vice President, and Controller

David E. Conner, Vice President and Chief Claims Officer

Barrie W. Ernst, Vice President and Chief Investment Officer

Operator

Good morning. My name is Christine and I'll be your conference operator today. At this time I would like to welcome everyone to the United Fire Group 2014 fourth quarter and year-end financial results conference call. All participants are in a listen only mode. A brief Question and Answer session will follow the formal presentation.
If anyone should require operator assistance during the conference, please press *0 on your telephone keypad.
As a reminder, this conference is being recorded.

Thank you. I will now turn the call over to Anita Novak, Director of Investor Relations.

Anita Novak, Director of Investor Relations

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 www.unitedfiregroup.com. Press releases and slides are located under the Investor Relations tab.

Our speakers today are Michael Wilkins, Executive Vice President and Chief Operating Officer, and Kevin Helbing, Interim Principal Financial Officer, Assistant Vice President, and Controller. Our President and Chief Executive Officer, Randy Ramlo, is traveling today but is expected to join the call when possible. Other members of our executive team are also available for the question-and-answer session that will follow our prepared remarks.

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. Michael Wilkins, Executive Vice President and Chief Operating Officer of United Fire Group.

Michael T. Wilkins, Executive Vice President and Chief Operating Officer

Good morning, everyone, and welcome to United Fire's 2014 fourth quarter and year-end conference call. Randy Ramlo is traveling today, but will attempt to join our call, if possible, to participate in the question and answer session.

We are pleased to report operating income of $1.34 per share and a GAAP combined ratio of 83.6 percent for the quarter. For the year, operating income was $2.13 per share, our GAAP combined ratio was 97.8 percent, our book value was $32.67 per share, and our return on equity was 7.4 percent.

We continued to benefit from modest rate increases during fourth quarter, as well as a lack of significant catastrophic events, favorable claim activity and favorable reserve development on prior accident year claims.

Market Conditions

Competitive market conditions during the quarter increased on renewals while persisting on new business.

Commercial lines renewal pricing varied by region, with average percentage increases in the mid-single digits on most small and mid-market accounts. Larger accounts remain more competitive with only small increases obtainable. This is the thirteenth consecutive quarter of commercial lines pricing increases.

Personal auto renewal pricing increases during the quarter remained modest and in the low-single digits. The homeowners pricing experienced average percentage increases in the mid- to high-single digits during the quarter. Overall, personal lines renewal pricing increased slightly during the fourth quarter. Premium written from new business remained strong, up from the prior quarter as well as the same quarter a year ago. Our success ratio on quoted accounts increased slightly and remained strong. New business discretionary pricing was unchanged.

We believe current rate increases are exceeding the loss cost trends and loss cost trends will remain at low levels in 2015; however, we do expect the gap between loss costs and rate increases to shrink as 2015 progresses.

Policy retention remains strong at 83 percent, increasing slightly from the prior quarter for the group and most regions. Premium retention was down slightly from the previous quarter to 86 percent, but remained strong. Policies in force remained flat as new policies written were sufficient to offset policies lost or non-renewed.

The U.S. economy continues to grow at a slow rate. Premium from endorsements and premium audit continue positive trends, up from the same quarter a year ago.

During the fourth quarter premiums written increased 11.3 percent --- 3.0 percent is attributed to new business; 0.6 percent is attributed to endorsements; and 7.7 percent is attributed to rate change and policy revisions.

Our expectations for 2015 are premium rate increases in the mid-single digits range at the beginning of the year, but tapering to low single digits by the end of the year.

Our Specialty division of business continued to expand in the fourth quarter. During the year, the line operated in four western states. During 2015, the division is expected to expand into at least two additional states. The division will create an admitted and non-admitted option in each of the active states. We expect strong premium growth for this division in 2015, but it will not be material to the overall operations.

Catastrophes and Other Losses

Kevin will cover the details of our catastrophe loss activity for 2014, which was near what we budgeted for this year.

Large Losses

Catastrophe losses were within our expectations for the year; however, we did see an uptick in large losses during 2014. During first quarter, we reported a large loss due to an east coast condominium fire that affected multiple units. As an update, we continue to expect favorable subrogation recovery on this claim; however, we do not anticipate subrogation efforts to occur before 2016.

During second quarter, we reported a large loss due to fire which destroyed nearly an entire city block. This claim is still in the investigative stages.

During second and third quarters of 2014, we reported increased frequency in a number of property lines claims. While storms caused some of these losses, the big driver was large fires. Though we see these events in most quarters, there seemed to be a greater concentration in second and especially third quarter this year. As a result, we have initiated detailed loss studies, conducted underwriting audits and asked each region to include tactics for improving the property line of business in their 2015 regional plans. In the commercial lines these plans include stronger pricing on tougher accounts and a stronger focus on risk selection and loss control compliance. We fully expect that recent loss studies will also help determine the appropriate accounts to target in order to improve results in these lines of business. In our personal lines, our continued focus will be on our signature premier homes, which are homes valued between $400,000 and $2,000,000.

Reinsurance Program

Our reinsurance program for 2015 remained essentially the same with a few minor tweaks – the most important one being that we expanded the hours clause to our catastrophe program from 96 hours to 120 hours. The catastrophe program experienced favorable pricing with rate levels down approximately 10 percent. Pricing on the core program was flat.

Life Company

Sales of our single premium whole life policies have lagged behind annuity sales due to our efforts to maintain price diligence on our single premium whole life product in order to achieve adequate rate spreads. As a result, net income for the life insurance segment has declined approximately twenty-two percent for the year.

Losses and loss settlement expenses increased $5 million for the year due to corresponding fluctuations in death benefits paid. Fluctuations in the timing of death benefits occur from year-to-year.

The increase in liability for future policy benefits improved during the year due to a decrease in sales of life insurance products.

Interest credited decreased $4.9 million for the year due to net annuity withdrawals decreasing the base on which interest is paid along with the periodic reduction in the interest rate credited on annuity products throughout 2014.

Deferred annuity deposits increased for the year. Guaranteed interest rates of our products increased in the second half of 2013 and in the first quarter of 2014 resulting in more favorable retention of maturing deferred annuity deposits as opposed to lapse of policies due to maturity and increased deposits due to additional annuity sales for the year.

ROE

As Randy mentioned in the press release earlier today, book value growth is very important to us. Equally important is obtaining an appropriate return on equity. Kevin will address the issue of book value in a moment, but I'd like to take a moment to discuss return on equity. We make strategic decisions based on a double-digit return on equity, and that has not changed even though the current investment environment is challenging. We will continue to focus on underwriting results rather than rely on investment portfolio returns to achieve double-digit returns on equity. Over the last few years, we have based our strategic plan on this premise. We have addressed our elevated expense ratio, we have developed our program business and increased our coverage of program associations, we have expanded our product offerings including the specialty division, and we continue to successfully achieve rate increases. Obtaining double-digit returns on equity remains a primary objective in our 2020 Vision strategic plan. These are all actions designed to improve underwriting results and bolster our return on equity.

With that, I'll turn the financial discussion over to Kevin Helbing.

Kevin Helbing, Principal Financial Officer, Assistant Vice President, and Controller

Thanks Mike.

Consolidated net income, including net realized investment gains and losses, was $34.8 million or $1.38 per share for the quarter compared to $26.5 million or $1.04 per share last year. For the full year, consolidated net income, including net realized investment gains and losses, was $59.1 million or $2.32 per share compared to $76.1 million or $2.98 per share in 2013.

Losses and loss settlement expenses increased by $4.2 million, or 3.8 percent, during the fourth quarter compared to the fourth quarter of 2013 and $77.4 million, or 16.9 percent for the full year. As Mike mentioned earlier, 2014 losses and loss settlement expenses were unusually impacted by large losses, which was beginning to look like a trend. Fourth quarter, however, was more consistent with expectations in these lines of business. Nonetheless, management continues to aggressively pursue actions to mitigate future concerns. As Mike mentioned earlier, our emphasis is primarily on a regional basis but does include some home office scrutiny as well.

Pre-tax catastrophe losses for the quarter totaled $2.5 million or $0.06 per share after tax, compared to $3.0 million, or $0.08 per share after tax. These losses added 1.2 percentage points to our combined ratio.

For the year, catastrophe losses totaled $49.7 million or $1.27 per share after tax, and added 6.5 percentage points to the combined ratio. Our expectation for catastrophe losses in any given year is six percentage points of the combined ratio. It's important to note, however, that our book of business remains primarily in regions of the country that are susceptible to seasonal weather events such as winter and spring convective storms, which will likely result in volatility in our results from quarter to quarter. As a company we don't get too excited about this volatility since our final analysis is based on annual results.

Favorable reserve development for the fourth quarter was $24.2 million compared to $8.5 million in the fourth quarter of 2013. The positive impact on net income for the quarter was $0.62 per share compared to $0.22 per share in 2013. For the full year, favorable reserve development was $56.7 million, or $1.45 per share compared to $57.5 million, or $1.46 per share. As we have stated on many occasions, reserve development will vary from quarter to quarter and year to year due to the number of claims settled and the settlement terms. During the fourth quarter, the increase in favorable reserve development is attributable to the timing of paid claims as well as decreases in our IBNR reserves related to our commercial liability lines of business. For the full year, prior year reserve development was consistent with long-term average releases. I will remind our audience that we have historically reserved on a conservative basis and continue to do so. At December 31, 2014 our total reserves remained relatively flat and within our actuarial estimates.

Investments

Consolidated net investment income was $27.4 million for the fourth quarter, which was a decrease of 8.8 percent as compared $30.0 million in fourth quarter 2013. For the year, consolidated net investment income was $104.6 million, a decrease of 7.3 percent, as compared to net investment income of $112.8 million for 2013. The year-to-date decreases are primarily due to changes in the value of our investments in limited liability partnerships, which are heavily weighted in banc funds, and are recorded on the equity method of accounting. Because the equity method of accounting is based on changing market conditions, the results can be volatile from period to period.

We continue to feel the impact of lower investment yields on the majority of our investment portfolio and we expect a continuation of low interest rates into 2015. The weighted average effective duration of our fixed maturity securities portfolio at December 31, 2014 and 2013 was 5.0 years. Our overall portfolio yield was 3.3 percent.

Consolidated net realized investment gains for the quarter were $1.5 million compared to net realized investment gains of $1.4 million in 2013. For the year, consolidated net realized investment gains were $7.3 million compared to $8.7 million in 2013.

Consolidated net unrealized investment gains, net of tax, totaled $149.6 million as of December 31, 2014, which is an increase of $33.0 million or 28.3 percent from December 31, 2013. The majority of the increase in net unrealized gains is a result of an increase in the fair value of the fixed maturity investment portfolio due to interest rate declines.

Expense Ratio

The expense ratio for the fourth quarter was 31.3 percentage points, compared to 31.4 percentage points for the fourth quarter of 2013. For the full year, the expense ratio decreased to 31.4 percentage points compared to 31.8 percentage points in 2013. The expense ratio continues to gradually improve and as we indicated in our earnings release this morning, 2015 was the year that we expected we would finally reach our target of 30 percent. However, the lingering low interest rate environment continues to impact our retirement benefit plan obligations which somewhat offset the savings anticipated in 2015 from other sources. During 2015, many of the added expenses associated with the Mercer Insurance integration project will be eliminated; however, those savings will likely be offset by amortization costs associated with the retirement pension benefit obligations.

This might be a good time to discuss the change in valuation of our retirement benefit obligations because of the impact these changes will have on the expense ratio and book value. In 2014, the declining interest rate environment and to a lesser extent, the adoption of new mortality tables, created significant changes in the valuation of our retirement benefit plans. The impact to book value in 2014 was $1.14 per share, which is a balance sheet impact only; however, there will be an income statement impact in 2015 due to the amortization of increases in our benefit obligation liability, as mentioned before.

<u>Balance Sheet Highlights</u>

Our stockholders' equity increased 4.4 percent to $817.4 million at December 31, 2014 from $782.8 million at December 31, 2013. The increase was primarily attributable to net income of $59.1 million and an increase in net unrealized investment gains of $33.0 million, net of tax. These increases were offset by a change in valuation of our retirement benefit obligations of $29.0 million, shareholder dividends of $19.7 million and share repurchases of $12.9 million. At December 31, 2014 the book value per share of our common stock was $32.67 compared to $30.87 at December 31, 2013.

<u>Capital Management</u>

During the fourth quarter, we declared and paid a $0.20 per share cash dividend to shareholders of record on December 1, 2014. For the full year, we declared and paid dividends of $0.78 per share.

In addition, during the fourth quarter we repurchased 60,316 shares of United Fire common shares at an average price of $28.07. For the year, we repurchased 461,835 shares of our common stock for a total cash expenditure of $12.9 million at an average cost per share of $28.02.

As a reminder, under our current share repurchase program, we may purchase United Fire common stock on the open market or through privately negotiated transactions. The amount and timing of any purchases will be at management's discretion and will depend upon 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 1.6 million shares of common stock under the new program which expires August 31, 2016.

With that, I'll open the lines for questions.

Q & A

Operator:

Thank you. We will now be conducting a question and answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star key. One moment, please, while we poll for questions. Thank you.

Our first question comes from the line of Vincent DeAugustino with KBW. Please proceed with your question.

Vincent DeAugustino:

Good morning, everyone.

Michael Wilkins:

Good morning.

Vincent DeAugustino:

Just to start, maybe a question for Kevin, just to your comments on the 2015 income statement impact. Any sense of the ballpark drag from that pension side, either in terms of dollars or on the expense ratio?

Kevin Helbing:

It would be approximately 7 million addition on the expense ratio, $7 million.

Vincent DeAugustino:

Okay, great, and then …

Michael Wilkins:

Vincent, this is Mike, if I can just add to that. We don't anticipate the expense ratio moving much in 2015. We've got other initiatives that we think will offset that increased expense. At this point, the thing to us is just we expected to make good inroads into our expense ratio in 2015, and that'll be more difficult now with the impact of the pension obligation.

Vincent DeAugustino:

Okay, makes sense there. So, I guess the other question would be here, kind of on the premium growth. So, the volume here has just been kind of much better than I've been expecting here over the last couple of quarters, and so, frankly, I'm starting to wonder if I failed to fully appreciate some of your comments around just being a little bit more aggressive on new business growth plans embedded within your 2020 plan, and so I just wanted to touch on any specific targets that are in that 2020 plan, and then the split between kind of exposure, new business and, you know, rate looking kind of further out to that 2020 mark?

Michael Wilkins:

Vincent, this is Mike again. I'll start with some generalities and then if you want me to drill down, I can try to do that. We look at our growth carefully each quarter and make sure that we're comfortable with it. A lot of the growth, as you know, has been driven by rate increases, which we think is a very positive thing, but in addition to that, we've added the specialty unit, which we've been talking a little bit about, that added over one point of our growth this year, and we also have had material reinsurance reductions over the last three years, which we're seeding less premiums, so that's helpful on our growth. The economy has improved, so we are seeing better endorsement premium as people add exposures back, and also a better audit premium. So, our new business growth is good and we feel good about that, but it's not the primary driver of our overall growth.

Vincent DeAugustino:

Okay, but I guess to make sure I'm not missing anything, there's no specific external target for growth?

Michael Wilkins:

We have some targets, but they're not anything we disclose.

Vincent DeAugustino:

Okay, all right, fair enough. Then, just on the reserve kind of side, in the press release there was a mention of normal reallocation reserves following the comment on 2013—actually, in your IBNR releases—and so I was just kind of hoping we might be able to define kind of what the implication is for the reallocation process. I just want to make sure I understood that.

Kevin Helbing:

As you go forward in time, as you build out your current accident year, you shift your IBNR from the previous accident year into the new accident year, and that's what that comment reflected.

Vincent DeAugustino:

Okay, all right, thank you for that, and then just one last question and maybe it's probably best for Randy, if he's connected, or we can follow up, you know, next quarter, or maybe we'd get a release before then, but the question goes to just kind of getting an update on how the CFO search is going, if you guys could comment on that, or I'd also understand if it was a bit too early.

Randy Ramlo:

No, but can you hear me, Vincent?

Vincent DeAugustino:

I can, thank you, loud and clear.

Randy Ramlo:

Okay, good. Yes, we had a very strong pool of interest. I think we had a total of 25 applicants initially. The search firm narrowed that group down to 12. Mike Wilkins and myself kind of picked the top five out of that group and we have narrowed that, tentatively, right now to a group of two, and then our plans are to have those two come back and do a more extensive interview with not only members of staff, but also with some of our Boards of Directors. So, we had a very strong pool from the outside and internally and we're very excited.

Vincent DeAugustino:

All right, thank you very much. Best of luck, guys.

Randy Ramlo:

Thank you.

Michael Wilkins:

Thank you.

Operator:

As a reminder, if you would like to ask a question, press star, one on your telephone keypad. If you are using a speakerphone, you may need to pick up your handset before you press the star key.

Our next question comes from the line of Paul Newsome with Sandler O'Neill. Please proceed with your question.

Paul Newsome:

Good morning and congratulations on the call. I wanted to ask about the cat load assumption. Are you using about a 6% load for your pricing of your product?

Michael Wilkins:

Paul, yes, we are using a 6% budget number, assumption number, estimated impact on an annual basis. I think our 10-year average has been 7, but we've done—we've combined the actual 10-year average with modeling results to come up with the 6, and we think our 10-year average is a little higher than we would anticipate going forward.

Paul Newsome:

Are you assuming that the underlying level of catastrophe risk, in general, is a positive slope; in other words, that there's an increasing level of activity in general? It sounds like you're assuming the opposite.

Michael Wilkins:

Yes, I think we've spent a lot of effort trying to mitigate our exposure to cat losses. We've reduced exposure in concentrated areas, especially coastal, and our belief is that we've moved the needle in the right direction. Also, with the Mercer acquisition, the business that we acquired in the two new locations, East Coast and West Coast, is less susceptible to catastrophe loss than our Midwest business, so we think that also should bring our average down.

Paul Newsome:

Okay, and just a quick accounting question. Did I hear right that you do not allocate IBNR reserves on an accident year basis?

Kevin Helbing:

We do, and as you move forward in time, that accident year allocation changes as you add the exposure for the current year.

Paul Newsome:

But the individual IBNR buckets would just change on their own, right?

Kevin Helbing:

Correct.

Paul Newsome:

Okay. That's it; thank you, guys. I appreciate it.

Michael Wilkins:

Thanks, Paul.

Operator:

Thank you. It appears we have no further questions at this time. I would now like to turn the floor back over to Management for closing comments.

Anita Novak, Director of Investor Relations

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

Operator

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