United Fire Group, Inc. Management Discusses Q3 2014 Results – Earnings Call Transcript (Prepared Remarks with Attached Q&A Transcription)

United Fire Group, Inc. (NASDAQ: UFCS) 3Q2014 Earnings Call November 4, 2014 10:00 am EST

Executives

Randy A. Ramlo, President and Chief Executive Officer

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

Dianne M. Lyons, Senior Vice President and Chief Financial Officer

David E. Conner, Vice President and Chief Claims Officer

Barrie W. Ernst, Vice President and Chief Investment Officer

Michael J. Sheeley, Vice President and Chief Operating Officer, United Life Ins. Co.

Operator

Good morning. My name is Diego and I'll be your conference operator today. At this time I would like to welcome everyone to the United Fire Group third quarter 2014 financial results conference call. At this time, all participants are in a listen only mode. A brief Question and Answer session will follow the formal presentation. Should anyone require operator assistance, please press *0 on your telephone keypad. As a reminder, today's call 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 Randy Ramlo, President and Chief Executive Officer, Mike Wilkins, Executive Vice President and Chief Operating Officer and Dianne Lyons, Senior Vice President and Chief Financial Officer. 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. Randy Ramlo, President and Chief Executive Officer of United Fire Group.

Randy A. Ramlo, President and Chief Executive Officer

Good morning, everyone, and welcome to United Fire's third quarter conference call.

Earlier this morning, we reported a third quarter operating loss of $0.01 per share; net earnings of $0.01; and a GAAP combined ratio of 107.4 percent. Year-to-date, we reported operating earnings per share of $0.81; net income per diluted share of $0.95; and a combined ratio of 103.0 percent. Our current book value is $32.26 per share and our annualized return on equity is 4.1 percent. All of these details can be seen on Slide number 3 of our webcast.

Clearly, these are not the results we expected to report three quarters through the year. Third quarter was significantly impacted by large losses, especially fire losses, and carryover claims associated with late second quarter catastrophe losses from convective storms. Both of these issues will be addressed on this morning's call.

<u>Market Conditions</u>

Overall, our P&C premium increases from organic growth totaled 10.5 percent. We attribute 6.7 percent to rate increases, 3.2 percent to new business and 0.6 percent to exposure increases. We believe loss cost trends remain at approximately 3.5 percent. We base our loss cost trend on an inflation index from Towers Watson and other actuarial resources.

We are hearing competitive sentiments from our underwriting and marketing departments, but so far, it is more of an internal opinion since retention is still good and we are still getting rate increases. Our hit ratios are still good as well.

Commercial lines renewal pricing increased with average percentage increases in the low- to mid-single digits on most small and mid-market accounts, but larger accounts have become more competitive.

Personal auto lines renewal pricing increases during the quarter decelerated to low-single digits, while homeowners pricing experienced average percentage increases in the mid- to high-single digits, especially in areas affected by large convective storms.

Competitive market conditions persisted on new business during the quarter. Premiums written from new business remained strong, exceeding both the prior quarter and the same quarter in 2013. Our success ratio on quoted accounts was down slightly due to increased competition and our willingness to walk away from business inappropriately priced, especially in personal lines.

Policy retention was down some, but still above 82 percent, which shows we continue to push rate. We will continue to push rate until retention drops more. Premium retention was down slightly for the quarter to 86.8 percent. We consider both of these metrics to be strong and well within the range where we believe modest price increases are still possible.

<u>Life Segment</u>

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 ten percent year-to-date. For the quarter, we did experience additional net income due to increased net premiums earned on single premium whole life policies initiated previously.

Losses and loss settlement expenses decreased $1.0 million for the third quarter and increased $2.5 million year-to-date due to corresponding fluctuations in death benefits paid. Fluctuations in the timing of death benefits occur from quarter-to-quarter and year-to-year.

The increase in liability for future policy benefits deteriorated during the third quarter due to an increase in sales of life insurance products partially offset by net withdrawals of deferred annuities.

Deferred annuity deposits decreased during the quarter but increased year-to-date. 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 year-to-date. Since the beginning of the second quarter, guaranteed interest rates of our products have periodically declined resulting in a decrease in deferred annuity deposits for the quarter as compared to the same period in 2013.

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

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

Thanks, Randy.

<u>Catastrophes and Other Losses</u>

As Randy indicated and as we pre-released twice this quarter, we experienced both significant catastrophe losses and large losses during third quarter. We are accustomed to accounting for catastrophe losses, especially in second and third quarters due to severe late spring and early summer convective storms, but this year has been especially significant. We experienced six catastrophic events during the latter weeks of June this year – one event occurred on June 30 and continued into July 1. None of the storms appeared to be unreasonably material and none exceeded $5 million. Early reported claims were primarily personal lines claims. As June passed into July, we experienced a significant increase in the number of reported commercial lines claims, mostly hail damage to large commercial roofs, which are more difficult and time-consuming to assess. Though not material on an individual storm basis, in aggregate, these carryover claims were significant.

As for large losses, we experienced an up-tick again during third quarter. Recurring quarters of large losses is highly unusual for us and a phenomenon we are taking very seriously. So far, we have not seen any specific trends with regard to these large losses. Similar to the catastrophe losses, they are multi-state events with no apparent trend due to branch or class of business. We have analyzed the data and we are not seeing disproportionate losses coming from new accounts. Claims are generally property-related due to fire losses, but also affect our commercial auto and commercial liability lines of business to a much lesser extent. We have taken steps to more closely identify any underlying or less obvious issues by putting our internal file audit team on task to review specific claims, policy changes and any other issues that might be a contributing factor. This team is a group of our most experienced underwriters representing all our branches.

Recent discussions with reinsurance brokers assure us that an increase in fire losses is currently an industry occurrence and is not an unusual trend as the economy emerges from an economic downturn since maintenance is usually down-sized during periods of economic decline. Nonetheless, we are uncomfortable with the frequency with which we are seeing these claims. We will continue to monitor the situation diligently.

For several quarters now, we have emphasized an increased interest in improving our workers' compensation line of business. We are not a stand-alone carrier of workers' compensation and only write policies in conjunction with our commercial package policies, but we strive for profitability in all of our lines. I am happy to report that we experienced improvement in the profitability of our workers' compensation line during the third quarter and year-to-date. This is the result of past rate increases in this line, continued focus on eliminating poor performing accounts, and various other measures that we continue to take to improve profitability in this line.

Frequency was up during the quarter and year-to-date --- again, as a result of catastrophe events. Frequency was slightly improved if catastrophe events were excluded.

The story is similar with regard to severity. We did see an uptick in severity as a result of the types of claims associated with individual catastrophic and large loss events.

Our Specialty Operation continued to grow during the quarter and the loss experience has been very good. I remind our listeners that we do not consider this business material during this first year of operations since premiums earned are not significant.

In the grand scope of things, falling reinsurance rates are a clear benefit to our organization and afford us the opportunity to maximize our reinsurance coverage at the least expensive rates in years. Conversely, for our assumed business, falling reinsurance rates are not preferable, but we do have the option of walking away from assumed business that is underpriced. Absent a major event, we do not expect reinsurance rates to increase any time soon.

With that, I'll turn the financial discussion over to Dianne Lyons.

Dianne Lyons, Senior Vice President and Chief Financial Officer

Thanks Mike.

Consolidated net income, including net realized investment gains and losses, was $0.3 million or $0.01 per share for the quarter compared to $11.7 million or $0.45 per share last year. Year-to-date, consolidated net income, including net realized investment gains and losses, was $24.3 million or $0.95 per share compared to $49.6 million or $1.94 per share in 2013.

Losses and loss settlement expenses increased by $23.2 million, or 17.7 percent, during the third quarter compared to the third quarter of 2013 and $73.2 million, or 21.0 percent year-to-date. For the quarter, losses and loss settlement expenses were impacted by a significant increase in both catastrophe losses and a significant number of large losses, especially in our commercial property line of business. The year-to-date losses and loss settlement expenses also included large losses due to a townhome complex fire reported in first quarter, a city block commercial fire reported in second quarter and a third quarter commercial fire in which we represented both the property owner and the business tenant.

Consistent with our pre-announcement on October 23, 2014, pre-tax catastrophe losses for the quarter totaled $23.3 million, or $0.60 per share after tax, compared to $8.5 million, or $0.21 per share after tax. These losses added 11.9 percentage points to our combined ratio. Year-to-date, catastrophe losses totaled $47.2 million, or $1.20 per share after tax, and added 8.4 percentage points to the combined ratio. Typically fourth quarter catastrophe losses are light which leads us to believe that our 2014 catastrophe losses will likely be more closely aligned with our annual catastrophe load expectations of 6.0 percentage points.

Favorable reserve development for the third quarter was $6.8 million compared to $8.6 million in the third quarter of 2013. The positive impact on net income for the quarter was $0.17 per share compared to $0.22 per share in 2013. The decline for the quarter is due to the timing of paid claims. Year-to-date, favorable reserve development was $32.5 million, or $0.83 per share compared to $49.0 million, or $1.25 per share. Our year-to-date favorable development reflects both the timing of paid claims from the third quarter and adverse development of large claims from prior accident years. As we have stated on many occasions, reserve development will vary from quarter to quarter and year to year due to the timing of the payment of claims. I will remind our audience that we have historically reserved on a conservative basis and continue to do so. At September 30, 2014 our total reserves remained relatively flat and within our actuarial estimates.

Investments

Consolidated net investment income was $22.8 million for the third quarter, which was a decrease of 16.3 percent as compared $27.3 million in third quarter 2013. Year-to-date, consolidated net investment income was $77.2 million, a decrease of 6.7 percent, as compared to net investment income of $82.8 million for the same period in 2013. The quarterly and year-to-date decreases are primarily due changes in the value of our investments in limited liability partnerships, which ae 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 periods. 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 for the remainder of 2014 and into 2015. The weighted average effective duration of our fixed maturity securities portfolio at September 30, 2014 was 4.7 years compared to 5.0 years at December 31, 2013. Our overall portfolio yield was 3.7 percent.

Consolidated net realized investment gains for the quarter were $0.9 million compared to net realized investment gains of $1.2 million in 2013. Year-to-date consolidated net realized investment gains were $5.8 million compared to $7.3 million in 2013. Consolidated net unrealized investment gains, net of tax, totaled $139.2 million as of September 30, 2014, which is an increase of $22.6 million or 19.3 percent from December 31, 2013. 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 at September 30, 2014, and to a lesser extent, an increase in the fair value of our equity investment portfolio, which was impacted by overall equity market improvement.

Expense Ratio

The expense ratio for the third quarter was 31.1 percentage points, compared to 30.5 percentage points for the third quarter of 2013. Year-to-date, the expense ratio was 31.4 percentage points compared to 31.9 percentage points in 2013. Even though the year-to-date expense ratio is down somewhat compared to a year ago, it is not where we would like it to be or where we expect it to be. It is currently being adversely impacted by an increase in premium taxes and assessments due to premium growth in specific lines of business. An additional third quarter factor is the deterioration in the profitability of certain lines of business caused by an increase in claims severity that limits the amount of underwriting expenses eligible for deferral. We continue to expect a gradual return to a more favorable expense ratio consistent with our history.

Balance Sheet Highlights

Our stockholders' equity increased 3.3 percent to $808.4 million at September 30, 2014 from $782.8 million at December 31, 2013. The increase was primarily attributable to net income of $24.3 million and an increase in net unrealized investment gains of $22.6 million, net of tax, during the first nine months of 2014. These increases were offset by shareholder dividends of $14.7 million and share repurchases of $11.2 million. At September 30, 2014 the book value per share of our common stock was $32.26 compared to $30.87 at December 31, 2013.

Capital Management

During the third quarter, we declared and paid a $0.20 per share cash dividend to shareholders of record on September 2, 2014. Year-to-date, we have declared and paid dividends of $0.58 per share.

In addition, during the third quarter we repurchased 200,003 shares of United Fire common shares at an average price of $28.41. On August 15, 2014, the Board of Directors authorized an additional 1,000,000 shares to the Share Repurchase program and extended its eligibility. As you can see from Slide number six, we have returned more than $25.9 million this year-to-date to shareholders and $117.6 million since 2010 in cash dividends and share repurchases.

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 1.7 million shares of common stock under the new program which expires August 31, 2016.

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

Operator:

Thank you. At this time, we will 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 that 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 keys.

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

Paul Newsome:

Good morning everyone.

Randy Ramlo:

Hi Paul.

Paul Newsome:

But, you know, for what it's worth, I appreciate the fact that you've stepped up the buybacks particularly with the stock this low. I was hoping you could kind of step back and look at your loss ratio ex cats over the last say, you know, look at the chart maybe since 2009, and I guess outside of 2009, if you kind of look at it from 2010 to present, it looks awfully flat in an environment where we should've been getting some fairly decent price increases. Could you kind of talk about what you think are the other factors involved here, that—and big picture obviously and maybe even outside of the quarter's fire issues.

Randy Ramlo:

Well, I would say Paul—this is Randy. If we're kind of getting all during that period, kind of a consistent mid-single digit rate increase minus inflation, you know, which may be say 3, 3.5, I'm not sure what it was going back to 2010. I think you'd expect maybe 3 points of margin expansion and that's kind of what we, what we had every year going back, maybe less so between 2012 and '13. But going back to '09, '10, and '11, it would seem to be 3 points would seem to make pretty good sense. This market has been kind of uniquely characterized with not having giant double-digit rate increases, but maybe we've shown a little bit more consistency. Mike, do you have anything to add to that?

Michael Wilkins:

No, I would agree with Randy's comments and I think, you know, why didn't we have that level of market expansion in 2013 and 2014. I think you can look at, some of the severity that we've had and that's, you know, where we're spending our time right now trying to address that issue.

Paul Newsome:

(Inaudible), obviously the question of the day, what you can add on those severity issues, that you are trying to address in terms of details. It sounds like the basic ideas of looking for particular business lines is not the where you—you've found obvious evidence of problems. What are the next steps?

Randy Ramlo:

Well, one thing we really got to, if you look at all of our lines of business, they're all doing okay except property, and part of that's, you know, catastrophic losses, part of it's smaller storm losses in the Midwest. You know, we're trying to diversify and write more nationwide business, especially in the East and West Coast. But we're not able to write new property business and non-cat exposed areas fast enough to offset our exposure, kind of in the Midwest and Gulf.

So, one of the things we've got to do is, step up pricing and selectivity and maybe some loss control and underwriting measures on our property book, you know, sooner rather than later, we probably have to adjust some goals in the property area. You've heard us comment in the past that we want to emphasize our BOP writings in small commercial, and obviously those have property lines that go with them. But, our experience has not been real bad in those areas, but it's really been, you know, our commercial property areas specifically some of the larger commercial roofs (ph), that have experienced hail damage.

So, we may have to look at more cosmetic damage endorsements, larger deductibles, obviously exiting from some accounts, and reducing our concentration. Our workers' compensation has improved nicely, auto has maybe ticked up a little bit, and we have to pay a little bit of attention to that. Our casualty experience has been good, personal lines has ticked up a little bit, the homeowners, again based mostly on storms, but then our personal auto has ticked up a little bit too and we've got some initiatives going for the future that I think is going to help that line.

Paul Newsome:

Terrific, thank you. I'll let somebody else ask some questions.

Randy Ramlo:

Thanks Paul.

Operator:

Just a reminder, to ask a question, press star, one on your telephone keypad.

Our next question comes from Vincent DeAugustino with KBW. Please go ahead.

Joab Dempsey:

Hi, good morning everyone, it's actually Joab Dempsey on for Vincent today. I work alongside Vincent here at KBW, and I'm going to be stepping in for him today. So with that being said, we just have a couple of quick questions. The first is related to your workers' comp initiatives. It looks like some of those initiatives that you have underway on workers' comp are actually gaining traction, and I was hoping that you might be able to provide some details on the workers' comp loss ratio improvement year-over-year, in terms of how much that is coming from your initiatives versus any swings in the reserve development or other items?

Randy Ramlo:

I think a lot of it, you know, is coming from our initiatives. You know, we've done some things with loss control that I won't get into the detail. We've really pushed that line hard on price increases and then we've kind of had, I think we've mentioned in the past, we tried to identify the worst 5% performing accounts in that line, and either severely increased the prices or exit from those accounts. So, those are really the biggest areas that we focused on.

Joab Dempsey:

Okay, great. We—

Randy Ramlo:

I don't know on the reserving, I think we've been pretty consistent there actually, that's actually one of our more consistent reserving lines. So, I don't think reserve changes contributed very much to the improvement.

Joab Dempsey:

Okay.

Michael Wilkins:

This is Mike Wilkins. I don't know the exact figures on the reserve changes either, but I do know our accident year has improved, as well as the calendar year. So, you know it's more than just reserving.

Joab Dempsey:

Okay, great and we noticed looking at the press releases between this quarter and last quarter, there was a little bit of a different commentary around the expense deferrals. I'm just curious that the difference here owes to some of the loss activities specifically in the quarter, or if there are any underlying go-forward assumption changes that are driving the change, and if you might be able to quantify the impact of the expense ratio this quarter?

Dianne Lyons:

This is Dianne Lyons and it's more of a quarter phenomenon than a year-to-date or going forward and I can't quantify that. I would kind of back of the envelope, would say it'd be about a one point difference there. I do see other initiatives that we're taking here from an expense standpoint. Some of them still related to Mercer, but to a lesser extent, other internal measures that we have that will be driving that down. Again, a lot of that has to do with the poor experience just as those lines where we had some severity which caused some premium deficiency, which ultimately leads us to need to write off some of those expenses, some of those deferred expenses.

Joab Dempsey:

Great and on the personal lines front, earlier in the call you guys mentioned you've been walking away from underpriced business. So, I guess I would have expected less deceleration on the rate increase pace there or is this a situation where you're, you know, losing some of the accounts that need the increase the most, therefore are (ph) skewing rate increases metrics towards your better accounts? Or should we potentially expect personal line increases to accelerate from here? How should we think about this?

Michael Wilkins:

Joab, this is Mike. I think when we talked about walking away from underpriced accounts, we're primarily talking coastal business.

Joab Dempsey:

Okay.

Michael Wilkins:

So it's really the books that we have in probably specifically New Jersey, but maybe also Louisiana, Florida, and Texas. That's where in some situations we feel we can't get adequate rate, write (ph) that at a level that long-term will provide the level of profit that we need to compensate us for the bad storm years that you have in those areas when you have a hurricane.

What was the second part of your question? Oh, go-forward just on the rate increases?

Joab Dempsey:

Yes, yes.

Michael Wilkins:

I would say in the storm-exposed areas, Midwest and the South in particular, the homeowner rate environment is very good; we're looking at upper-single digits, and there's been no deceleration there at all. I think we've probably seen a little bit more competition in the personal auto this year than we've seen in a couple of years. So those increases are low-single digits or maybe, you know a year or two ago they were mid-single digits.

Joab Dempsey:

Great and then just last, my last question here. I just wanted to check-in on the subrogation process from the Town Hall exposure earlier in the year; do you guys have an update on that at all?

David Conner:

This is Dave Conner with Claims. Not much of a specific update, I can tell you or reaffirm that our optimism still exists that our recovery will be forthcoming, and the only question still is, how long that will take and to what degree or how much we will recover on the overall loss. As I mentioned before, they initially will get a credit for, argue for, and rightfully so, replacement cost versus actual cash value that we know we won't get the entire amount back. We're very optimistic about a recovery; timing and how much of a recovery is still a question.

Joab Dempsey:

Okay. All right, that's all I had. Thanks so much for taking my questions today.

Randy Ramlo:

Thank you.

Operator:

There appears to be no further questions at this time. I'll turn the conference back to Management for closing remarks. Thank you.

Anita Novak, Director of Investor Relations

Thanks, Diego. 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.