United Fire Group, Inc.

Q2 2017 Financial Results Conference Call

August 2, 2017 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Randy Ramlo, *Chief Executive Officer*

Michael Wilkins, *Chief Operating Officer*

Dawn Jaffray, *Chief Financial Officer*

Randy Patten, *Assistant Vice President, Finance & Investor Relations*

PRESENTATION

Operator
Good morning. My name is Allison, and I'll be your conference operator today. At this time, I would like to welcome everyone to the United Fire Group Second Quarter 2017 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 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

Thank you, and I would now 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. The 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, Chief Executive Officer of United Fire Group.

Randy Ramlo
Thanks, Randy. Good morning, everyone, and welcome to the UFG Insurance Second Quarter 2017 Conference Call. Earlier this morning, we reported net income of 12 cents per diluted share, operating income of 5 cents per diluted share, and a GAAP-combined ratio of 107.2 percent for the second quarter of 2017. This compares with net income of 12 cents per diluted share, operating income of 8 cents per diluted share, and a GAAP-combined ratio of 104.8 percent in the second quarter of 2016.

Our second quarter 2017 net income was comparable to last year's second quarter. In both periods, we had an elevated level of losses in our P&C segment; however, in second quarter of 2016, losses were driven by catastrophes, and in the second quarter of 2017, losses were driven by an increase in frequency and severity of commercial auto claims. We are disappointed we are not making more progress in our commercial auto line. We will continue to take more aggressive action until we see improvement, focusing on rate increases, additional tightening of underwriting guidelines, loss control requirements, along with implementing new analytical tools. These initiatives will take some time before we realize the positive impact in our financial results. Mike will discuss the initiatives we're putting in place to improve our underwriting performance in this line in more detail.

In the second quarter of 2017, we had 16 large commercial auto claims, which we define as claims larger than $500,000, compared to five large commercial auto claims in the second quarter of 2016. These claims were geographically dispersed, with losses occurring in each of our regions. Year to date we've had 28 large commercial auto claims as compared to nine large claims in the prior year to date. In both the second quarter and year-to-date 2017, we also experienced an increase in frequency of commercial auto liability and commercial auto physical damage losses compared to the same period last year. This increase in the frequency and severity of commercial auto losses is the primary reason for the deterioration in the core loss ratio, adding 7.7 percentage points to the combined ratio.

Moving on to catastrophe losses, CATs added 11.6 percentage points to the combined ratio in the second quarter of 2017 compared to 15.3 percentage points in the second quarter of 2016. The CAT load for the second quarter of 2017 is in line with our ten-year historical average for the second quarter, of 11.3 percentage points.

Our expense ratio continues to meet our expectations at 30.3 percent for the second quarter of 2017, which is level with the second quarter of 2016. This is the fifth straight quarter of an expense ratio right at or around 30 percent.

For the life segment, we reported net income of $2.8 million, or 11 cents per diluted share, in the second quarter of 2017 compared to a net loss of $300,000, or 1 cent per diluted share, in the second quarter of 2016. Year-to-date net income was $4.2 million, or 16 cents per diluted share, compared to $100,000, or less than 1 cent per diluted share year-to-date 2016. In 2017, the life segment benefited from an increase in realized gains on the sale of two fixed-maturity securities that were previously impaired, which resulted in an after-tax gain of $1.5 million. In addition to these gains, we are beginning to see some positive momentum from the strategies we put in place earlier this year to improve profitability in this life segment. As we discussed in previous quarters, these strategies include pricing changes and the restructuring of commissions.

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

Michael Wilkins
Thanks, Randy, and good morning, everyone. As Randy indicated, we had a deterioration in our core loss ratio in the second quarter of 2017, driven by an increase in frequency and severity of losses in our commercial auto line of business. Much of this deterioration is due to strengthening of reserves on the last three prior accident years and only slightly due to an increase in current accident year paid losses. This reserve strengthening is partially due to bodily injury loss inflation, which we in the industry are experiencing. This inflation is due to jurisdictional issues and an increase in unfavorable awards, which increases potential exposures on commercial auto bodily injury cases. We believe the majority of this increase in commercial auto losses is due to an increase in miles driven and distracted driving.

As we mentioned last quarter, one of our initiatives that we will be implementing later this year is a distracted driving campaign. This campaign, which we are calling Worth It, is a comprehensive educational and marketing program to remind drivers that life is worth it; driving distracted is not. This collection of resources is designed to reach and engage. It can be used by business owners, insurance agents, educators, or individuals, basically anyone interested in helping fight the epidemic of distracted driving.

Other loss control efforts to improve profitability in our commercial auto line include tightening of underwriting guidelines and loss control requirements. During the second quarter of 2017, our loss control reps have increased the frequency of visits to our insureds aimed at improving commercial auto results. Our reps are working with insureds to implement vehicle-use policies to set guidelines for acceptable driving behavior. They are also grading accounts, A through F, on the account's vehicle use policy, their attitude towards cellphone use, as well as the level of rigor in monitoring and enforcing these policies.

Our underwriters are also using these loss control grades in the renewal and pricing decisions. They have significantly tightened underwriting guidelines and are aggressively increasing pricing on heavy auto exposures, including waste haulers, sand and gravel haulers, and other heavy-wheeled exposures that are driving some of our issues of severity of losses.

Commercial auto rate increases during the second quarter were in the mid- to upper-single digits, depending on the region. We will continue to push for rate increases in our commercial auto line and continue to review and non-renew underperforming accounts. We have increased the level of detail in our tracking of pricing increases in our commercial auto line of business to ensure we are getting the increases we are targeting.

One way we are doing this is through the use of new analytical tools. As we mentioned earlier this year, we created a new Analytics Department that rolled out a new analytical tool at the end of the second quarter to assist in providing pricing and acceptability guidance to underwriters on our commercial auto business.

Moving on to catastrophes. As Randy indicated, catastrophe losses in the second quarter were in line with our ten-year historical average and decreased compared to the prior year's second quarter. In the second quarter of 2017, we experienced a decrease in severity of catastrophe losses, with a slight increase in frequency of catastrophe events and claims. During the second quarter of 2017, we had 1,243 catastrophe claims from 20 events, as compared to 1,172 claims from 16 events in the second quarter of 2016.

Continuing on with our discussion on loss ratios, our commercial other liability loss ratio improved significantly in the second quarter of 2017 as compared to prior year, primarily due to favorable reserve development in prior accident reserves and a reallocation of IBNR reserves primarily from our construction defect book of business. While we saw a deterioration in our loss ratio in commercial fire and allied lines as well as personal auto and personal fire and allied lines of business, the deterioration is primarily due to an increase in frequency with claim counts increasing in each of these lines of business.

We continue to experience competitive market conditions, with an increase in competition in the second quarter of 2017. We were most successful on accounts with less than $10,000 in premium but also had success in accounts over $100,000 in certain regions, specifically in our Midwest, Rocky Mountain, and Gulf Coast regions. Overall, average renewal pricing changes for commercial lines was nearly flat, with first quarter of 2017, with pricing varying depending on the region and size of the account. Commercial auto and commercial property rate increases continue to be in the mid- to upper-single digits with negative rate changes for workers' compensation and BOP lines of business. Overall, average renewal pricing change for personal lines was in the low single digits.

Premium and policy retention were comparable to the first quarter of 2017 at 84 and 81 percent, respectively. Our success ratio on quoted accounts decreased 1 percent from the prior quarter to 33 percent. As we continue to address the deterioration in our auto book of business, our expectation is that premium and policy retention may be negatively impacted.

During the second quarter of 2017, property and casualty premium written increased 3 percent, as compared to second quarter of 2016, with the majority of the increase coming from endorsements and audits, with new business decreasing slightly during the quarter.

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

Dawn Jaffray
Thanks, Mike, and good morning. For the second quarter 2017, we reported consolidated net income of $3 million, or 12 cents per diluted share, as compared to $3.1 million, or 12 cents per diluted share, in the second quarter of 2016. Through 2017 year-to-date, consolidated net income was $22.9 million, or 89 cents per diluted share, compared with $25.5 million, or $1.00 per diluted share in 2016. The decrease in net income in the second quarter and year-to-date as compared to 2016, is primarily due to deterioration in our core loss ratio previously discussed by Randy and Mike.

Quarterly consolidated net premiums earned increased 2.4 percent in Q2 compared to 2016, and total revenues increased 2.6 percent. And year-to-date consolidated net premiums earned increased 3.8 percent and total revenues increased 4.5 percent compared with 2016 year to date. Specifically, property and casualty segment net premiums earned increased 5.6 percent in the second quarter and 6.4 percent year-to-date as compared with the same periods in 2016 and both relatively in line with previously mentioned expectations.

Consolidated net investment income was $24.6 million for the second quarter of 2017, which was comparable to the prior second quarter with $24.5 million. Year-to-date 2017 investment income was $49.6 million, or a 6.2 percent increase as compared to the same period in 2016. The increase in net investment income through the comparative first six months of 2017 was primarily driven by the change in value of our investments in limited liability partnerships and not due to a change in our investment philosophy. This resulted in an increase of $2.2 million in investment income year to date 2017 as compared to the same period of 2016.

Losses and loss settlement expenses increased by $17 million, or 9.6 percent, during the second quarter of 2017 compared with the second quarter of 2016, and increased $43 million, or 13.3 percent, over 2016 on a year-to-date basis. The primary driver of the increase in 2017 was due to an increase in severity in commercial auto losses, as we've already discussed.

Favorable reserve development for the second quarter of 2017 was $16.3 million compared to $2.5 million in the second quarter of 2016. Year-to-date 2017 favorable reserve development was $41.2 million as compared to $26.4 million in 2016. The impact on net income for the second quarter and year-to-date in 2017 was 41 cents and $1.04 per diluted share compared to 6 cents and 67 cents per diluted share in the same period of 2016.

Looking at favorable development in more detail in the second quarter of 2017, the majority of the favorable development impacted two lines—commercial liability, with $15.8 million, and worker's compensation with $6 million. The favorable development was offset by reserve strengthening in each of commercial fire and allied, with $3.8 million, and commercial auto, with $2.1 million of adverse development.

Year-to-date 2017, once again, the majority of the favorable development impacted two lines—commercial liability, with $41.5 million, and worker's compensation, with $10 million of favorable development. This favorable development was offset by reserve strengthening in both commercial fire and allied, with $6.3 million and assumed re-insurance with $5.4 million of adverse development. The combined ratio in the second quarter 2017 was 107.2 percent compared to 104.8 percent for the second quarter in 2016. Year-to-date 2017, the combined ratio was 102 percent compared to 98.7 percent for the same period of 2016.

Removing the impact of catastrophe losses and reserve development, our core loss ratio deteriorated 11.6 percent and 7.7 percent in the second quarter of 2017 and year-to-date, respectively, when compared with 2016. The primary driver of the deterioration in the core loss ratio is an increase in the severity of commercial auto losses as previously discussed. Referring to slide 9 in our slide deck on our website, we've provided a detailed reconciliation of the impact of catastrophes and reserve development on the combined ratio.

As Randy noted, our expense ratio for second quarter 2017 was 30.3 percent, level with second quarter 2016. Year-to-date our 2017 expense ratio was 30.3 percent, or a decrease of 0.7 percent, when compared to the same period in 2016. The decrease is primarily due to a decrease in post-retirement benefit expenses, which we've discussed the past few quarters, and a reduction in our accrual for contingent commissions based on the deterioration in the loss ratio. Partially offsetting these positive impacts to the expense ratio is $4.1 million of underwriting expenses typically eligible for deferral in our deferred acquisition costs. This adjustment is due to the deterioration of commercial and personal auto lines of business that has been previously discussed.

Return on equity was 4.8 percent year-to-date in 2017 compared to 5.6 percent in 2016. The decrease in ROE as compared to the same quarter last year was primarily due to a combination of a decrease in net income and an increase in shareholders' equity. Our return on equity, excluding unrealized investment gains, was 5.7 percent year-to-date 2017.

With respect to capital management, during the second quarter, we declared and paid a 28 cent per share cash dividend to the stockholders of record on June 1, 2017. And, as I mention each conference call, we have paid a quarterly dividend every quarter since March of 1968.

Continuing, during the second quarter of 2017, we remained active with our share repurchase program. During the second quarter, we repurchased 361,627 shares of our common stock at an average price of $42.68 and a total cost of $15.4 million.

Year-to-date through June, we have repurchased 496,608 shares of our common stock for a total cost of $21.2 million. As a reminder, we purchase United Fire common stock from time to time on the open market and/or through privately-negotiated transactions as the opportunity arises. The amount and timing of any purchases will be at management's discretion and will depend on 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 2.4 million shares of common stock under our share repurchase program which expires in August of 2018.

And with that, 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 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time, we will pause for a moment to assemble our roster.

Our first question will come from Paul Newsome from Sandler O'Neill. Please go ahead.

Paul Newsome
Good morning. Thanks for the conference call. I'm getting the impression—tell me if I'm wrong—that the issues in commercial auto are being primarily addressed with loss control efforts as opposed to just trying to raise rates. Is that a fair impression?

Randy Ramlo
Paul, this is Randy Ramlo. I'll maybe make a comment, and then maybe Michael Wilkins will want to comment as well, but, you know, I wish we could raise rates more. We were probably slightly disappointed with the rate increases that we were able to get. The market is kind of strange right now. I've never seen a time where—I would call this a soft market, but there is some hardness in commercial auto but not nearly enough in our markets anyway to be able to cure the problem. So we're having to do it with a combination of rate increases and underwriting actions and loss control actions, but, in essence, the market won't let us get the rate that we really need to solve the problem with rates alone.

Mike, do you have any other things to add?

Michael Wilkins
Yeah, Paul, maybe just to echo what Randy said. I would say it's a multi-pronged approach to try to improve the loss ratio, you know, everything from analytics to tightening underwriting guidelines, trying to get more rate, getting our loss control more involved, better tracking. And I'd say on the claims side, we're trying to do a better job managing the claims, especially if litigation is involved. So we're trying to take a multi-faceted approach to improve the results from a lot of different angles.

Paul Newsome
Okay, Thanks.

Randy Ramlo
Thank you, Paul.

Operator
Again, if you would like to ask a question, please press star and then 1.

Our next question will come from Brian Hollenden from Sidoti. Please go ahead.

Brian Hollenden
Good morning, and thanks for taking my call.

Randy Ramlo
Good morning.

Brian Hollenden
Is there a particular geographic region where you're seeing the weakness in commercial auto? And just echoing what you were just talking about, other than price increases, what sort of technology tools are you utilizing to help mitigate these losses?

Randy Ramlo
This is Randy Ramlo again, Brian. Thanks for the question. I would say that there are geographic differences in the problem, but it's a problem pretty much across the United States. Some of our regions that are doing a little bit better are maybe able to write business in less population-concentrated areas, but other than that, all of our regions have an issue with commercial auto. Like I said, some are much worse than others. You know, our West Coast has kind of continued to be the biggest area of our problem, and, again, that's has lot of population concentrations there as well.

Mike mentioned jurisdictions, along with what we're seeing in the distracted driving area. We're also seeing courts being very unsympathetic for people who cause accidents because they were distracted, so that's kind of multiplies itself. You know mileage is up, and we've learned that when mileage increases, losses don't increase by the same percentage but some multiple of that, so on the analytics side, we're just trying to find more predictive characteristics other the one that our underwriters have been using in the past. Mike, do you have any other things to add?

Michael Wilkins
Well, maybe the only thing to add to what Randy said, you know, I'd say the makeup of the book of business in the regions is also a factor, so we've seen more issues with books that have more heavy-wheeled exposure and particularly on the severity side.

Brian Hollenden
I appreciate the color. You reported a nice pickup in profitability within the life segment despite the significant decline in premiums. How much more opportunity do you see there?

Randy Ramlo
This is Randy again. Yes, as you can see, a lot of our profitability pickup was actually through the sales of some securities that we'd written down previously, but we did make some tough choices on commissions and rates that have been implemented fairly recently, but the good news is we are starting to see some pick up there. So that's obviously a very interest rate-driven business, but, yes, I think we've got a couple more things to—Dawn was pointing out to me that we have in the future, so we think we can get a little bit more lift in that area in the quarters to come.

Brian Hollenden
Okay. And in terms of new premiums and organic growth, can you talk a little bit about your geographic expansion, and is that going as expected, better or worse, and just provide a little bit of overview, you know, maybe your outlook and opportunities there.

Randy Ramlo
Okay. This is Randy again. So in our past, our philosophy has been that it's very difficult to grow from square one in new geographic areas. We've tended to grow geographically through

acquisitions, but over the last couple of years, we've put out the plan to grow in four additional states that we have somewhat surrounded. Ohio was our first expansion of a new state from scratch, and that is exceeding expectations. For a competitive state, that's went very well.

Kentucky, I'd probably list pretty new in the game, but, as expected, and then Michigan and Washington will be our two next areas of expansion, and kind of due to some internal resource strain on some other projects we have, we'll probably be pushing those two back maybe a couple of quarters, but that's kind of in a nutshell, how we're doing. A lot of our organic growth is really growing in areas that we're already successful, and that's the plan for the future.

Brian Hollenden
Appreciate the color, and if I could ask one more, and I'll hop back into the queue. Can you just talk—can you talk about your time—the framework with the share buybacks? Do you have a particular target range based on a price to book or is it more a function of organic premium growth opportunities? How do you guys think about capital allocation internally?

Randy Ramlo
Well, I've always felt that our best use of capital is organic growth, writing new business. That being said, we have a price-to-book level that when our shares fall below that, we do buy back. And so we look at share buybacks as probably the worst use of capital that we have, but it is a use of capital, and sometimes when there are no other opportunities, such as acquisitions and things like that, it is a use of capital.

So when our share prices drop below a certain price-to-book value, we do buy back. We're somewhat limited just by our daily number of shares traded, so we're not able to make as big of an impact. But we like to use our capital for organic growth, which we do, but every now and then when our shares drop below a certain price- to- book, then we do that as well, so we try to. Our capital management, really, is kind of looking at using all the tools we possibly can to utilize the capital in the best way.

Brian Hollenden
All right. Thanks for taking my questions.

Operator
This will conclude our question-and-answer session. I would like to turn the conference back over to Randy Patten for any closing remarks.

CONCLUSION

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

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.