United Fire Group

Full Year and Fourth Quarter 2022 Results Conference Call

February 16, 2023 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Eric Martin - *SVP and CFO*

Kevin Leidwinger - *President and CEO*

PRESENTATION

Operator
Good morning, and welcome to the UFG Full Year and Fourth Quarter 2022 Results Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on a touchtone phone. To withdraw your question, please press star then two. Please note this event is being recorded.

I would now like to turn the conference over to UFG, Senior Vice President and Chief Financial Officer, Eric Martin. Please go ahead, sir.

Eric Martin
Good morning, and thank you for joining this call. Yesterday afternoon, we issued a press 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 Investors tab.

Joining me today on the call is UFG President and Chief Executive Officer, Kevin Leidwinger. Before I turn the call over to Kevin, a couple of reminders. First, 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. The actual results may differ materially due to a variety of factors, which are described in our press release and SEC filings.

Also, please 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 will turn the call over to Mr. Kevin Leidwinger, CEO of UFG Insurance.

Kevin Leidwinger
Thanks, Eric. Good morning, everyone, and welcome to our fourth quarter conference call. I'll begin this morning by providing insight into the fourth quarter results, then provide an overview of our full year performance.

First, let me say I'm pleased with the progress I've seen since joining UFG in August. We continue to position our company for superior financial and operational performance. Over the past year, we have further diversified our portfolio, improved its underlying fundamentals and intensified our focus on reducing the expense ratio. I'm proud of the work our team has done in executing our strategic plan.

Turning now to fourth quarter results, we're pleased to report net written premium increased 6.3% to $235 million compared to $221 million in the fourth quarter of 2021. This marks the third consecutive quarter of net written premium growth as the business gains momentum following the re-underwriting exercise of the last several years. Growth was driven by our specialty, surety and assumed reinsurance businesses.

Our core commercial business, including construction, middle market, small business and marine was down slightly. However, we are encouraged by the improved retention ratios and increased new

business production we saw in the quarter. The momentum continued into January, and we expect the core commercial business to return to profitable growth in the coming quarters.

The combined ratio was 103.6% in the fourth quarter and was impacted by 5 points of catastrophe loss activity and 5 points of adverse development. The adverse development in the quarter was the result of the more granular analysis of the construction defect portfolio. The underlying combined ratio for the fourth quarter was 93.8%.

As mentioned last quarter, we remain intensely focused on lowering our expense ratio, which fell to 33.8% in the fourth quarter of 2022 as early benefits of our expense management actions begin to take effect.

Turning now to our full year results. Net written premium increased 4.6% to $984 million compared to $941 million in 2021. As with our most recent quarters, growth was driven by our specialty, surety and assumed reinsurance businesses, while our core commercial business continues to recover.

The combined ratio for full year 2022 was 101.4%, a slight deterioration over full year 2021. The combined ratio was impacted by 7.7 points of catastrophe loss activity and prior period development was neutral. The underlying combined ratio was 93.6% for full year 2022, a 3.4 point improvement over the previous year. The underlying loss ratio improved 5.2 points to 59.2%, our best underlying loss ratio in the last 10 years.

The improvement in our underlying loss ratio was the result of significant actions taken over the past several years to improve profitability, diversify our portfolio, strengthen underwriting governance and reduce volatility.

With respect to reinsurance, I'm pleased to share that we successfully renewed our multiline and catastrophe programs on January 1. Although we experienced increased costs and modest terms and conditions changes, they were consistent with the broader market. With the increased cost of reinsurance, we will continue pursuing property rate increases.

We also made the strategic decision to add a variable quota-share treaty to support growth and reduce volatility in our specialty portfolio. Despite the many challenges we face as an industry, I'm confident the actions we are taking today will put our company in a strong position to deliver consistent superior financial and operational performance for the benefit of all of the UFG stakeholders.

Finally, I'd like to welcome Julie Stephenson to UFG. Julie joined UFG at the end of January as Executive Vice President and Chief Operating Officer. Julie is an accomplished leader who brings a wealth of operational, underwriting and portfolio management experience to our company. We are thrilled to have her onboard as we continue to execute our strategic plan and position UFG for long-term success.

I'll now turn the call over to our Chief Financial Officer, Eric Martin, for a detailed discussion of the fourth quarter and full year results. Eric.

Eric Martin
Thanks, Kevin, and good morning again.

In the fourth quarter, we reported net income of $0.79 per diluted share and non-GAAP adjusted operating income of $0.18 per diluted share. Net written premiums increased 6.3% in the fourth quarter compared to the prior year. Our core commercial lines premiums are stabilizing with the slowing rate of

decline, driven by average renewal premium change of 8.3% for the quarter and increasing levels of premium retention and new business. This reflects our transition from re-underwriting actions to positioning the core commercial portfolio for profitable growth. Notably, new business in the fourth quarter increased 55% and retention was 7 points higher than the fourth quarter of 2021.

From a profitability perspective, our fourth quarter combined ratio was 103.6%, which includes 4.9 points of catastrophe losses and 4.9 points of prior year reserve strengthening. The catastrophe losses of $12 million in the fourth quarter were primarily driven by Winter Storm Elliott. With the resulting catastrophe loss ratio of 4.9% within historical ranges of performance for the fourth quarter at 1 point above our 10-year average catastrophe loss ratio and 1 point below our 5-year average catastrophe loss ratio.

In the fourth quarter, we strengthened prior year reserves by $12 million or 4.9 points of combined ratio impact, focusing on our construction defect business in accident years 2015 through 2019, where a combination of deeper analytical insights and emerging claims experience has increased our view of potential exposure and aligned with long reporting lags.

Since we've had two consecutive quarters of reserve strengthening, I'm going to address our results for the full year at this time. For the full year, our prior year reserve actions have had a neutral effect on our combined ratio and reflect two different themes playing out across the year. In the first two quarters, we experienced favorable reserve releases in our commercial auto line of business that continued in the third and fourth quarters. This favorable emergence resulted from strong case reserving and reduced claim handling costs, facilitated by our specialized claims operating model.

In the third and fourth quarters, these reserve releases were offset by strengthening in our commercial liability portfolio, where a deeper view of our data has given us new perspectives and lines of business where the most uncertainty exists. The third quarter strengthening focused on excess umbrella where social and economic inflationary pressures are increasing the propensity for claims to pierce the excess layers, in line with what others in the industry are reporting. We've also experienced healthy growth in our specialty excess and surplus business that writes excess layer coverage.

While our results have historically been superior to the industry, we felt it prudent to take a cautious approach here to enable continuation of our historic track record to continue to create financial benefits. The same theme continued in the fourth quarter with the actions focused on construction defect claims that I just described.

Turning to investment results, net investment income benefited from strategically positioning our fixed maturity portfolio toward a shorter duration profile that facilitates reinvesting at higher interest rates. As a result, fourth quarter investment income from fixed maturity assets increased by $2 million or 19% compared to last year. This increase in fixed maturity income was offset by lower valuations in our long-term investment portfolio, resulting in net investment income of $12.9 million in the fourth quarter, relatively flat compared to the fourth quarter of 2021.

In the fourth quarter, both our equity and fixed income portfolios outperformed our market benchmarks. Our equity portfolio generated $20 million in investment gains and the unrealized fixed income loss on our balance sheet decreased by $24 million during the quarter. This improvement in equity and fixed income asset values drove a 5.5% increase in book value from Q3 to Q4.

Our investment portfolio balance was $1.8 billion of invested assets in the fourth quarter, of which 84% is allocated to a high-quality fixed income book.

For the full year, net income per diluted share was $0.59, and non-GAAP adjusted operating income per diluted share was $1.09. For the full year, net written premiums increased 4.6%. Within our core commercial business, the average renewal premium change was 8.3% for the year, with rate increases of 5.2% and exposure increases of 3.1% as we continue to focus on adequate property valuation considering today's inflationary environment. Both new business and retention improved on a full year basis as our core commercial book transitioned out of re-underwriting actions.

Our full year combined ratio of 101.4% included an expense ratio of 34.4%. This is higher than 2021 by 1.8 points, due to one-time impact from changes in post-employee benefits that favorably impacted the 2021 expense ratio. Excluding the impact of those one-time items, the 2022 full year expense ratio would have been 0.3 points lower than 2021, building positive momentum into 2023 as we seek to aggressively improve our expense ratio.

The full year catastrophe loss ratio of 7.7% is a 2.5 point improvement compared to our experience in 2021. As described earlier, prior year reserve development had a neutral impact on our full year loss ratio as releases in the first two quarters focused on commercial auto were offset by strengthening in the third and fourth quarters in excess umbrella and construction defect coverages.

Full year net investment income of $45 million was down $11 million from 2021, as a result of lower long-term partnership valuations in the first half of the year that decreased investment income by $17 million. This more than offset the increased earnings power of reinvesting at higher interest rates that began improving net investment income in the second half of the year and increased fixed maturity income by $5.5 million for the year.

During the quarter, we declared and paid a $0.16 per share cash dividend to shareholders of record as of December 2, 2022, continuing our 54-year history of paying dividends dating back to March 1968.

This concludes our 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 on a 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 two. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Paul Newsome with Piper Sandler.

Paul Newsome
I wanted to ask a little bit more detail on the reserve development in the last couple of quarters. Was there anything that changed either from a philosophical perspective or was there a special look into the reserves the last couple of quarters? Obviously, new management oftentimes takes a different approach or at least a new look. Did anything like that happened during the quarter? Is this simply just the emergence that showed up in the last six months?

Eric Martin
Good morning, Paul. This is Eric. Thank you for joining us and thanks for your question. And it's a really good question. So what I would say is, in general, we have not had a change in philosophy. So if you look back at our history over the past couple of years, we've had some items within our commercial auto book that we have taken action on. But when I look back over the past couple of quarters, and I

think about all four quarters of the year, the first two quarters, we had favorable development of about $23 million. In the second half of the year, we've had that exact same amount going the other way, $23 million of unfavorable.

And as we have had new management come in, we haven't had a change in philosophy. One of the things that we wanted to look at was a deeper segmentation and more analysis around some of our longer tail businesses. So these are the items that all show up in our other liability line. It's excess umbrella coverage, it's product liability or construction defects. So we have taken an opportunity to have a more granular view on those things, especially as we're coming through the year in an inflationary environment, as we see courts reopening, that sort of thing. We really wanted to have a good feel for our exposure on some of these longer tailed lines.

So I think what you might see is, as we've seen this development, as we've been somewhat quick to react, but the underlying themes make sense to us. And I think that's what you'll see going forward is we will be quicker to react to negative news and perhaps a little longer to react to positive news.

Paul Newsome
Do you think the process of taking a more granular approach is finished on the other liability book? And/or do you think that process will be extended to other parts of the business as well?

Eric Martin
So these are the places where we've got the long tail lines. We've done a lot of work on commercial auto over the past. Some of our other lines, probably a little different surety or workers' comp. Our workers' comp line isn't very big right now. We are wanting to continue to grow that. So while I can never say we're done with anything, I think the actions we've taken here we'll continue to get that granular insight, but we've hit the lines with the long tails here.

Kevin Leidwinger
Paul, it's Kevin. Just an additional observation. I mean, it's our intent to use all the tools available to us to gain as much insight as we possibly can. And of course, then we'll take the appropriate action relative to the insights that are provided back through those analysis. And I think Eric's point about being prudent and taking action more quickly on negative trends and perhaps a little more slowly on positive trends is exactly spot on.

Paul Newsome
Makes sense. Obviously, [cough] has a long track record of capable reserve [indiscernible].

I also want to ask about reinsurance and the impact both on a cost basis as well as on the assumed basis. Maybe you could split those two pieces apart for us and talk about impact on the business and the bottom line for what I assume will be a higher reinsurance cost for this year as a purchaser. And then maybe you could talk about any changes you've seen in the assumed reinsurance book as well.

Kevin Leidwinger
Sure. Let me just give you a little bit more color on the reinsurance program. As we mentioned in our prepared comments, all of our reinsurance renews on 1/1. And so like many others, we did experience some pricing increases across our portfolio, along with some changes in terms of conditions.

Let me just give you some context there. So the property CAT XOL premium increased about 54% on a risk-adjusted basis. We saw some increases on our earthquake quota-share program that are about 40%. The pillared occurrence program rate increase was about 20%, but that was a bit moderated or muted compared to the CAT program due to some structural changes with the annual aggregate

deductible. And then what we call our core program, which is the multiline, the working program, rate increased a little bit over 30%. And so clearly, the pricing is somewhat reflective of what the rest of the market experienced.

Let me just give you some context around retentions. So our property CAT XOL retention increased from $15 million to $20 million. We also saw a co-participation increase on the first layer to 28.5%. Our earthquake quota-share limit was reduced by about $10 million. So it's now at $170 million, but still provides coverage in excess of 1 in 250 PML.

On our pillared occurrence, which was a new program we put in place in 2022, we saw an increase in placement. So in 2022, it was 66.5% placed. In 2023, it was 90% placed. So we're pretty happy with the increased participation. We also saw an increase in our overall limit there from $25 million to $30 million, and so we consider that placement a success, particularly in light of this market.

The retention increased from $5 million to $6 million in the annual aggregate deductible increase there from $5 million to $10 million. So certainly, we'll see some additional debt exposure in both the property CAT XOL and the pillared occurrence.

On our core property casualty program, we did take a $5 million annual aggregate deductible on the program this year. We did maintain our $3 million retention. And other than the annual aggregate deductible, there are no changes to the layers or the structure and that program is 100% placed.

So again, much like others saw, premium increase as well as some retention increases in our overall program. We clearly understand the importance of pushing harder on property rate increases, particularly in CAT-exposed parts of our portfolio and that work is underway today, and we would anticipate over the course of the coming year to see improved pricing on the property side to compensate for the additional reinsurance costs.

I'll just pause there and see if you have any questions about that. Otherwise, I'll turn to the assumed.

Paul Newsome
I mean just to simplify it for folks like me, [indiscernible] of the world, essentially, it looks like maybe all things being equal, a little bit more CAT load because of the higher retention and then maybe a little bit of overall pressure on the underwriting margins. The total excess of loss cost goes up a bit. Is that a fair amount of—

Kevin Leidwinger
I think we'll probably have to spend a little bit more time on that issue. So while we saw an increase in the retention under the CAT program, the pillared occurrence is really designed to help manage the frequency of small CAT events that have to accumulate losses inside of the CAT XOL program, and so we saw an increase in placement on the pillared occurrence program. So we're still working through what we think the overall additional exposure to company. But I think there's an offsetting component based on the pillared occurrence increased participation to the overall net increase on the CAT XOL. So those two things are interrelated.

Paul Newsome
Okay, that makes sense. Okay.

Kevin Leidwinger
And then turning now to the assumed reinsurance business, we certainly were the beneficiary of the other side of the market. Clearly, as you saw on our ceded program, there were increases. obviously,

on the assumed reinsurance component of the portfolio, we certainly got the benefit of increased pricing and where that came through for us was certainly on the standard treaty. So we had a significant amount of opportunity for participation on regional carrier treaty reinsurance. As other carriers were reducing their participation, those opportunities were presented to us and so we saw some significant benefit to participate opportunistically on some standard treaty business in this cycle, and so we were quite pleased with that participation.

Paul Newsome
Is there some sort of target or goal for the reinsurance book relative to the rest of the book as a percent of premium or something along on those lines?

Kevin Leidwinger
Yes, sure. So we're managing that to about 25% of the portfolio, so that's the target today. We're I think just a little bit below that. And while we'll manage that in general to 25%, as the entire portfolio grows, obviously, the premium associated with that will become larger. But we will also be opportunistic where there are moments in the market like we experienced most recent renewal cycle we'll take advantage of that. So while we anticipate it being right around 25%, there may be moments when issued a little bit higher than that because the opportunity was there for us to further diversify our portfolio and do it at significant underwriting profits.

Paul Newsome
Thank you, I really appreciate the help. And I'll let someone else ask some questions.

Kevin Leidwinger
You're welcome.

CONCLUSION

Operator
Again, if you have a question, please press star then one to be joined in the queue.

This concludes our question-and-answer session. I would like to turn the call over to Kevin Leidwinger, President and CEO, for any closing remarks.

Kevin Leidwinger
Thanks for joining us for this quarter, and we look forward to talking with you again next quarter.

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