



# ***Transcript of EMC Insurance Group 2010 First Quarter Earnings Call May 3, 2010***

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## **Participants**

Bruce G. Kelley, President and CEO  
Ron Jean, EVP for Corporate Development  
Rich Schulz, SVP Claims  
Mark Reese, SVP and CFO  
Kevin Hovick, SVP Business Development  
Scott Jean, VP Actuary  
Kelvin Sederburg, VP Actuary

## **Presentation**

### **Operator**

Greetings and welcome to the EMC Insurance Group, Inc., First Quarter 2010 Earnings conference call. At this time all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ms. Anita Novak, Director of Investor Relations for EMC Insurance Group, Inc. Thank you, Ms. Novak, you may begin.

### **Anita Novak - EMC Insurance Group - Asst. Secy., Director of Investor Relations**

Thank you, Jackie. Good morning, everyone and welcome to EMC Insurance Group's 2010 first quarter earnings call. A supplemental investor packet is available on the investor relations page of our Website, which can be found at [www.emcins.com/ir](http://www.emcins.com/ir). The Webcast for replay purposes is also available at this site until May 17, 2010. The transcript of the Webcast will be available for one year.

This presentation includes some forward-looking statements about our expectations for our future performance. Actual results could differ materially from those suggested by our comments today. Additional information about factors that could affect future results is addressed in our SEC filings, including Forms S-1, 10-K, 10-Q, and 8-K. Any information provided today should be read in conjunction with the 2010 first quarter earnings release with accompanying financial tables issued earlier today.

With us today are several members of EMC Insurance Group's executive management team. They are Mr. Bruce Kelley, President and Chief Executive Officer; Mr. Ron Jean, Executive Vice President for Corporate Development; Mr. Ray Davis, Senior Vice President, Investments & Treasurer; Mr. Rich Schulz, Senior Vice President – Claims; Mr. Kevin Hovick, Senior Vice President – Business Development; Mr. Scott Jean, Vice President – Actuary; Mr. Kelvin Sederburg, Vice President – Actuary; and Mr. Mark Reese, Senior Vice President and Chief Financial



Officer. At this time it is my pleasure to introduce EMC's Chief Executive Officer, Bruce Kelley.

**Bruce Kelley - EMC Insurance Group - President and CEO**

Thank you, Anita.

For those of you who have seen our 2009 annual report, you know that our theme this year is "strong foundation – solid results." I'm happy to report that our first quarter results are in keeping with both these standards.

For the quarter ended March 31, 2010, operating income tallied \$0.73 per share, net income was \$0.75 per share and our GAAP combined ratio was 98.1. Our balance sheet shows total assets of \$1.2 billion; invested assets of \$1.1 billion and total stockholders' equity of \$359 million. We continue to manage through the soft market focused on remaining financially strong so we can take advantage of growth opportunities when soft conditions begin to subside.

In a few moments, Mark Reese, our chief financial officer, will discuss our quarterly financial results. I'd like to spend a few minutes discussing general market conditions and a few of our strategies for successfully managing through the soft market environment.

Current market conditions are mixed. We are getting moderate rate increases in personal lines of business, especially personal auto and homeowners'. However, commercial lines remain very competitive. Fortunately, the rate increases in personal lines and additional premium generated by our reinsurance segment have been sufficient to off-set lost premium on commercial policies.

Net written premiums in the first quarter increased 0.7% in the property and casualty segment and 6.3% in the reinsurance segment, which resulted in an overall increase in net written premiums of 1.8%. Breaking this down just a little further provides some insight into what is driving the premium results.

In the commercial lines, in-force premium volume was flat; however, policy count was up 1.9 percent – a clear indication that rates remain competitive in commercial lines. We attribute the increased policy count to expansion of our agency force in the states of Oregon and New Mexico and an increased emphasis on writing businessowners' or BOP policies. As indicated in previous communications, we believe organic growth is our strongest strategy during a weak economy and we continue to pursue new marketing opportunities. Retention in commercial lines was approximately 86% which is consistent with our averages.

For personal lines, in-force premium volume was up 25.5%, but this is over-stated as a result of our conversion from six-month to annual policies for personal auto. We estimate that the actual in-force premium volume increased roughly 2.1% with policy count up about 1.6%. Improved pricing was a contributing factor, but the impact is mitigated by our ongoing withdrawal from personal lines in selected territories. As previously discussed, we are now concentrating our marketing efforts in those regions where we believe profitable growth potential exists. It is important to note that as we discontinue or run off policies in some regions of the country, good growth in other regions is providing an offset so personal lines policy count is still increasing slightly. Retention for personal lines is estimated to be 84.4%, a bit below our averages, but reflective of the discontinued policies mentioned earlier.

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As I mentioned before, net written premiums for the reinsurance segment increased 6.3% for the quarter when compared to first quarter 2009. This increase is due to the addition of new facility business obtained during the quarter as well as new property business being written in Central and Eastern Europe. January renewals for the segment were generally flat from a pricing perspective. MRB is modifying their former direct-only reinsurance marketing with certain strategically targeted broker business, which has resulted in a positive premium momentum for our reinsurance segment beginning this year.

First quarter was heavily impacted by catastrophe and storm losses world-wide, but fortunately, did not severely impact our financial position. Our catastrophe and storm losses were only slightly higher than our first quarter averages.

Overall non-CAT frequency was up about 4.8% for claims reported in the first quarter of 2010 compared to first quarter 2009. The largest increase came from property lines, both commercial and personal, where there was a significant increase in non-CAT weather-related claims including ice dams and roof collapse due to weight of snow. Because of the nature of these claims, severity was down slightly. Frequency was also up for Other Liability and Workers' Compensation. We don't believe this is a trend at this point, but we will be watching future periods closely.

Our strategy for 2010 will be sticking to basics and building on our solid foundation by adhering to our strategic plan, maintaining disciplined underwriting standards, and prudently monitoring and managing both underwriting and investment risk. We expect personal lines rates to continue to firm in 2010 and commercial lines rates to remain competitive at least into the latter half of 2010.

Before I turn over the discussion of our current quarter financial results to Mark Reese, I'd like to take this opportunity to mention just a few of the many technology awards and accolades we have received recently.

We are a two-time recipient of the Best Practices Award of Excellence from the Big "I" agents; we are the recipient of numerous technology awards including the 2009 interface Partner Award and the 2009 Real Time Breakthrough Award; we have been recognized by the EPA for our Rehab the Lab and ChemEyes risk management programs; and most recently, we were named to the Forbes.com list of 100 most trustworthy companies. EMCI was one of six insurance companies that made the list and one of 39 small cap companies. We are very proud of all these accomplishments.

With that, I'll ask Mark Reese for a discussion on our current quarter results.

**Mark Reese - EMC Insurance Group - SVP and CFO**

Thank you, Bruce.

Overall premium rate levels declined 1.9% during the first quarter of 2010, primarily due to increased usage of underwriting modification credits. Rate increases were implemented in the personal auto and homeowners lines of business. Rates for Workers' Compensation were also increased slightly, but were down for all other commercial lines of business. Rate competition continues to be very strong in the commercial lines of business, and we expect this level of competition to continue through at least the first half of the year.

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Investment income increased 2% to \$12.5 million in the first quarter. The increase is primarily attributed to the reinvestment of short-term holdings into Build America Bonds.

Catastrophe and storm losses declined significantly from the high level experienced in 2009, but were still nearly 1% point higher than our historic first-quarter average. Active weather patterns in the Midwest and Mid-Atlantic regions were the primary reason for the above average storm losses.

The Company experienced \$21.4 million dollars of favorable reserve development in the first quarter, compared to \$21.1 million dollars in the first quarter of 2009. The reinsurance segment experienced an unusually large amount of favorable reserve development in the first quarter, totaling \$7.8 million or \$0.39 per share after tax compared to \$4.2 million or \$0.21 per share after tax in the first quarter of 2009. This favorable development primarily resulted from a reduction in the bulk IBNR reserve for accident years 2007 – 2009 in the property pro rata, catastrophe and casualty excess lines of business.

We experienced \$650,000 or \$0.03 per share after tax of adverse reserve development on prior accident years' storm loss reserves in the first quarter of 2010, compared to \$1.4 million or \$0.07 per share after tax of favorable development in the first quarter 2009.

The most recent actuarial analysis of our carried reserves indicates a level of adequacy consistent with other recent evaluations. From management's perspective, this measure is more relevant to an understanding of the Company's results of operations than the composition of the underwriting results between the current and prior accident years.

Large losses, which we define as losses greater than \$250,000, excluding catastrophe and storm losses, amounted to \$0.23 per share for the first quarter compared to \$0.28 per share for the first quarter of 2009.

During the first quarter, our equity portfolio returned 6.51%, compared to 5.39% for the S&P 500. The current annualized yield on our bond portfolio is 5.13% and the effective duration is 5.89 years, which is down from 6.12 years at December 31.

As announced on February 3, 2010, management is projecting that 2010 operating income will be within a range of \$1.90 to \$2.15 per share. This guidance is based on a projected GAAP combined ratio of 103.7% for the year.

When this guidance was issued, it did not reflect the \$800,000 reduction in our deferred tax asset that resulted from the enactment of the Patient Protection and Affordable Care Act on March 23rd, or the elimination of the projected increase in the deferred tax asset associated with the retiree drug subsidy that was expected to occur during 2010. The total reduction in the deferred tax asset as a result of the new healthcare legislation will amount to approximately \$0.08 per share in 2010. Including this reduction in the deferred tax asset, our current projection of 2010 operating income is still within the \$1.90 to \$2.15 per share range. Therefore, we are reaffirming our guidance at this time.

No shares were acquired under the Company's stock repurchase program during the first quarter of 2010. As of March 31, approximately \$7.1 million remains available for the purchase of additional shares.

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At this time, I would like to open the phones for questions.

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**Operator**

Thank you. We will now be conducting a question and answer session.  
[OPERATOR'S INSTRUCTIONS] One moment, please, while we poll for questions.  
Thank you. Our first question's coming from Bob Farnam of Keefe, Bruyette & Woods.

<Q>: Hi, there. Good morning. In terms of premium leverage, what range are you happy getting up to?

**Bruce Kelley - EMC Insurance Group - President and CEO**

Thanks for your question, Bob, on premium leverage. I think I'd like to first talk a little bit about the premium leverage concerning the situation that our premiums are flat, but we hope to increase them. Are you getting at the relationship of our premiums to surplus ratio, Bob?

<Q>: Yes. It's almost a two-part question here, because I want to know what leverage premiums to surplus you're happy with and the second part of the question was if the soft market is prolonged, can you make any changes to the 30% pooling percentage to increase that, for example?

**Bruce Kelley - EMC Insurance Group - President and CEO**

Well, I believe our writings to surplus ratio are pretty close to one-to-one. We're not to one-to-one yet. That would be my first comment on that first part of your question. The second part of the questions as to pool changes, there are no pool changes planned at this time.

**Mark Reese - EMC Insurance Group - SVP and CFO**

Yes, Bob, this is Mark Reese. Our leverage ratio has been running around 1.6 for the public company; the 1.1 that Bruce is talking about or one-to-one is for our consolidated operating results, but we're generally around 1.6 and have been recently and it's been holding pretty steady.

<Q>: Okay, so you wouldn't expect to have that go up or want that to go up much.

**Mark Reese - EMC Insurance Group - SVP and CFO**

Not a whole lot. I mean we're comfortable below two-to-one.

<Q>: Okay. In the reinsurance segment, the other underwriting expenses seem relatively high versus earlier quarters. Any driver of that?

**Mark Reese - EMC Insurance Group - SVP and CFO**

Yes, that was kind of impacted by commissions and contingent commissions that were basically accrued for in this quarter at a slightly higher level.

<Q>: Okay, so is that kind of a net result of the favorable development you had in there, meaning more profits and so you're paying more commissions on that?

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**Mark Reese - EMC Insurance Group - SVP and CFO**

That's going to have a little bit of impact, but I think it's just good results that we're seeing.

<Q>: And a similar one is the tax rate. The 32% seems a little bit higher than it has been in the earlier quarters as well. Is that a function of a mix between investment and underwriting results?

**Mark Reese - EMC Insurance Group - SVP and CFO**

Well, it was impacted by the decrease in our deferred tax assets that we had to recognize in the first quarter, plus our results were pretty high for the quarter. We had a pretty good first quarter, so the rate's going to be a little higher than what our ultimate projection is for the year.

<Q>: Right. Okay, very good, thanks.

**Mark Reese - EMC Insurance Group - SVP and CFO**

Sure.

**Operator**

Our next question's coming from Paul Newsome of Sandler O'Neill & Partners.

<Q>: Good morning, folks.

**Bruce Kelley - EMC Insurance Group - President and CEO**

Hi, Paul.

<Q>: I was wondering if you could walk us through what the factors would be between your current full year earnings guidance of I think you said 103 and the 98 that you reported this quarter. What will change throughout the first of the year in terms of your guidance to get you to that higher combined ratio?

**Mark Reese - EMC Insurance Group - SVP and CFO**

Well, the big factor is going to be CAT and storms. The first quarter is generally pretty strong for us, so we don't have a whole lot of storm activity. The second quarter, as you know, is usually the quarter that kind of dictates how the year's going to go. So, even though we had a very good first quarter, we don't think it's appropriate to change our guidance at this point just because we know second and even third quarter can be pretty volatile when it comes to storm activity.

<Q>: Are there factors other than catastrophe losses?

**Mark Reese - EMC Insurance Group - SVP and CFO**

Oh, that's the big one. Development is also another factor included in those numbers and we didn't see anything out of the norm in the first quarter that would make us want to change our guidance for the year.

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<Q>: I'd like to follow-up as well on the pooling arrangement. Why is it in your view 30% the right level for the pool?

**Bruce Kelley - EMC Insurance Group - President and CEO**

We've had 30% for a number of years on the pool and we believe that that's a good number because we have to keep the relationship between our various companies on the writing to surplus ratio in a good balance according to the insurance departments that we deal with. We believe that the 30% ratio is appropriate given the financial structure that we have right now. So, we don't have any plans to change that.

<Q>: I understand that. I'm wondering about how do you come up with 30%? Why isn't 25% or 35%? Is there a formula? Is there a rough measure of how you want to establish the relationship between one subsidiary and the other, or is it just purely a historic number that just hasn't changed all these years? I'm just curious if there's—

**Bruce Kelley - EMC Insurance Group - President and CEO**

Well, Paul, let me just say that as far as this number, it is a historical number. I mean, we've been in business— this public company has gone over 25 years. So, we have that historic activity going there, but we also have the thing with this public company that is part of the mutual and we also have our stockholders that we want to treat fairly with dividend and stock appreciation over time.

We also have the insurance department and other regulatory agencies that want to make sure that we're using our capital appropriately as an insurance company. And so, if we would make these changes, we would make those changes given those various stakeholders in our business. I'll turn it over now to Ron Jean for some further comments on this.

**Ron Jean - EMC Insurance Group - EVP for Corporate Development**

Just a couple of additional points, Paul; we changed the percentage from I think it was 23.5% to 30% after the stock govern back in 2004 as we generated some more capital to the public company. We used that then to increase the pooling percentage, but we do try to maintain a somewhat consistent level of leverage, premium to surplus ratios between the various companies partially because the A.M. Best rating is a group rating and they look at the various leverage factors that we have in each of the companies.

As Mark said, the public companies do have a higher leverage or level of premium to surplus than what our consolidated does. So, we're already kind of stretching that a little bit, but 30% seems to be a number that works pretty good for us right now.

<Q>: So, the idea is that you want to have relatively equal leverage between the mutual entities and the public entities?

**Ron Jean - EMC Insurance Group - EVP for Corporate Development**

With the idea that generally the public entities will be more highly leveraged.

<Q>: Okay, good. Thank you.

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**Operator**

Thank you. At this time, there are no further questions. I'd like to hand the floor back over to management for any closing thoughts.

**Anita Novak - EMC Insurance Group - Asst. Secy., Director of Investor Relations**

Thank you, ladies and gentlemen. This now concludes this conference call. I would like to remind you that a playback of this call will be available on the Company's investor relations page of the Company's website at [www.emcins.com/ir](http://www.emcins.com/ir) until August 3, 2010 and a transcript of this conference call will be available until May 2, 2011, which can also be accessed from our investor relations page later today. We appreciate your interest in EMC Insurance Group Inc. and all of us wish you an enjoyable day.

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