# FINAL TRANSCRIPT

Thomson StreetEvents℠

# EMCI - Q2 2007 EMC Insurance Group Earnings Conference Call

Event Date/Time: Aug. 07. 2007 / 11:00AM ET

## CORPORATE PARTICIPANTS

**Anita Novak**
*EMC Insurance Group - Director - IR*

**Bill Murray**
*EMC Insurance Group - COO, EVP*

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

**Steve Peck**
*EMC Insurance Group - SVP - Actuary*

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

## CONFERENCE CALL PARTICIPANTS

**Ed Shields**
*A.G. Edwards - Analyst*

**Robert Farnam**
*Keefe Bruyette & Woods - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the 2007 Second Quarter Earnings Conference Call. My name is Jen, and I will be your coordinator for today.

(OPERATOR INSTRUCTIONS)

I will now turn the presentation over to Ms. Anita Novak, Director of Investor Relations. Please proceed, ma'am.

---

**Anita Novak** - *EMC Insurance Group - Director - IR*

Thank you, Jen. Good morning, everyone, and welcome to EMC Insurance Group's 2007 second quarter earnings call.

The supplemental investor packet is available on the investor relations page of our website, which can be found at www.EMCInsurance.com.

The simulcast for replay purposes is also available at this site until August 14, 2007. 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 2007 second 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. Bill Murray, Executive Vice President and Chief Operating Officer; Mr. Ron Jean, Executive Vice President for Corporate Development; Mr. Steven Peck, Senior Vice President Actuary; Mr. Rich Schulz, Senior Vice President Claims; and Mr. Mark Reese, Senior Vice President and Chief Financial Officer.

Mr. Bruce Kelley, President and CEO, was unable to join us today. At this time, it is my pleasure to introduce EMC's Chief Operating Officer, Bill Murray.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Thank you, Anita, and good morning, everyone.

The second quarter was another record-breaking quarter for us. Operating income was $1.01 per share, net income was $1.02 per share, and book value as $24.18 per share, an increase of 7.8% from December 31.

Today, I'd like to touch briefly on our expectations for the remainder of 2007. Our focus is two-fold -- the bottom line or net income, and the top-line, or premium growth.

Although the extent may vary by region, the insurance industry certainly remains competitive, and we expect that to continue during the second half of 2007, barring some sort of catastrophic event or series of events.

As with many of our competitors, our expectation is that our top-line growth will need to come from new business writings and continued efforts to maintain or improve policy retention.

In previous presentations, Mr. Kelley has discussed some of the ways we intend to achieve our corporate goals. Today, I'd like to discuss some of those issues in greater detail.

The first involves profitability. Profitability is directly related to the quality of the book of business we insure. It's a major component of our strategic plan.

As a management team, we must ask ourselves a plethora of questions such as, first, "although our current book of business is profitable, where are the problem areas?"

Secondly, "if the current book of business is generally profitable, is that profitability sustainable at our current pricing model?"

Thirdly, "how do we address lines of business and/or selected geographic regions that may or may not be profitable?"

And lastly, "What tools do we need in place to effectively and efficiently complete our evaluations associated with the profitability of our book of business, our pricing strategies and other business processes?"

And of course, there are many other such questions that we as a management team continue to address. But let's discuss the questions posed.

Our book of business is profitable. In second quarter 2007, our GAAP combined ratio was 91.2, which, by the way, was exactly the same as first quarter 2007.

The loss ratio for the book of business was 56.7%. This loss ratio reflects 13 percentage points of favorable development on prior years' reserves.

But as we have mentioned before, we expect favorable development to continue in future quarters due to the conservative nature of our reserving philosophy.

Our expense ratio for the quarter and year-to-date was 34.5% and 34.6% respectively, which is higher than we would like, but consistent with our expectations.

With regard to identifying both lines of business and geographic regions that may or may not be profitable, we employ a host of sophisticated underwriting tools for evaluating both our current book of business and new business.

These tools include predictive modeling capabilities and monitoring tools, many of which were not available to us during the last soft market.

These new capabilities allow our underwriters to make better-informed decisions regarding the assumption of risk and the appropriate pricing strategy relevant to each individual risk.

Why is this an important distinction? Because these monitoring capabilities allow us to capture and retain vital information that will allow us to make sound underwriting and pricing decisions based on individual risk rather than decisions based on averages projected on multiple risks.

Through the use of these expanded capabilities, we are able to track the quality of our book of business at nearly any level of detail, monitor changes in the quality of our book of business over time, assuring that pricing and underwriting decisions are consistent with profit objectives, and develop action plans to address specific book quality and profitability concerns.

Once we've identified specific concerns and established a strategic plan, we can then quantify the impact of our plan execution.

Is that profitability sustainable at our current pricing model? We believe it is. On an overall basis, premium rates for most lines of business are still considered adequate.

Our current retention for our commercial lines is 87% as compared to an industry average of approximately 82%. Our personal lines retention remains consistent at 86% which, again, is better than industry averages.

Of course, this remains a dynamic issue, one that we'll continue to monitor and respond to appropriately as deemed necessary.

In prior presentations, we've discussed our niche market such as EMC Choice products, our target markets and our safety dividend groups. We've spoken previously about our revitalized small business product.

There will always be competition for this business, so it's extremely important for us to identify and promote our strengths and ability to provide value-added services.

For example, EMC's risk improvement department is second to none and continues to identify individual hazards for commercial customers and to work with them and our underwriters to implement the steps designed to reduce future claims.

Another very important aspect of any business model is growth. We acknowledge that under softening market conditions, growth is not easily obtainable. However, we continue to initiate strategies to encourage growth, ever mindful that the growth we desire must be profitable.

We believe our challenge is to be aware of what business is being lost and replace it with quality business at a profitable rate.

We also want to be sure we're getting a look at the best business that's available. Our only distribution source is the independent agency system.

Through 16 branch offices, we partner with more than 2,400 independent insurance agencies strategically located throughout the United States. We benefit from knowing local marketing conditions and the regional environment in which our agency partners work.

I do want to emphasize, however, that these partnerships with independent agencies are by no means passive relationships.

We work diligently to build strong relationships with our agency force that provides an opportunity for us to develop individual strategic plans for success and provides the support and flexibility needed to make doing business with EMC a favorable venture for all concerned.

Two-way communication is key. We strive to communicate in a variety of ways -- through agency access on our Web site, through agency sales meetings and newsletters, and through agency visits for joint planning sessions.

These planning sessions are designed to share information and develop goals for specific ways we can better serve our agencies and also communicate our specific business model.

We've developed a unique means of evaluating agents, one that also improves communication between EMC and our agencies, aiding in the business planning process and allowing EMC to take the best approach in working together.

There's one last issue I'd like to touch on today, and that's our reserving philosophy. We do not use accident year loss picks to establish reserves. Case and IBNR reserves are established independently of each other and added together to get our total reserve estimates.

Since this is different methodology than most of our peers, we believe it merits additional explanation. Our approach minimizes the possibility that earnings can be manipulated by playing with the accident year loss picks.

Accident year results are instead driven by the sum of all the individual adjustor decisions and individual claim files and reflect the best judgment of those trained to make such decisions.

Case loss reserves are based on the probable outcome for each claim, with probable outcome defined as what is most likely to be awarded if the case were to be decided by a civil court in the applicable venue or, in the case of a workers compensation case, by the state's workers compensation commission.

On an individual claim basis, case loss reserves represent the Company's best estimate of exposure. However, when accumulated, the total is believed to be somewhat conservative because all claims will not be settled at the probable outcome amount.

IBNR reserves are calculated by line of business and are allocated to various accident years using historical claim emergence patterns. The current and more recent accident years have a higher proportion of case, IBNR and settlement expense reserves than earlier accident years.

Since the Company's reserves are established somewhat conservatively, the relatively high proportion of reserves in the most recent accident years generates relatively high loss and settlement expense ratios in the early stages of an accident year's development.

As those accident years mature, claims are gradually settled, the reserves for those years become smaller, and the loss and settlement expense ratios generally decline. As a result, favorable development on prior years' reserves are not unusual for our company.

With that, I'll ask for comments from Mark Reese, Senior Vice President and Chief Financial Officer.

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

Thank you, Bill. I'd like to begin my discussion today with a few additional comments regarding reserve development.

We reported a large amount of favorable development on prior years' reserves in the second quarter of 2007. And similar to the first quarter, the majority of the favorable development occurred in the property and casualty insurance segment.

On a direct basis, approximately 65% of the favorable development came from case loss reserves, and in aggregate all of this development is associated with the final settlement of closed claims.

Approximately 25% of the favorable development came from IBNR reserves and was partially driven by a decline in IBNR emergence through the second quarter. The remaining favorable development came from settlement expense reserves.

Once again, I would like to caution our investors against getting overly concerned with the composition of our underwriting results -- that is, the amount of favorable development reported on prior year reserves versus current accident year results -- because our reserving methodology does not lend itself to that type of analysis very well.

Without a proper understanding of our reserving methodology, the current and more recent accident year combined ratios can be misleading. For example, the Company reported a 91.2% combined ratio for the first six months of 2007.

If you add back the large amount of favorable development experienced on prior years' reserves during this period, it would appear that the 2007 accident year is generating a combined ratio of 107.5% through the first six months of the year, which, by the way, is down from 110.3% at the end of March.

However, the Company's current actuarial projections indicate that the 2007 accident year combined ratio will continue to decline as the accident year matures and will ultimately reach 98.2%.

It is our intention to continue to apply our reserving methodology on a consistent basis. With reasonably consistent levels of reserve adequacy, we expect earnings from downward development of prior accident year reserves to continue in future years.

For that reason, we believe that investors should place less emphasis on the composition of the Company's underwriting results between current and prior accident years and should place more emphasis on where the Company's carried reserves fall within the range of actuarial indications.

At December 31, 2006, the Company's actuarial analysis indicated that carried reserves were in the upper quartile of the range of actuarial reserve estimates.

At June 30, 2007, the Company's actuarial analysis indicated that carried reserves remained in the upper quartile of the range of actuarial reserve estimates. However, a moderate decline within the range was indicated.

As part of our ongoing efforts to enhance the effectiveness of our reserving approaches, management is exploring the possibility of utilizing bulk case loss reserve adjustments to help maintain a consistent level of reserve adequacy in the future.

If implemented, bulk case loss reserve adjustments -- and those could be either positive or negative -- would be established when necessary to keep the estimated adequacy of the Company's carried case loss reserves within a targeted narrow band that management believes represents the best overall estimate of the Company's liability.

Current reserving practices and monitoring mechanisms were designed to achieve greater consistency in individual case loss reserve adequacy. The use of a bulk reserve would most likely result in only moderate adjustments to carried reserves on a periodic basis.

Now I would like to make a few comments on our second quarter results.

Operating income for the second quarter was a record $13.8 million, which is an increase of 33.3% from the previous record of $10.4 million established in the second quarter of 2006.

For the first six months of 2007, operating income was $27.7 million, which is a slight decline of 2.6% from the $28.5 million reported in 2006.

Net income for the second quarter was a record $14 million, which is an 18.4% increase from the $11.8 million reported in 2006.

Net income for the first six months of 2007 was $28.7 million, which is a 7.7% decline from the record $31.1 million reported last year.

On an overall basis, rate competition continued to increase moderately in the property and casualty insurance marketplace during the quarter, resulting in an approximate 4.8% decline in premium rate levels from June of 2006.

Market conditions are expected to remain competitive for the remainder of the year, which will likely result in a further decline in premium rate levels as the year progresses.

There are also indications of increasing rate competition in the reinsurance marketplace which could result in lower rates on future contract renewals and on new contracts.

Net written premiums increased 4.8% to $103.4 million in the second quarter and 3.5% to $193.3 million for the first six months of 2007.

However, it should be noted that the increase for the first six months of 2007 reflects a negative $3.4 million portfolio adjustment recorded in the first quarter of 2006 in the reinsurance segment in connection with Employers Mutual's reduced participation in the MRB pool.

Excluding this adjustment, written premiums increased 1.7% in the first six months of 2007.

Commercial lines net written premiums increased 3.4% in the second quarter and 2.8% for the first six months of 2007 as new business premium was sufficient to offset premium loss from declining premium rates and business not renewed.

Personal lines net written premiums declined 5% in the second quarter and 6.2% for the first six months of 2007.

Even though we continue to experience declines in personal lines written premiums during the second quarter, the declines continued to be smaller than recent quarters as a result of an increase in new policy counts.

For the first six months of the year, new commercial lines premium is up nearly 19% over a year ago and new personal lines premium is up over 17%, with much of that coming in selected territories with greater profit potential.

Catastrophe and storm losses totaled $0.46 per share in the second quarter of 2007 compared to $0.23 per share in 2006. For the first six months of the year, catastrophe and storm losses totaled $0.58 per share compared to $0.33 per share last year.

The amounts reported for 2007 include $0.29 per share of losses associated with the May tornado that devastated Greensburg, Kansas.

Investment income increased 2.5% in the second quarter and 2.1% for the first six months of 2007 as a result of higher average invested asset balances and a small increase in the yield on fixed maturity securities.

The total rate of return on our equity portfolio for the first six months of the year was 11.04%, which compares to 6.96% for the S&P 500.

The current annualized yield on our bond portfolio is 5.535% and the effective duration is 4.36 years, which is up from 3.91 years at the end of 2006.

The Company has no direct exposure to subprime residential lending, holding only $1.6 million of residential mortgage-backed securities, all of which are seasoned, government-backed 30-year fixed Ginnie Mae securities.

No collateralized debt obligations or collateralized mortgage obligations are held.

The Company does have indirect exposure to subprime lending markets as it has significant holdings of agency debentures as well as debt and equity positions in both the banking and financial services sectors.

While the Company's holdings do not include companies engaged in originating residential lending as their primary business, it does hold positions in banks, brokers and financial service companies that may be engaged in this type of lending.

However, none of these positions have been considered for other than temporary impairment at this time. With that, I would like to open up the phone for questions.

## QUESTIONS AND ANSWERS

**Operator**

Thank you, sir. (OPERATOR INSTRUCTIONS)

Your first question comes from [Ed Shields] with A.G. Edwards.

**Ed Shields** - *A.G. Edwards - Analyst*

Good morning, and thank you for taking my questions.

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Good morning.

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

Good morning, Ed.

**Ed Shields** - *A.G. Edwards - Analyst*

Could you provide a little bit more color on the reserve release this quarter in terms of what lines of business it may have came from and the IBNR versus claims closed? I don't think I quite caught all of that.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Ed, I believe Steve Peck would like to respond to that.

---

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

The case reserve development really came in all major lines of business. However, three lines of business represented about 78% of the total. Those were workers comp, other liability, and commercial property.

And as was mentioned earlier, the case reserve development for the year represented over 60% of the segments that developed downward.

The case reserve development was widespread also in terms of branches. Thirteen of our 16 branches developed downward (technical difficulty) developed upward.

Most of the case reserve development is coming from recent accident years. For all lines combined, 93% of the downward development is coming from accident year 2003 (technical difficulty).

---

**Ed Shields** - *A.G. Edwards - Analyst*

Okay.

---

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

On the IBNR side, that represented about 25% of the segments that developed downward, and that is an increase in downward development from a year ago, primarily due to the fact that on a 30% basis we had in the neighborhood of 4.5 million to 5 million fewer IBNR claims recorded the first half of 2007 than in the first half of 2006.

The line that had the largest downward -- or the largest reduction in recorded IBNR claims in the first half was workers comp, but there are about five other lines that also (technical difficulty) as IBNR (inaudible).

As far as the IBNR development, that really is spread over all lines of business and it's really not possible to pick out any one line of business where there is a major concentration.

Most of the (technical difficulty) accounts for all of the IBNR development by looking at (inaudible) 2005.

---

**Ed Shields** - *A.G. Edwards - Analyst*

Okay. Thank you very much. My second question has to do with the particularly strong performance of the reinsurance segment this quarter.

Could you explain what's driving that and what you might anticipate for the remainder of '07 and into 2008?

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Steve?

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

This is a small segment, and there is, by the virtue of its relatively small size and the fact that it's reinsurance -- there is going to be some volatility from quarter to quarter.

We very much use a balance sheet approach on this. Key is where do we set the IBNR reserve. And because this is a reinsurance segment, we believe it's appropriate to have the IBNR established at a level at which our total reserves for this segment -- at very near the top of the range.

And it just so happened that this quarter we're at the top of the range, only very slightly below, at ultimates that were somewhat lower than they were at the end of the first quarter.

I really can't attribute that to anything but the randomness which is inherent in all book difficult segment.

**Ed Shields** - *A.G. Edwards - Analyst*

Okay. One of the other things I noticed in the release -- and this will be my last question -- was that the expense ratio for the property and casualty segment ticked upwards a little bit to 38%.

And it looks a little bit higher than it had been kind of average over the quarterly past two years, quarter basis, about mid 36% range, 36.3%, 36.5%.

What's contributing to the increased expense ratio, and where do you expect it to be a year from now?

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

This is Ron Jean. I can maybe address that --

**Ed Shields** - *A.G. Edwards - Analyst*

Okay.

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

-- in a general sense. The expense ratio does tend to bounce around a little bit quarter to quarter because it depends on when we book certain things, whether it's a pension expense or pensions for retiree benefit (technical difficulty), but there is some fluctuation on a quarter (technical difficulty).

We had anticipated that the expense ratio here would be relatively flat compared to (inaudible) the year.

As Bill indicated, the expense ratio is higher than what we would like it to be at this time, but it certainly wasn't unexpected -- relatively flat premiums we've had over the last years that is pushing it up some -- just the nature of the way we do business with branch operations, multiple clients in multiple territories. There is a little bit more expense associated with that.

**Ed Shields** - *A.G. Edwards - Analyst*

Right.

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

Our expense ratio in general is going to be a little bit higher than our competition.

**Ed Shields** - *A.G. Edwards - Analyst*

Yes. Thank you very much, and I'll get back in queue.

**Operator**

Your next question comes from Robert Farnam with KBW.

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Hi. Good morning. I want to go into the guidance. I just want to know what types -- what favorable -- I assume favorable -- reserve development you're expecting in the second half of the year and what assumptions for cat loss is in there. Is that normal or is it higher or lower than normal?

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

This is Steve Peck. As far as the development, the only development explicitly built in is 4% reduction in the combined due to -- 4% reduction in the loss reserve due to case reserve development (technical difficulty) no other development explicitly built in.

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay.

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

The second half storm ratio is not higher than anticipated (inaudible) is not higher than anticipated -- figure of 7.1%.

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay. And a question on the carried reserves -- how frequently do you have external actuaries take a look at it? And if it's in the upper quartile, is that internal or -- and external actuaries that come to the same opinion?

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

We do not have a regular schedule for outside reviews. We have had reviews done, though, for the pool at the end of 2006, and we had a review done for the Iowa insurance department, or we paid for it, on a consolidated basis.

The result for the 2005 review was rather similar to our results, certainly well up in the range. The conclusion for the 2006 review, outside review, was that we were closer to the midpoint of the range, whereas we were showing somewhere in the (technical difficulty).

One of the independent reviews was consistent, one (technical difficulty)

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay. All right. Another question is I know you talked about increasing your expense ratio. How have commissions been trending? And has there been any change in terms of conditions and policies recently?

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Our commission rates have actually been fairly consistent over time with very few changes, so any impact would be primarily the result of changes in the distribution of our business. But the rates themselves have been fairly consistent, Bob.

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay. And no change in terms and conditions, no weakening of those?

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

With respect to the commission rates, or --

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

No.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

-- (inaudible) or what --?

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

I'll address that offline with you.

The last question I have is the workers comp line looks like it grew pretty well. Obviously, rates are going down in workers comp. Where are you growing workers comp, and what has the rate environment looked like?

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

We've grown recently in a couple of states where we haven't been too active. South Carolina is one where we've grown some, and that's been related to some of the commercial business that we've written.

The overall rate levels for workers compensation -- the adequacy can very a lot from state to state.

Our approach on workers compensation hasn't changed all that much in writing workers compensation. We still look at it as a fairly troubled line. It's one that we continue to update action plans on in the various states.

And we still look at it as an account that we -- a line that we can write in order to round out accounts.

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

All right.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

The largest increase in workers compensation premium this year is probably in South Carolina.

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay. But you said --

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Did you have some --

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

-- it's more of a -- part of a package rather than a monoline workers comp.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

That is correct. We are not a monoline workers compensation writer.

---

**Steve Peck** - *EMC Insurance Group - SVP - Actuary*

Yes. This is Steve Peck. From a rate level adequacy standpoint, workers compensation remains our rather unruly line.

Overall we're showing that rate levels at -- rates of return that most people I think would consider reasonable [according to] the rate levels that those returns are adequate.

The one line that stands out as probably not being adequate and maybe not close is workers comp.

---

**Robert Farnam** - *Keefe Bruyette & Woods - Analyst*

Okay. I'll leave it there. Thanks. Thanks for answering the questions.

---

**Bill Murray** - *EMC Insurance Group - COO, EVP*

Thank you, Bob.

**Operator**

As there are no further questions in the queue, I'll turn the call back to management for closing remarks.

**Anita Novak** - *EMC Insurance Group - Director - IR*

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 website at www.EMCInsurance.com until August 14th, and a transcript of this conference call will be available until August 2008, which can be accessed from our website as well.

We appreciate your interest in EMC Insurance Group, and all of us wish you an enjoyable day.

**Operator**

Ladies and gentlemen, we thank you for your participation in today's conference. This does conclude the presentation, and you may now disconnect. Have a good day.