



***Transcript of
EMC Insurance Group Inc (EMCI)
Fourth Quarter 2008 Earnings Conference
Call
February 27, 2009***

Vcall
601 Moorefield Park Dr.
Richmond, VA 23236

Phone: 888-301-5399
Fax: 804-327-7554

info@vcall.com
www.vcall.com

Participants

Bruce Kelly, President, CEO
Ron Jean, EVP Corporate Development
Steve Peck, SVP Actuary
Ray Davis, SVP Investments, Treasurer
Mark Reese, SVP, CFO
Kevin Hovick, SVP Business Development
Anita Novak, Asst. Secretary - Director, Investor Relations

Presentation

Operator

Greetings and welcome to the EMC Insurance Group Fourth Quarter 2008 Earning Conference Call. [Operator Instructions].

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

Anita Novak, Asst. Secy. – Director of Investor Relations

Thank you Shay (ph). Good morning, everyone and welcome to EMC Insurance Group's 2008 fourth quarter earnings call. A supplemental investor packet is available on the investor relations page of our website, which can be found at www.emcinsurance.com. The webcast for replay purposes is also available at this site until February 26, 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, 10k, 10q, and 8k. Any information provided today should be read in conjunction with the 2008 fourth 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. Steve Peck, Senior Vice President - Actuary, Mr. Ray Davis, Senior Vice President - Investments



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and Treasurer; and Mr. Kevin Hovick, Senior Vice President - Business Development 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, President and CEO

Thank you, Anita.

I am pleased to report that even though last year presented serious challenges on several fronts, we remain financially strong and secure. It is doubtful that anyone could have been completely prepared for the events of 2008, but we believe our strong financial position and our overall strategic approach helped us weather a very difficult year. My intent today is to describe how we addressed the challenges of 2008 and our expectations for 2009 and beyond.

The events of 2008 certainly had a significant impact on EMC Insurance Group Inc. We experienced our largest amount of catastrophe and storm losses ever, recognized a record amount of investment impairment losses in our equity portfolio, had a significant decline in the amount of unrealized gains in our investment portfolio, and were confronted with a generally competitive environment for marketing property and casualty insurance.

Catastrophe and Storm Losses

The Company has a branch structure and a risk management approach that promotes diversifying our exposures; however, even as diversified as we are, catastrophe and storm losses were a major issue in 2008. Storms were unusually large and numerous in 2008, often spreading across much of the United States. Major events in 2008 included Hurricanes Gustav and Hurricane Ike and the EF5 tornado that hit Parkersburg, Iowa. Catastrophe and storm losses added 13.0 percentage points to our combined ratio in 2008, compared to an average over the last decade of 5.4 percentage points. Factoring in a normal amount of catastrophe and storm losses, our underwriting results would have been in line with management's expectations. Excess catastrophe and storm losses alone accounted for a decline of \$19.2 million in stockholders' equity in 2008.

Widespread storms generating large numbers of claims in numerous territories created serious challenges for claims adjusters. The Company was able to meet those challenges by utilizing our automated claims management system and distributing the claims processing throughout the branch offices in order to more timely and effectively facilitate the increased volume of claims, thereby expediting the final payment of claims. The system allowed the various branch offices to easily share data and check the status of all claims, which significantly decreased the burden of claims processing for any one geographic location. This was an important factor, especially with Hurricane Ike claims since both our Birmingham Branch and our Cincinnati Branch were physically affected by the storm. 100% of all catastrophe and storm loss claims have been adjusted and nearly all have been paid.

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Record impairment losses

As you know from this morning's earnings release, the Company reported a net loss for the year of \$0.13 per share. The net loss was directly related to net realized investment losses. As is the case with nearly all our competitors, we have felt the effects of the global recession and severely depressed equity markets. Realized investment losses for the year totaled \$24.5 million or \$1.17 per share after taxes, and reflect \$30.9 million or \$1.49 per share after tax, of "other-than-temporary" investment impairment losses. \$14.9 million of those impairment losses are attributed to perpetual preferred stocks issued by Freddie Mac and Fannie Mae.

It should be noted, however, that \$31 million of impairments is less than 3% of our 2007 invested assets; a relatively small fraction of our investment portfolio. We have a well-diversified investment portfolio that does not have any large concentrations in any one asset class or single investment. Additionally, our investment policy does not permit investments within our own industry. These limitations have created a well-diversified investment portfolio that has produced negative annual returns only twice in the Company's history.

Investment portfolio and benefit plans

Due to adverse economic conditions, the Company's investment portfolio experienced approximately \$36 million in unrealized investment losses. The adverse economic conditions also had a negative impact on the funded status of our employee benefit plans, which generated a \$16.7 million decline in equity.

Competitive Market

Soft pricing conditions prevailed during 2008 but rates stabilized somewhat toward the end of the year. On an overall basis, premium rate levels declined approximately 4.8 percent in 2008.

We attribute our ability to effectively price and retain good business to our branch structure and independent agency relationships. Our branch structure puts us in close physical proximity to our agents' offices, and allows us to focus our efforts in those areas where we believe good business can be written. Through our branch offices, we provide local service for underwriting, risk improvement, marketing and claims management.

In some respects, 2008 could be viewed as a "perfect storm", as we were confronted with record amounts of both catastrophe and storm losses and investment losses. Although somewhat damaged, we survived that storm and are well prepared for the challenges of the new year.

As we begin 2009, we expect market conditions to remain competitive, with premium rates stabilizing at current levels. Premium rates could begin to improve during the second half of the year, with any improvements likely to occur first in personal lines and reinsurance, followed by commercial lines.

As regards the economy, we don't expect much improvement before the latter half of the year. Based on those expectations, our operating income guidance for 2009 is a

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range of \$1.45 to \$1.70 per share. This range is based on achieving a GAAP combined ratio of 105.5, which reflects the lagging affect of previous rate level reductions and assumes a more normal catastrophe and storm loss year.

With that, I will call on Mark Reese, Senior Vice President and CFO to discuss the financials statements. We would be happy to answer any questions after his presentation.

Mark Reese, Senior Vice President and Chief Financial Officer

Thank you, Bruce.

Operating income for the fourth quarter was \$5.6 million, which is up slightly from \$5.4 million reported in the fourth quarter of 2007. For the year, operating income was \$14.2 million, which is down significantly from \$40.1 million reported in 2007. Operating income for calendar year 2008 was negatively impacted by a record \$50.8 million of catastrophe and storm losses, compared to \$21.5 million in 2007. In addition to the record amount of catastrophe and storm losses, operating income for 2008 reflects a slight decrease in the amount of favorable development experienced on prior years' reserves, and a moderate, but steady decline in overall premium rate levels.

Net income for the fourth quarter was \$474,000 compared to net income of \$7.1 million for the same period in 2007. For the year, the Company reported a net loss of \$1.7 million compared to net income of \$42.5 million in 2007. Results for the fourth quarter and year-ended December 31, 2008 were negatively impacted by record "other-than-temporary" investment impairment losses of \$9.2 million and \$30.9 million, respectively, resulting from the severe and prolonged turmoil in the financial markets. For comparative purposes, "other-than-temporary" investment impairment losses totaled \$1.3 million in calendar year 2007.

Net written premiums decreased 5.8 percent to \$85.4 million in the fourth quarter and 2.2 percent to \$386.6 million for the year. In the property and casualty insurance segment, net written premiums declined 3.3% in the commercial lines of business and 4.8% in the personal lines of business. In the reinsurance segment, net written premiums increased 3.7%, primarily as a result of an increase in earned but not reported premiums associated with property pro rata business and accrued reinstatement premiums. Under the terms of the quota share agreement, the reinsurance segment receives reinstatement premium income that is collected by Employers Mutual from the ceding companies when coverage is reinstated after a loss event; however, the cap on losses assumed per event under the quota share agreement is automatically reinstated without cost to the reinsurance subsidiary.

For calendar year 2008, new business premium was down 8.9 percent in the commercial lines of business, reflecting a decline in premium rates and reduced exposures. Personal lines new business premium was up 9.9 percent, with much of the increase coming in select territories which management believes offer greater profit potential. In total, new business premium was down 7.6 percent.

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Investment income decreased 3.0 percent to \$12.2 million for the fourth quarter and 0.2 percent to \$48.4 million for the year. These declines are primarily attributed to the elimination of the dividends on the Freddie Mac and Fannie Mae preferred stocks, as well as a decrease in the yield on cash and short-term investments.

The total rate of return on our equity portfolio for 2008 was negative 37.4 percent, which is consistent with the negative 37.0 percent total return on the S&P 500. During the fourth quarter, our equity portfolio returned negative 23.0 percent, compared to negative 21.9 percent for the S&P 500. The current annualized yield on our bond portfolio is 5.53 percent and the effective duration is 5.6 years, which is up from 3.75 years at year-end 2007.

The net book value of the Company's stock at December 31, 2008 was \$21.32 per share, a decrease of 18.5 percent from \$26.15 per share at year-end 2007; consolidated assets totaled \$1.1 billion, including \$965.2 million in the investment portfolio; and stockholders' equity was \$282.9 million.

In 2008, the Company's Board of Directors authorized a stock repurchase plan totaling \$25 million dollars. The program does not have an expiration date and the timing and terms of the purchases are determined by management based on market conditions and the applicable rules of the SEC. As of February 23, 2009, 590,515 shares have been repurchased and \$10.2 million remains available for the purchase of additional shares.

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

Operator

Thank you. [Operator Instructions].

Our first question comes from Paul Newsome from Sandler O'Neill & Partners. Please pose your question.

Paul Newsome, Sandler O'Neill

Good morning folks. Thanks for the call. I was hoping you could walk through the combined ratio assumptions that you have for next year. And my back-of-the-envelope I think following on the third quarter but if you're running maybe an accident year by 102 but you've had price increases or decreases that are probably mid single digits, and I assume that there's some lost cost inflation out there. So I'm having trouble getting to a -- to as low as a 105, and just if you could just kind of think it -- help my think in that regard that would be very much appreciated.

Bruce Kelley, CEO, President

Thanks, Paul, for your question. This is Bruce Kelley. First, I'll have Mark Reese give an overview of the combined ratio, and then Steve Peck will add some details to that.

Mark Reese, CFO

We have -- the assumption is 105.5 for the year, and that does reflect the lagging effect of rate decreases that were implemented in prior years, and also assumes a

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more normal cat storm loss year than we experienced in 2008. With those comments, I'll turn it over to Steve and let him get into a little more of the details.

Steve Peck, SVP, Actuary

All right. I've assumed largely because of economic conditions, of the policy count reduction of 2.5%, severity and frequency, it's a little difficult right now. But my assumption is, an increase in frequency of 7%, and a reduction in -- I'm sorry, an increase in severity of 7%, and reduction in frequency of 4.2%. I'm assuming that the impact of 2008 rate changes on 2009 premium will be about 1.6% reduction on a written basis, and somewhere in the neighborhood of 3% on an earned basis. In addition to that, I'm assuming no change in 2009 in manual rates, that is, rates that we would be implementing on the manual side, would not change the overall rate level in 2009, and I'm also assuming no change in the average underwriting credit on commercial policies. The cat load that is included in the -- and I should also say that those -- those statistics are for the accrual, which is the driver of the combined. The overall cat load, including EMC Re that I have assumed is 7.6%, and that breaks down to 5.9% on accrual and 15.1% on EMC Re. Finally, the one area of reserve development that can affect the combined ratio case reserve development, I'm assuming no case reserve development in 2009, either up or down.

Bruce Kelley, CEO, President

Does that help you, Paul?

Paul Newsome, Sandler O'Neill

Yes, it does. Two clarifications. It sounds like you are assuming flat pricing at least from your perspective next year.

Steve Peck, SVP, Actuary

On an ongoing basis, yes.

Paul Newsome, Sandler O'Neill

I mean, are we assuming a similar amount this year than last, or I mean I know your reserve systems are a little bit different than others.

Steve Peck, SVP, Actuary

Right.

Paul Newsome, Sandler O'Neill

But just to be clear, you'd have to have some reserve releases in there I would imagine given they're about half your earnings right now.

Steve Peck, SVP, Actuary

Well, yeah. We have to distinguish between reserve releases -- we have to identify reserve releases that actually impact combined ratio. A lot of our development is caused by a reallocation of the bulk reserves to -- from the prior accident years to the current accident year, as we move through -- through the year. Doesn't mean that those reserves are going to change at all, but they can show up as development, downward development, if the take down in the reserve for prior years exceeds the

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reported loss for prior years during that calendar year. The only area where development would directly impact the combined ratio would be case reserve development. In 2008, we assumed a case reserve development on accrual of a minus 2%. It actually came in a little higher than that at about, I believe, 2.7, minus 2.7. This year, compared to the minus 2, the assumption of zero. And the reason for that is a decline in the estimated adequacy of the case reserves. I might mention that the downward development of the case reserves last year, which was partially due to a reduction in adequacy, was more than offset -- well, I don't know if the development was more than offset. But at least partially offset by the increase in the bulk case reserve to offset the decline in the individual case reserve adequacy. So it is -- it is a long answer to your question. The short answer, the assumption this year is zero, compared to minus 2 a year ago.

Paul Newsome, Sandler O'Neill

Great, thank you very much.

Unidentified Member of Management

Remember, Paul, last year Steve predicted the 101. And if we had a normal storm year, he would have been spot-on with his prediction. So real pleased with his predictive ability. Ron has a comment.

Ronald Jean, EVP Corporate Development

Yeah, Paul, this is Ron Jean. I've got just a question on that to add to what Steve said. Since we have a very conservative reserving position, even though we see some favorable development from old years, we're putting up adequate reserves on the -- or very conservative reserves on the new year as well. So we're maintaining a fairly consistent level of reserve adequacy. So whatever release you see from old years is somewhat offset by new reserves being put up on a calendar year basis.

Operator

That is all your questions?

Paul Newsome, Sandler O'Neill

Yes, thank you very much.

Operator

Thank you. [Operator Instructions]. Our next question is comes from Bob Farnam with Keefe, Bruyette & Woods. Please pose your question.

Bob Farnam, Keefe, Bruyette & Woods

Yes, hi there, thanks. Two questions. One was the growth, written premium growth in the property casualty segment was low -- I think it was down 10% for the quarter. And I just wanted to know if that was -- was there anything in particular in that quarter that drove that number down so much relative to the earlier quarters during the year?

Bruce Kelley, CEO, President

I'll let Mark talk about that and then I think Kevin has some comments also.

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Mark Reese, CFO

Yes, Bob, as far as the quarterly fluctuations, we see a lot of fluctuation by quarter in the P and C segment. So I wouldn't read too much into that change for the quarter. I think it's more important to look at that time year-to-date results and that was about 3.7 decline for the year, and that's consistent with what our expectations were. On a quarter-to-quarter basis there's going to be fluctuations as to what policy terms are actually booked and when. So you're going to have a little bit of that from quarter to quarter.

Kevin Hovick, SVP, Business Development

Yeah, this is Kevin Hovick. I don't have a whole lot to add to what Mark had to say on that. We didn't see restocks -- we continue to see a fairly steady inflow of new business into our branches during the fourth quarter and during the year last year. It wasn't quite as strong as it was in 2007. Our personal lines continue to stay fairly strong and our renewal retention continues to stay pretty strong. Again, I think it's some of a reflection of the continuing of fairly soft marketplace out there.

Bob Farnam, Keefe, Bruyette & Woods

Do you -- what was the renewal retention in that business, do you have a number?

Kevin Hovick, SVP, Business Development

Yes, it was in the neighborhood of 86%, to be a little more precise if I can find the page here. Yes, it was about 86% on commercial lines, and about 87% on personal.

Bruce Kelley, CEO, President

Remember, Bob, we are doing some underwriting on some of our coastal exposures. We are getting out of business that we don't want to have long term.

Bob Farnam, Keefe, Bruyette & Woods

Got you. Okay. And the second question is more of a number question, too. Your effective tax rate is been kind of screwed up the second half of the year. I've been assuming 25% tax rate going forward. Does that still sound reasonable?

Kevin Hovick, SVP, Business Development

Well, yes you have noticed a fluctuation this year. And that's really due to the fact that we have quite a bit of our investment income is tax exempt. And our book income has been fluctuating pretty dramatically throughout the year as a result of the high level of cat and storm losses and the impairment losses that we've been recording. On a going-forward basis, our assumption is that our effective rate for 2009 is going to be 14.6%.

Bob Farnam, Keefe, Bruyette & Woods

14.6.

Kevin Hovick, SVP, Business Development

So a little bit less than the 25 that you've been using.

Bob Farnam, Keefe, Bruyette & Woods

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Sure, okay. Very good, thanks.

Kevin Hovick, SVP, Business Development

Thanks Bob.

Operator

Thank you. At this time we have no further questions. I'd like to turn the call back over to the speakers for any closing comments.

Anita Novak, Director, Investor Relations

Thank you ladies and gentlemen. This now concludes this conference call. I would like to remind you that the playback of this call will be available on the company's Website at www.emcinsurance.com until March 12th, 2009, and a transcript of this conference call will be available until February 2010, 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

Thank you. This will conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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