Transcript of
EMC Insurance Group Inc.
2016 Third Quarter Earnings Conference Call
November 4, 2016

Participants

Bruce Kelley – President and Chief Executive Officer
Jason Bogart – Senior Vice President, Branch Operations
Kevin Hovick – Executive Vice President & Chief Operating Officer
Mick Lovell – Executive Vice President for Corporate Development
Mark Reese – Senior Vice President & Chief Financial Officer
Steve Walsh – Director of Investor Relations

Analysts

Paul Newsome – Sandler O'Neill
Arash Soleimani –Keefe, Bruyette & Woods (KBW)

Presentation

Operator
Good afternoon and welcome to the EMC Insurance Group 2016 third quarter 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 * then 1 on your touch-tone phone. To withdraw your question, please press * then 2.

Please note this event is being recorded. I would now like to turn the conference over to Steve Walsh, Director of Investor Relations. Please go ahead.

Steve Walsh *– EMC Insurance Group Inc. – Director of Investor Relations*
Thank you Jamie. Good afternoon everyone, and welcome to EMC Insurance Group's 2016 third quarter earnings call. A copy of the press release is available on the Investor Relations page of our website, which can be found at www.emcins.com/ir. The archived audio webcast will be available for replay for approximately 90 days following the earnings call. 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. These statements are not guarantees of future performance, and actual results could differ materially from those suggested by our comments today due to a variety of factors. 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 2016 third quarter earnings release with accompanying financial tables issued earlier today. Certain non-GAAP terms may be used during today's discussions. Please refer to the Company's press release and SEC filings for a description and reconciliation of these terms.

Speaking today will be Bruce Kelley, President and Chief Executive Officer; Mark Reese, Senior Vice President and Chief Financial Officer; and Kevin Hovick, Executive Vice President and Chief Operating Officer. They will be available to answer questions following their prepared remarks. At this time, it is my pleasure to introduce the Company's President and CEO, Bruce Kelley

Bruce Kelley – *EMC Insurance Group Inc. – President and Chief Executive Officer*
Thank you Steve, and welcome to those joining us.

Earlier today we reported net income of $0.20 per share and operating income of $0.23 per share, compared to net income of $0.54 per share and operating income of $0.31 per share in the third quarter of 2015. The decline in net income is because we reported net realized investment losses of $1.2 million for the third quarter of 2016, compared to net realized investment gains of $7.5 million in the third quarter of 2015. The difference in realized gains was primarily driven by our equity tail risk hedging strategy, which generated a large amount of realized investment gains in August 2015 when the equity markets declined sharply. This year, the property and casualty insurance segment reported an increase in catastrophe and storm losses and unfavorable results in the commercial auto and personal lines of business, which impacted both net income and operating income per share. The decline in underwriting profitability in the property and casualty insurance segment was partially offset by improvement in the reinsurance segment due to a decline in catastrophe and storm losses, as the third quarter of 2015 included $4.1 million of net losses from the Tianjin, China explosion. The GAAP combined ratio for the quarter was 102.9 percent, up from 101.8 percent in the prior year quarter.

Our 2016 operating income guidance of $1.55 to $1.75 per share stands. There was little change in our projected GAAP combined ratio for the year or in our projected investment income. The load for catastrophe and storm losses has been reduced to 8.7 points from the previous load of 10.2 points; however, this 1.5 point decline in the loss ratio was offset by an increase in the core loss ratio.

Net investment income increased 1.5 percent in the third quarter due to an increase in dividend income, and more interest income because of a higher average invested balance in fixed maturity securities. The yield on new fixed maturity investments remains below the average book yield of the fixed maturity portfolio, and will therefore likely continue to limit future growth in net investment income. The effective duration of the fixed maturity portfolio, excluding interest-only securities, increased slightly to 4.7 from 4.6 at year end. Total return on the equity portfolio was 2.2 percent, which was below the 3.9 percent return of the S&P 500 for the third quarter.

Book value was $26.67 per share, representing a decline of 0.5 percent for the third quarter, which reflects a decline in unrealized gains on the investment portfolio. For the first nine months of the year, book value per share increased 5.6 percent, driven primarily by an increase in unrealized gains and investment income.

Premiums earned increased 4.4 percent for the third quarter. In the property and casualty insurance segment, premiums earned increased 2.3 percent, which includes the cession of $765,000 of premiums to Employers Mutual Casualty Company, the Company's parent company, for the cost of the new aggregate catastrophe excess of loss reinsurance program. Excluding this cost, premiums earned increased 3.0 percent. The majority of this increase is attributed to growth in insured exposures, an increase in both commercial and personal lines new business, and small rate level increases on renewal business.

Premiums written increased 3.1 percent in our property and casualty insurance segment. Renewal rate level increases have continued to soften and are now only slightly positive for the first nine months of the year. Competition remains heightened as companies seek to protect quality accounts within their renewal book of business. We are currently in our sixth consecutive year of obtaining above-industry rate level increases. We have achieved this while maintaining strong retention levels over this period, currently at 86.7 percent. Business Owner Policy and commercial auto remain the lines of business that are achieving rate level increases in the low single-digits, while workers' compensation and commercial umbrella, our best performing commercial lines of business, are reporting slight rate level declines. Workers' compensation continues to see mandatory rate reductions in some of the states in which we write this line of business. In 2017, we expect overall rate levels to be flat in our commercial lines and increase in the low-single digits in our personal lines.

In our reinsurance segment, premiums earned increased 11.8 percent and premiums written increased 18.7 percent. These increases were driven by the addition of some new accounts and growth in the pro rata line of business. The difference in the percentage increases of premiums earned and premiums written is due to the impact of two items. First, the purchase of Industry Loss Warranties by our reinsurance company to provide increased protection in peak exposure territories, and second, the earning pattern of the offshore energy and liability proportional account.

We expect continued pricing pressure on our assumed reinsurance business during the upcoming January 1 renewal season, when approximately 70 percent of our reinsurance business renews. Abundant capital remains in the marketplace, and losses from the Alberta wildfires and Hurricane Matthew are not expected to have much impact on future pricing. We are closely monitoring the terms and pricing offered to ensure they meet our strict underwriting standards, which promote profitability.

I am also pleased to report that we recently announced a 10.5 percent increase in our quarterly cash dividend to twenty one cents ($0.21) per share, from the previous nineteen cents ($0.19) per share. This is the seventh consecutive year the board of directors has increased the quarterly cash dividend to provide an attractive return for stockholders.

Before I turn the call over to Mark Reese, I would like to note that for the third consecutive year, EMC Insurance Group is on the 50 Most Trustworthy Financial Companies list, announced by Forbes. To create the trustworthy list, MSCI ESG Research reviewed nearly 700 publicly-traded North American financial companies with market caps of $250 million or greater for the year ending December 2015. An accounting and governance risk score is then given to each company. The final list highlights 50 companies that are transparent and accurately report their financial results. We are very proud of this recognition as it demonstrates our culture of honesty and integrity--one of the guiding beliefs that shapes and directs the way we work at EMC.

So with that, I'll turn the call over to Mark Reese, our Chief Financial Officer, who will discuss the implementation of our new reserving methodology, as well as some additional highlights of the quarter.

Mark Reese *– EMC Insurance Group Inc. – SVP & Chief Financial Officer*
Thank you Bruce, and good afternoon everyone.

The previously announced transition to the new reserving methodology for the determination of direct bulk reserves in the property and casualty insurance segment is now complete. The new methodology, referred to as the accident year ultimate estimate approach, will provide increased transparency of the drivers of the property and casualty insurance segment's performance and better conform to industry practices. The explicit drivers of development on prior years' reserves will be identifiable beginning in the first quarter of 2017, after the explicit accident year ultimate assumptions at December 31, 2016, have been determined.

The implementation of the new reserving methodology did not have a material impact on total carried reserves for the property and casualty insurance segment as of September 30, 2016; however, approximately $5.6 million of incurred but not reported (or IBNR) loss reserves and settlement expense reserves were reallocated from prior accident years to the current accident year in multiple lines of business. This reduction in prior accident years' reserves is reported as favorable development, but this development is "mechanical" in nature, and did not have any impact on earnings because the total amount of carried reserves did not change as a result of this reallocation. Excluding the “mechanical” favorable development amount, the implied amount of favorable development that had an impact on earnings was approximately $7.6 million for the third quarter. It is important to understand the difference between reported development amounts and the implied amounts of development that have an impact on earnings, because the implied amounts may lead to a different answer when calculating normalized earnings.

Large losses are defined as reported current accident year losses greater than $500,000 for the EMC Insurance Companies' pool, excluding catastrophe and storm losses. In the past, we have disclosed the impact that large losses had on earnings; however, under the new reserving methodology, large losses are taken into consideration when establishing the current accident quarter and accident year ultimate estimates of losses, but there is no longer a direct relationship between large losses and earnings. As a result, it is no longer meaningful to report large losses separately.

The Company's loss and settlement expense ratio increased to 71.1 percent in the third quarter from 70.4 percent in the third quarter of 2015.

The loss and settlement expense ratio for the property and casualty insurance segment increased to 70.2 percent from 66.8 percent in the third quarter of 2015, primarily due to an increase in catastrophe and storm losses. The property and casualty insurance segment recovered $3.5 million from Employers Mutual under the January 1 through June 30 excess of loss reinsurance treaty in the third quarter. Taking this recovery and the premium paid to Employers Mutual into consideration, the new reinsurance program reduced the loss and settlement expense ratio in the third quarter by 2.4 percentage points. No recoveries were made under the July 1 through December 31 treaty; however, only $213,000 of retention remains under this treaty, which means catastrophe and storm losses will be capped at $213,000 in the fourth quarter, unless the $12 million limit of protection is exceeded.

The personal lines of business and the commercial auto line of business continued to generate unfavorable results during the third quarter, posting loss and settlement expense ratios of 98.7 percent and 93.5 percent, respectively. The personal lines' ultimate loss estimate reflects an increase in loss severity for the current accident quarter, and the commercial auto line's ultimate loss estimate reflects an increase in both frequency and severity for the current accident quarter. Kevin Hovick will have more on the initiatives underway to improve performance in these lines of business.

The loss and settlement expense ratio in the reinsurance segment decreased to 74.1 percent for the third quarter of 2016 from 83.4 percent in 2015. This decrease is attributed to a decline in catastrophe and storm losses, as the third quarter of 2015 included $4.1 million of net losses from the Tianjin, China explosion. No recoveries have been made under the revised excess of loss reinsurance program with Employers Mutual during the first nine months of 2016. The decline in the total cost of the revised excess of loss reinsurance program with Employers Mutual produced an approximate 1.2 percentage point decrease in the loss and settlement expense ratio for the third quarter of 2016.

The Inter-Company Committees of the boards of directors of the Company and Employers Mutual recently approved revisions to the pricing of each of the intercompany reinsurance programs effective January 1, 2017. The cost of the treaties providing protection to the reinsurance subsidiary will decline $230,000, while the cost of the treaties providing protection to the property and casualty insurance subsidiaries will decline $500,000. The structure and terms of the treaties did not change for 2017.

Finally, I would like to provide an update on our estimated losses from Hurricane Matthew. While it was certainly a significant event for the industry and the communities that were in its path, it does not appear to be a significant event for the Company. We estimate losses for the property and casualty insurance segment will be below $500,000; however, as I previously noted, all catastrophe and storm losses above $213,000 and up to the $12 million limit will be recovered under the intercompany reinsurance program during the fourth quarter. We estimate losses for the reinsurance segment will be in a range of $1 million to $3 million.

Now I'll turn the call over to Kevin Hovick, Executive Vice President and Chief Operating Officer, to provide an update on the commercial auto project and the personal lines initiative, and discuss a new pilot program we are implementing in our school program.

Kevin Hovick – *EMC Insurance Group Inc. – EVP & Chief Operating Officer*
Thank you Mark, and good afternoon everyone.

The intensive multi-year Accelerate Commercial Auto Profitability project that we discussed on our last call has now been underway for a couple of months. The goal of this project is to return this line of business to profitability within the next three years. This is a difficult task given the current industry trends that include an increase in miles driven and distracted drivers on the road, which have resulted in an increase in loss frequency. In addition, vehicles cost more to repair, so collision severity has also increased.

Obtaining additional rate level increases in commercial auto is only part of the solution to turn this line around. The project includes eight teams that will complement local branch efforts, each focusing on different opportunities to further improve areas such as pricing, claims handling and underwriting. Commercial auto action plans have been created for each of our 16 local branch offices to address these issues, with plans for the southwest and southeast geographic areas being more rigorous due to their responsibility for an outsized portion of the commercial auto losses. New business has slowed considerably as we focus on more stringent underwriting and ratings guidelines, and we are taking steps to non-renew underperforming accounts because making this line of business profitable is a priority for the entire company.

Now for an update on our personal lines initiative. The Personal Lines Operation has done an excellent job executing the implementation of our new personal auto and homeowners products in the 22 states we actively write personal lines business. As of the second quarter earnings call, we had implemented both products in 7 states. We now have both products implemented in a total of 18 states, and have received approval to implement the additional states during November and December.

Our personal lines new business premium trend remains positive after several years of declining premium, and retention levels remain stable in the mid-80's. As we re-underwrite our existing book of business, the independent agents we write business with remain enthusiastic about our new products and competitive position in the marketplace.

The commercial liability and workers' compensation lines of business both continue to perform well. Workers' compensation continues to benefit from the multi-faceted collaboration project that was developed to continuously improve outcomes through our underwriting and claims processes. With the use of our loss control services, we can help reduce the probability of a claim. When an injury does occur, we work with the insured to get the injured party the necessary care and support to get them back to work as quickly as medically possible through our Return to Work and Select Provider Programs. These programs help to significantly reduce the insured's claim costs and differentiate the coverage we provide. Accounts with workers' compensation premium of $50,000 or more recently reached an all-time high participation level of 58 percent in both programs, representing a significant increase from 29 percent just two years ago.

Our Target Markets and Safety Group programs, which are geographically and industry specific programs that require a greater degree of expertise or increased customization, continue to grow at a slightly faster rate than our non-program business as we expand these programs into different branches, and create new classes of business within these programs. These programs represent approximately 30 percent of direct premiums written in our property and casualty insurance segment. Generally, these programs report a lower loss ratio than non-program business, and a contributing factor continues to be our loss control services.

One of our larger programs is our school program, and we recently announced the piloting of a new service in partnership with Hartford Steam Boiler to use an electronic monitoring system to help schools manage risk using real-time data. The system features remote-operated sensors that monitor doors, temperature, humidity, vibration and water. These sensors can help schools prevent losses such as vandalism and theft, mold, HVAC failure and flooding. The sensors not only help prevent losses, they also help equipment operate more efficiently. With loss control services like these, we look forward to continued profitability from our Target Markets and Safety Group programs.

Before I open the call up for questions, I would like to discuss our parent company's recent investment in the Global Insurance Accelerator (or GIA), which is a business accelerator focused on developing and growing insurance-centric startups that are building solutions to support the insurance industry. As an investor, Employers Mutual will help fund the startups accepted into the GIA program and be exposed to the newest industry-technology trends ahead of competitors. Employers Mutual will be better able to evaluate future engagement with, and potential investment in, emerging technologies. This investment fits well with the work the innovation lab is doing to find new and creative insurance-related solutions that help set our agents apart, while creating value for policyholders.

So with that, we are now ready to open the call for questions.

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Operator
Ladies and gentlemen, at this time, we'll open the question-and-answer session. To ask a question you may press * then 1 on your touch-tone phone. If you are using a speakerphone, please pick up your handset before pressing the keys to ensure the best sound quality. To withdraw your question please press * then 2. At this time, we will pause momentarily to assemble the roster.

And our first question today comes from Arash Soleimani from KBW. Please go ahead with your question.

Arash Soleimani – *KBW – Analyst*
Hi. Good afternoon.

Steve Walsh – *EMC Insurance Group Inc. – Director of Investor Relations*
Good morning, Arash.

Arash Soleimani – *KBW – Analyst*
Good morning. Could you maybe talk about some of the technologies that you've seen in this accelerate program you're mentioning. And you know, are there any of them that you think you could actually use in the near to medium term?

Steve Walsh – *EMC Insurance Group Inc. – Director of Investor Relations*
Sure Arash. We're going to have -- Mick Lovell is in here with us. He is the Executive Vice President for Corporate Development and overseas our IT department. So he is probably the best one to take that question.

Mick Lovell – *EMC Insurance Group Inc. – EVP for Corporate Development*
Yes, good morning. The classes in the GIA traditionally run between five and seven startups, is what the ultimate class will get to. And we see quite a bit of technology surrounding wearables and telematics, (technology) not only for automobiles, but also for smart buildings as well as workers' compensation. So we believe that there are quite a few of those technologies that we will be watching. The 2017 class is just now beginning to form. So we have yet to see all of the applicants for that class. We have had discussions and formed some partners with the 2016 class in the area of telematics, and also in the area of big data. So we do believe there is quite a bit of opportunity there that will help us in our business operations.

Arash Soleimani – *KBW – Analyst*
Thank you for that. The other question I had, in terms of commercial auto, I was wondering if you can provide some more detail there, I mean, not just you guys but everyone seems to be having issues with that line. What do you think you guys can do aside from rate as you were mentioning, it can't just be rate to I guess tackle the distracted driving issue?

Steve Walsh – *EMC Insurance Group Inc. – Director of Investor Relations*
Sure Arash. I think Kevin Hovick will take this one.

Kevin Hovick – *EMC Insurance Group Inc. – EVP & Chief Operating Officer*
As I mentioned, we've got eight sub teams that were working on and what we're trying to do is get everybody kind of pull in the same direction on this. And some of these sub-teams are just kind of -- just give you high level of what we are looking at, we're looking at agency with -- working with the agents on what we can do for them. Audit enhancements, make sure we're picking up and rating correctly the policies that we have and making sure we're picking up additional vehicles and on -- like on dealer programs. Claims enhancements, giving some specialized claims to people involved with some of this, especially on some of the heavier equipment, some of the heavier trucks that we have, making sure that we understand exactly what happens. We have these people, we're starting to focus in a little bit more. We're doing a data portfolio management just analyzing all the data we have, then we're looking at pricing. Our risk improvement which is our loss control, we're continuing to refine what we're looking at out there making sure that we have the information we need. The telematics and big data, using the information that we can get working with insureds, doing some of the telematics that they have in their trucks and some of the information that we can help working with them, and then vehicle and driver information. We're finding too often that we don't have some of the correct information on vehicles, and we're finding that some of these accidents that we have are a result of unreported drivers that probably would not meet our acceptability standards. So we want to make sure that we understand who is driving it and what they're driving. So those are kind of the eight major categories that we're looking at with this.

Arash Soleimani – *KBW – Analyst*
Thanks for that answer. So when you put all of those initiatives together, I mean how long do you think you could see as meaningful, I guess, improved margin, improvement in commercial auto something that, you know like a two to three-year story or is it more short-term than that, longer-term than that, like, what do you think the timeframe is for commercial auto to kind of get back to where it should be?

Kevin Hovick – *EMC Insurance Group Inc. – EVP & Chief Operating Officer*
Well, as I mentioned in the call, we are -- we've got a kind of a three-year timeframe for this team that we've assembled for this. But we hope, we plan to see some incremental improvement as we are continuing to especially get some rate increases, especially in some of the territories and that should help offset a little bit. And a lot of these initiatives when we start getting some of these deliverables, they're going to -- it doesn't all come on at once, it's going to kind of phase in over time. And even if -- once we do get them all in by the time you get it through the process and the policies renew, it's going to be a delayed effect a little bit. But we expect to see some improvement here, I don't know, coming up shortly, but again we've got a three year timeframe on this team that we've put together to continue to work on this to get the deliverables that we want to have.

Arash Soleimani – *KBW – Analyst*
Okay, thank you. That makes sense. And I guess my last question is just on kind of the rate environment. Can you talk about any, I guess pricing segmentation efforts you have in place? And looking at, I guess your best performing accounts, your average accounts and your worst performing kind of the rate increases you're applying to each and the retention you're seeing in each of those segments?

Jason Bogart – *EMC Insurance Group Inc. – SVP Branch Operations*
This is Jason Bogart. We go account by account on that. Overall, our retentions are where we want them to be in the mid-80s. We are seeing where the retention ratios on our -- when we model out the accounts and the ones that model out the worst, the retention ratios are lower on them than on the others. We are pushing to get more rate on those than others. And so we are seeing some differentiation there. And I would say on the commercial auto, we're also focused today in our operational -- in our direct operations, we have been eliminating underperforming accounts. We have been getting as you mentioned focused rate increase on the ones that model out the worst and also eliminating some of those accounts. And we're putting a lot more

emphasis on our safety, the driver safety and the screening of drivers that will take a little while to work through, but we think we've already begun making a lot of the moves we need to make to get those results improved.

Arash Soleimani – *KBW – Analyst*
Okay, great. Thank you very much for the answers.

Operator
Once again if you would like to ask a question you may press * then 1 on your touch-tone phone.

Our next question comes from Paul Newsome from Sandler O'Neill. Please go ahead with your question.

Paul Newsome –- *Sandler O'Neill – Analyst*
Good morning. I was going to -- I want to ask about, as we think about margins prospectively, I think you made the comment that you expected flat rate overall for next year. Should we be thinking as we project out further some margin contraction given the underlying claims inflation?

Steve Walsh – *EMC Insurance Group Inc. – Director of Investor Relations*
Yeah. Paul, this is Steve. I think Mark Reese is going to take that question.

Mark Reese – *EMC Insurance Group Inc. – SVP & Chief Financial Officer*
Yeah, Paul. Yeah, I think we could see a little bit with just the rating environment by itself, but we truly believe that we're going to start to see some improvements from these initiatives and projects we have in place. Our commercial auto project, the personal lines initiative and then the work we're doing on strategic analytics, I think those are going to benefit the bottom line in the claims side. So hopefully the improvement there will be enough to offset the decline in the rate levels that we're anticipating.

Bruce Kelley– *EMC Insurance Group Inc. – President and Chief Executive Officer*
Yeah. This is Bruce Kelley. As I mentioned in my comments, workers' compensation and general liability are performing well and we're going to continue to try to get increases there -- if we can and if certain bureaus and workers' compensation filings will allow us to. But, I think you can see that in the lines that we're emphasizing that have the high loss ratios, we're going to really try to push rate increases there as well. So it will be difficult, but I think we're all -- all parts of the company are focused on this, and I think our branch structure allows us better because we have a deeper dive into our book of business through our branches to be able to focus better on getting more rates.

Paul Newsome –- *Sandler O'Neill – Analyst*
Fantastic. Thank you for the call.

Operator
And at this time, I'm showing no additional questions. We will end today's question-and-answer session. I'd like to turn the conference call back over to Steve Walsh for any closing remarks.

Steve Walsh – *EMC Insurance Group Inc. – Director of Investor Relations*
I would like to thank you all for joining us today. We appreciate your interest in the EMC Insurance Group, and look forward to speaking with you again on our fourth quarter earnings conference call. Have a great day.

Operator
Ladies and gentlemen, today's conference is now concluded. We thank you for attending today's presentation. You may now disconnect your lines.