Transcript of
EMC Insurance Group Inc.
2016 Fourth Quarter Earnings Conference Call
February 10, 2017

Participants

Bruce Kelley – President and Chief Executive Officer
Scott Jean – Executive Vice President for Finance and Analytics
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)
Ron Bobman – Capital Returns

Presentation

Operator
Good afternoon and welcome to the EMC Insurance Group 2016 fourth 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 William. Good afternoon everyone, and welcome to EMC Insurance Group's 2016 fourth 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 fourth 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 Scott Jean, Executive Vice President for Finance and Analytics. 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 today.

Earlier today we reported net income of $1.01 per share and non-GAAP operating income of $0.86 per share, compared to net income of $0.48 per share and non-GAAP operating income of $0.65 per share in the fourth quarter of 2015. The GAAP combined ratio for the quarter was 91.7 percent--our lowest fourth quarter GAAP combined ratio since 2005, which compared favorably to the 94.1 percent reported in 2015. These excellent results allowed us to exceed expectations for the year.

Over half of the increase in net income per share is due to the fact that we reported net realized investment gains for the fourth quarter of 2016, compared to net realized investment losses in 2015. The gains in the fourth quarter of 2016 resulted primarily from the sale of equity securities following a slight rebalance of our investment portfolio during the quarter. Both periods include realized investment losses as a result of our equity tail risk hedging strategy; however, losses were elevated in 2015 as equity markets recovered following their sharp decline in August.

Underwriting income for the property and casualty insurance segment improved significantly in the fourth quarter, impacting both net income and non-GAAP operating income per share. This was primarily driven by favorable development on prior years' reserves, reflecting moderate reductions in the ultimate loss ratios for several accident years in the workers' compensation line of business and a reduction in settlement expense reserves. This was partially offset by a decline in favorable reserve development in the reinsurance segment, which reported an unusually large amount of favorable development in the fourth quarter of 2015.

Book value per share declined slightly in the fourth quarter due to a decrease in the market value of the investment portfolio caused by an increase in interest rates. For the year, book value per share increased 3.2 percent, reflecting the contribution from net income, partially offset by a decline in unrealized gains on the investment portfolio.

Net investment income for the fourth quarter was consistent with 2015, and increased 4.2 percent for the year. This increase primarily reflects growth in dividend income and income from our other invested assets portfolio. The effective duration of the fixed maturity portfolio, excluding interest-only securities, increased to 5.2 compared to 4.6 at the end of 2015, due to the increase in interest rates primarily in the fourth quarter, which caused the duration of callable securities to lengthen. Total return on the equity portfolio for the quarter was 5.1 percent, which was above the 3.8 percent return of the S&P 500.

Premiums earned increased 7.0 percent for the fourth quarter. In the property and casualty insurance segment, premiums earned and written increased approximately 4 percent, after excluding the cost of the new intercompany reinsurance program. These increases are attributed to growth in insured exposures, an increase in both commercial and personal lines new business, an increase in retained policies in the commercial lines of business, and small rate level increases on renewal business.

Renewal rate level increases have continued to soften, finishing slightly positive for the year. 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. There will be some variance by line of business, as we are targeting rate level increases in the low single-digits in the commercial auto and businessowners lines of business, while rate levels will likely continue to decline in workers' compensation due to the mandatory rate reductions implemented in many of the states in which we write this line of business. Our underwriters will continue to target rate level increases in the lines, locations and accounts where they are needed most. This has worked well for us during the current cycle, as our retention levels have remained strong at 86.8 percent.

In our reinsurance segment, premiums earned increased 22.1 percent and premiums written increased 17.0 percent for the fourth quarter of 2016; however, after excluding certain adjustments detailed in our earnings release filed earlier this morning, premiums earned and premiums written actually declined slightly.

The reinsurance segment continues to see pricing pressures due to the abundance of nontraditional capital and the lack of major catastrophic events. During the January 1, 2017 renewal season, when approximately 70 percent of our treaties renew, we experienced more moderate price declines than the previous year. Our current estimate is that prices declined in the range of 3 – 5 percent across our excess book of business. In some cases, we were not able to justify the terms offered, and had to pass on opportunities we might have otherwise taken. We currently expect premiums earned in the reinsurance segment to be flat or decline slightly in 2017.

Our 2017 non-GAAP operating income guidance of $1.35 to $1.55 per share is down from our 2016 results as we anticipate some additional margin compression due to the continued pressure on rates in this competitive market, and a slightly higher level of catastrophe and storm losses in our reinsurance segment, which is more in line with our 10-year average compared to the relatively low amount reported for 2016. We remain optimistic that some of this guidance decline may be partially offset by improved performance in our commercial auto and personal lines of business from our initiatives to improve profitability in those lines of business.

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

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

The Company's loss and settlement expense ratio decreased to 60.1 percent in the fourth quarter from 63.9 percent in 2015, due to an 8.3 percentage point improvement in the loss and settlement expense ratio for the property and casualty insurance segment. This improvement was due in part to a slight decline in the core loss ratio and an increase in favorable reserve development.

Year-end reserves in the property and casualty insurance segment were determined using the new reserving methodology. As a result, the explicit drivers of the property and casualty insurance segment's performance, including development on prior years' reserves, will be identifiable beginning in the first quarter of 2017.

Catastrophe and storm losses totaled $2.4 million in the fourth quarter of 2016, which compared favorably to the $3.6 million reported in the prior year. In the property and casualty insurance segment, approximately $4.2 million of catastrophe and storm losses related to the Tennessee wildfires were incurred during the fourth quarter; however, only $512,000 of total catastrophe and storm losses incurred during the fourth quarter were retained, and the remainder was ceded to Employers Mutual under the intercompany reinsurance program. Catastrophe and storm losses in the reinsurance segment were lower than expected. Losses incurred to date from Hurricane Matthew are less than $300,000.

As a reminder, the intercompany reinsurance programs were renewed for 2017, with the total cost of the treaties declining approximately $730,000. The structure and terms of the treaties did not change. New in 2016, the intercompany reinsurance program for the property and casualty insurance segment performed as expected given the amount of catastrophe and storm losses that were incurred each quarter. No recoveries were made under the reinsurance segment's intercompany reinsurance program during 2016 as catastrophe and storm losses were relatively low compared to the most recent 10-year average.

Effective January 1, 2017, the external reinsurance agreements that provide protection to all parties to the reinsurance pooling agreement with Employers Mutual, including protection against losses arising from catastrophic events, were renewed with similar coverages and limits as the prior year. The notable changes include increasing the top limit of the pool's property catastrophe program by $5 million to $220 million, increasing the placement of our first property catastrophe layer from 50 percent to approximately 78 percent, and increasing the workers' compensation catastrophe excess limit from $40 million to $50 million. Based on past loss experience under these treaties and marginal changes to our coverages and limits, we project the ceded deposit premiums for our 2017 excess of loss reinsurance coverage will be slightly higher than 2016.

The loss and settlement expense ratio in the reinsurance segment increased approximately 15 percentage points to 65.2 percent for the fourth quarter of 2016. A large amount of favorable reserve development was reported in the fourth quarter of 2015 due to an unusually large reduction in reported reserves.

The fourth quarter acquisition expense ratio increased in both segments. The increase in the property and casualty insurance segment is primarily due to an increase in policyholder dividends resulting from favorable loss experience on some safety dividend groups. In the reinsurance segment, the 2015 ratio was relatively low due to a negative commission adjustment recorded in conjunction with the negative premium adjustment

I'll now turn the call over to Scott Jean, Executive Vice President for Finance and Analytics, to provide updates on some of our initiatives, and make some closing remarks.

Scott Jean – *EMC Insurance Group Inc. – EVP for Finance and Analytics*
Thank you Mark, and good afternoon everyone.

The personal lines of business reported much improved results for the fourth quarter due to the performance of our homeowners business; however, it is far too early to evaluate the overall performance of the new products that have been implemented in connection with our personal lines initiative. We only recently finished implementation in the final 4 states where we write personal lines. Total premiums written for the year were down high single-digits, while new business premium was up double-digits. Our retention level remains in the mid-80's despite the changes that we've made, which is a tribute to the excellent job that our Personal Lines Operation has done during this transition. We will provide additional information as 2017 progresses and more data becomes available regarding the performance of our new products.

During the fourth quarter, the commercial auto line of business showed a slight improvement compared to the third quarter, as well as the fourth quarter of 2015, although it remains an underperforming line of business. Frequency was down across all lines except commercial auto, which was up in the low single-digits. In addition, commercial auto severity was elevated primarily due to an increase in commercial auto liability average claim costs.

On past calls, we've talked about our multi-year Accelerate Commercial Auto Profitability project, with the goal of returning this line of business to profitability by mid-2019. Underwriters remain very selective on new commercial auto business, focusing on writing higher quality accounts to improve the mix of business. We target overall profitability of an account, so we must ensure that any rate level increases within our commercial auto business are not subsidized by reducing rates in other lines. We are also non-renewing certain underperforming accounts, with the greatest focus on the southwest and southeast parts of the country. Our branch structure provides a tremendous platform to communicate specific plans for each branch, and our independent agents appreciate the thoughtful approach we are taking to implement these changes. We remain optimistic that we will start to see incremental improvement from the action plans implemented by each of the eight teams charged with returning this line of business to profitability.

We are also excited about our recent announcement that we joined the Insurance Institute for Highway Safety and Highway Loss Data Institute's nonprofit research organization, which publishes insurance loss statistics for most automobiles on U.S. roads. This membership will grant access to research studies and their data warehouses, which will provide us more accurate, automated vehicle data. This information will be useful to our underwriters and risk improvement representatives as they work to improve the performance of our commercial auto book of business.

Innovation was a common theme for EMC throughout the year. Last quarter, we discussed our new pilot program 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 to help prevent losses for the schools we insure. Recognizing the potential benefits offered from this pilot program, we entered into a partnership with MākuSafe, an innovative startup, in early 2017. MākuSafe has developed patent pending wearable technology that monitors environmental exposures to identify risks in industrial workplace environments. These types of investments reflect the importance we are placing on using data and analytics to find innovative solutions that can add value for our policyholders and agents.

Our agents and policyholders are demanding more, so we must find innovative solutions that help set our agents apart, while at the same time, creating value for policyholders. This is what makes EMC different—our approach to innovation is to give our agents more to sell, while providing benefits to our policyholders, which we believe will help move the industry into the future. We know the business is changing, and that successful carriers will be those that learn to innovate and adapt as the industry and business changes. But make no mistake, while innovation will continue to be a priority, we remain in the business of providing insurance—selling and servicing our policies, while paying the claims we owe.

That focus allowed us to produce excellent operating results for 2016, and provided us with the opportunity to continue to reward our stockholders by increasing our quarterly cash dividend by 10.5 percent. This was the seventh consecutive year that we have increased the quarterly dividend, and over the past five years, our dividend has a compound annual growth rate of 8.7 percent. This remains our preferred method of returning excess capital to stockholders. Looking forward to 2017, we must continue to execute on the strategies that led to this year's success as we navigate this increasingly competitive marketplace.

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. This might be a question for Mark. The other revenue line item, what gets recorded in there?

Mark Reese – *EMC Insurance Group Inc. – SVP & Chief Financial Officer*
That's primarily our foreign exchange adjustments on our foreign business.

Arash Soleimani – *KBW – Analyst*
Okay. And, can you guys maybe talk about, if we do have tax reform that takes the corporate tax rates down, how that changes, if at all, your underwriting appetite? Do you think that would lead to more aggressive pricing? Or do you think those tax changes would basically just go straight to the bottom line?

Bruce Kelley – *EMC Insurance Group Inc. – President and Chief Executive Officer*
This is Bruce Kelly. Let me take the first stab at that, and others may want to talk. We believe that the tax reform that's before Congress will reduce the overall corporate rate. We also believe it would also increase the ability of American companies to write business more profitably in the United States, by restricting to some degree, the ability of foreign insurance companies to do that. As to our underwriting stance, I believe that we're planning to allow that to flow to the bottom line, as we continue to compete in the market, which would probably be unaffected by this tax reform.

Mark Reese – *EMC Insurance Group Inc. – SVP & Chief Financial Officer*
I'd also add to that, even if the rate goes down, I'm almost certain that there will be some other tax changes that will have an impact on that. So, it's really difficult at this early stage to project what type of impact any tax reform could have on the bottom line. We'll monitor the situation and keep you updated.

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

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

Operator
Our next questioner today is Paul Newsome, with Sandler O'Neill. Please go ahead.

Paul Newsome – *Sandler O'Neill – Analyst*
Good morning. I was hoping you could walk through a little bit of your guidance. Specifically, looking at your expected underwriting performance comparing this year with -- 2017 with 2016. It sounds like you're hoping a couple of lines of business like commercial auto will remediate and improve. Can you talk about what specific lines you expect to improve, and what specific lines you think might deteriorate over the course of the year?

Scott Jean – *EMC Insurance Group Inc. – EVP for Finance & Analytics*
Good morning, Paul. This is Scott Jean. I'll try to field that question for you.

In trying to compare 2016 to 2017, it does get a little challenging, in that 2016 was a fairly positive year, especially for EMC Reinsurance, on the assumed book. And, their catastrophe ratio was over 6 points below expectations for the year, as worldwide catastrophes were down -- at least that's how it affected our book. Looking at the guidance, that pushes that up a little bit. So the expectation for 2017 is higher than where we finished 2016, partially due to that.

We're also, as we mentioned, expecting rates to be relatively flat on the direct side of the business. And when we see that, and we also see a loss cost trend that's increasing, then that definitely puts pressure on the underwriting results, and that's reflected in the guidance that we issued.

Now, from an individual line of business, commercial auto did start to improve late in 2016. We still think it's going to take a little time to get to where it needs to be from a profitability perspective. I would expect commercial auto to slightly improve in 2017. Workers' Compensation may, however, go the other way. We have a very good book of workers' comp business. It's performed very well the last two years, but there's a lot of pressure and the rating bureaus are taking rates down, which is going to put pressure on those loss ratios for workers' compensation. We do expect, and without any major catastrophes, our Personal lines book to improve. And for general liability and Businessowners, we're focusing on those lines of business, also, to improve those. BOP could continue to deteriorate a little bit, general liability, we expect to remain fairly consistent with where it's been. So, you put that all together, and that's how we ended up getting to the point where we are with our guidance. Does that kind of answer your question, Paul?

Paul Newsome – *Sandler O'Neill – Analyst*
Yes, fantastic. Thank you.

Bruce Kelley – *EMC Insurance Group Inc. – President and Chief Executive Officer*
Yes, Paul, this is Bruce Kelly. I just wanted to tag onto what Scott very adequately said. We do a rigorous analysis to create our earnings projection, and historically we have not over-predicted. We have a robust internal actuarial department that's able to do this, so I'm very confident that the earnings guidance that we provided is very well set for the year – excluding catastrophe and storm losses (which can be somewhat unpredictable).

Paul Newsome – *Sandler O'Neill – Analyst*
That makes sense. Thank you very much.

Operator
Our next questioner today is Ron Bobman, with Capital Returns. Please go ahead.

Ron Bobman – *Capital Returns*
Hi, gentlemen. Nice results. Congrats on the year. I just had a couple of quick questions. I was wondering, you mentioned retention number, Bruce, but I was wondering if by chance you have any retention figures by line? And what I was really moved interested in was retention for the Workers' Comp book.

Bruce Kelley – *EMC Insurance Group Inc. – President and Chief Executive Officer*
I'll have to turn that over to Scott for an analysis of our Workers' Comp book on retention.

Ron Bobman – *Capital Returns*
Thanks.

Scott Jean – *EMC Insurance Group Inc. – EVP for Finance & Analytics*
I think our Commercial line retention is pretty consistent by line of business. We write, primarily, accounts with multi-lines. We don't write a lot of mono-line workers' compensation, so our workers' compensation is generally going to follow the same retention ratios as the rest of our book. And I'm taking a quick look at a few numbers right now. We're seeing retention is actually a little better for workers' compensation than it is for the rest of our book. So, we have had a lot of success in retaining a lot of our good worker's compensation accounts.

Ron Bobman – *Capital Returns*
Clearly, thanks. I'm assuming that the guidance for 2017 assumes no favorable or unfavorable development. Is that safe?

Scott Jean – *EMC Insurance Group Inc. – EVP for Finance & Analytics*
It probably does assume some favorable development. We, almost every year, have seen favorable development, and it's almost an expectation that we have when we're looking at our projections. More than likely we anticipate seeing some favorable development in 2017.

Ron Bobman – *Capital Returns*
Thanks. So, then to delve a little bit deeper, is it's safe to assume that the amount of favorable development implied in the 2017 guidance is less than the amount that you actually booked in 2016?

Scott Jean – *EMC Insurance Group Inc. – EVP for Finance & Analytics*
Yes, I would say so.

Ron Bobman – *Capital Returns*
Okay. And my last question, is it safe to assume -- I don't think you -- it wasn't in the press release, I don't believe. Is it safe to assume that you did not buy any stock back, but you still have an authorization to buy back stock?

Mark Reese – *EMC Insurance Group Inc. – SVP and Chief Financial Officer*
Yes, in 2016 we bought back 17,000 shares in the first quarter. We didn't have any further activity during 2016, so our authorization is still in place.

Ron Bobman – *Capital Returns*
Thanks a ton, gentlemen. Best of luck and hope that it continues.

Bruce Kelley – *EMC Insurance Group Inc. – President and Chief Executive Officer*
Thank you.

Operator
It looks like we have no further questioners, so this will conclude our question-and-answer session. I would like to turn conference back over to Steve Walsh for any closing remarks.

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