ISSUERDIRECT
Trading Under the Symbol: ISDR

Transcript of
EMC Insurance Group
Fourth Quarter 2014 Earnings Conference Call
February 13, 2015

Participants

Steve Walsh – Director, Investor Relations
Bruce Kelley – President and Chief Executive Officer
Mark Reese – Senior Vice President and CFO

Analysts

Paul Newsome – Sandler O'Neill
John Deysher – Pinnacle Value Fund

Presentation

Operator
Good afternoon and welcome to EMC Insurance Group's 2014 Fourth Quarter Earnings Conference call. At this time, all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Steve Walsh, Director of Investor Relations.

Steve Walsh – Director, Investor Relations
Good afternoon everyone, and welcome to EMC Insurance Group's 2014 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 webcast is also available on this site for replay purposes until May 13, 2015. 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 2014 fourth quarter earnings release with accompanying financial tables issued earlier today. In addition, certain non-GAAP terms may be used during today's discussions. Please refer to the Company's press release and/or SEC filings for a description and reconciliation of these terms.

Mr. Bruce Kelley, President and Chief Executive Officer, and Mr. Mark Reese, Senior Vice President and Chief Financial Officer, have prepared remarks this afternoon, and other executive officers are available to answer questions. At this time, it is my pleasure to introduce the Company's President and CEO, Bruce Kelley.

Bruce Kelley – President and Chief Executive Officer
Thank you Steve, and welcome to those joining us this afternoon. Earlier today we reported our best fourth quarter operating income per share since 2005— $1.14 per share compared to $0.95 per share in 2013. We reported net income of $1.19 per share for the fourth quarter, compared to $1.20 per share in 2013.

Operating results for the fourth quarter were better than expected as the reinsurance segment posted a 74.4 percent combined ratio driven by favorable reserve development and minimal storm activity. Both the property and casualty insurance segment and the reinsurance segment reported an underwriting profit for the quarter, providing positive momentum for 2015.

Net written premium growth for the quarter remained in the mid-single digits in the property and casualty insurance segment, growing 5.9 percent. Net written premiums in commercial lines of business were up 7.2 percent, while personal lines of business were down 3.3 percent due to continuing efforts to reduce our policy count to lessen exposure concentrations. Commercial lines policy count was up 1.7 percent for the year, and personal lines policy count was down 9.6 percent. In August, we created a new personal lines operation that will eventually assume responsibility and accountability for the growth and profitability of personal lines business throughout the country. This will take some time to implement, but in the end we expect improved performance of our personal lines business. This change in structure will also allow our 16 local branch offices to focus their efforts on commercial lines insurance, which accounts for approximately 90 percent of net written premiums of the property and casualty insurance segment.

During 2014, renewal rates across our commercial lines of business increased approximately 4.5 percent and personal lines of business increased approximately 3.5 percent, as premium rate levels increased at all branch locations and across all major lines of business. Renewal rate increases slowed across most lines of business as the year progressed, but the slowing varied across lines of business. Certain lines of business, like business owners, commercial auto and commercial property are getting larger increases of between 5 percent and 7 percent, while renewal rates in workers' compensation, (which has performed well for us this year), are up approximately 1 percent.

The pace of property and casualty insurance rate level increases continues to slow, but our well-focused process of evaluating the loss experience and exposures associated with each policy when determining targeted rate level increases remains the same. This enables us to maintain high retention levels and retain our best business, while increasing rate adequacy on accounts that need it the most. We anticipate that we will continue to implement targeted rate level increases during 2015, although at a lower level than 2014.

Overall, premium income was flat for the fourth quarter. In the property and casualty insurance segment, however, premiums earned increased 7.4 percent, with the vast majority of the growth attributable to rate level increases on renewal business and, to a lesser extent, growth in insured exposures. We are comfortable with this level of growth because the overwhelming majority is attributed to rate level increases implemented on retained policies. New business is growing at a slightly faster clip in regions outside the Midwest, contributing to a gradual diversification into areas that are less prone to weather-related events. New business policy counts were down 3.3 percent in commercial lines and 8.8 percent in personal lines for the year, as new accounts are being carefully selected.

In the reinsurance segment, premium income was down 22.9 percent for the quarter. This decline was not caused by rate level decreases or a loss of business, but rather, is attributed to a decline in the amount of earned but not reported premiums recognized on pro rata contracts. Mark Reese will discuss this in greater detail during his remarks. The reinsurance marketplace remains challenging, but we are cautiously optimistic that 2015 reinsurance premium income will exceed 2014, and likely be closer to the 2013 premium income amount of $122.8 million.

Retention: Retention levels based on policy count were 86.7 percent for commercial lines of business, and 84.8 percent for personal lines of business, with an overall retention level of 85.9 percent. This is slightly above our 85 percent retention level at the end of 2013. Retention levels in the mid-to-upper 80 percent range are well within our comfort level and expectations due to the large amount of commercial lines group business contained in our core book of business. This business tends to consistently renew because of marketing strategies designed to reward favorable loss experience.

Balance Sheet: Book value of the Company's stock increased 8.4 percent to $37.08 per share, from $34.21 per share at year-end 2013. Excluding accumulated other comprehensive income from the calculation, book value increased to $31.06 per share from $29.78 per share at year-end 2013.

Guidance: Management is projecting that 2015 operating income will be within a range of $2.75 to $3 per share. This guidance is based on a projected GAAP combined ratio of 97.8 percent for the year and investment income consistent with the amount reported in 2014. The projected GAAP combined ratio has a load of 11 points for catastrophe and storm losses.

Other Items: Before I turn the call over to Mark, I would like to take a minute to discuss our workers' compensation line of business. Employers Mutual Casualty Company was founded in 1911 to provide workers' compensation coverage to Iowa manufacturers, and this product remains an integral part of our business. To help improve underwriting profitability, we have engaged in an ongoing multi-faceted workers' compensation collaboration project to improve outcomes through both our underwriting and claims processes. Initially, we help make workplaces safer by increasing the use of our loss control services, which reduces 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 quickly through our Return to Work and Select Provider Programs. With these enhancements in place, we are confident that we can continue to profitably write workers' compensation policies in the future.

Finally, I am proud to note that for the third consecutive year, EMC Insurance Companies is listed as one of the 40 best companies for leaders by *Chief Executive* magazine. EMC ranks 4th this year, jumping from 26th in 2014, and is listed among other notable companies such as General Electric and IBM. This annual ranking is based on a worldwide survey of organizations conducted by the magazine. We are very proud of this ranking as we have created a culture that emphasizes leadership development and employee advancement at all levels of our organization.

With that, I'll turn the discussion over to our CFO, Mark Reese.

Mark Reese – Senior Vice & Chief Financial Officer
Thank you Bruce, and good afternoon everyone. As Bruce mentioned earlier, and as noted in our earnings release, premiums earned in the reinsurance segment were down 22.9 percent for the fourth quarter due to an $8.7 million decline in the amount of earned but not reported premiums recognized on pro rata contracts. As previously reported, management began reviewing the premium recognition period of all pro rata contracts during the third quarter. This review was completed during the fourth quarter, and was the primary driver of the decline in earned but not reported premiums.

The decline in earned but not reported premiums did not have a material impact on 2014 net income because corresponding adjustments were made to incurred but not reported loss reserves, commission expense reserves and the cost of the excess of loss reinsurance protection. Without the reduction in the amount of earned but not reported premiums, earned premiums in the reinsurance segment would have increased approximately 3.2 percent in the fourth quarter and 2.7 percent for the year, due to growth in existing accounts and the addition of some new business.

Losses and Settlement Expenses: The loss and settlement expense ratio increased slightly to 62.1 percent in the fourth quarter, from 61.7 percent in the prior year. The property and casualty insurance segment's loss and settlement expense ratio increased slightly, primarily due to an increase in large losses, which we define as losses greater than $500,000 for the EMC Insurance Companies pool, excluding catastrophe and storm losses. The increase in large losses was partially offset by a decline in catastrophe and storm losses. The reinsurance segment's loss and settlement expense ratio declined in the fourth quarter, driven by favorable reserve development and minimal storm activity.

Large losses increased to $11.9 million, or $0.57 per share after tax, in the fourth quarter of 2014, from $7 million, or $0.34 per share after tax, in the fourth quarter of 2013. Commercial auto losses were elevated during the fourth quarter compared to the prior year, which impacted the commercial auto and commercial liability lines of business. This was similar to what we, and many in the industry, experienced throughout the first nine months of the year. As with all of our policies, we are evaluating the underlying exposures to ensure that we are getting an adequate price for the risks we are insuring when these policies renew. I am pleased to report that the increased frequency of large homeowners and commercial property fire losses that we experienced during the first nine months of the year did not continue during the fourth quarter.

Fourth quarter catastrophe and storm losses accounted for 3.3 percentage points of the combined ratio, which is equal to the Company's most recent 10-year average for this period and below the 5 percentage points experienced in the fourth quarter of 2013. There were no catastrophe and storm loss events in the reinsurance segment during the fourth quarter that exceeded the $4 million retention level contained in the excess of loss agreement.

Effective January 1, 2015, Employers Mutual Casualty Company renewed the core property and casualty reinsurance agreements that provide protection to the pool and each of its participants, including protection against losses arising from catastrophic events, with favorable pricing terms along with expanded coverage. The notable changes to the property catastrophe program include increasing the top limit by $10 million and expanding the coverage time period of the property catastrophe program for wind perils to 120-hour coverage, up from 96-hour coverage on portions of the layers in 2014. The top property catastrophe layer remains at 96-hour coverage. Even with these additional limits and expanded coverage terms, we still project ceding less premium under our 2015 property catastrophe reinsurance program than in 2014.

Claims frequency and severity were both higher than expected for the year due to losses stemming from the severe winter weather during the first quarter, convective storms during the second quarter, and increased frequency and severity of fire related losses and commercial auto losses. Renewal rate increases continue to exceed our estimated long-term loss cost trend.

During the 2013 fourth quarter earnings call, I included a brief discussion about the reserving methodology utilized by the property and casualty insurance segment, including the composition of the development amounts that are produced under this methodology at each year-end. I want to revisit that discussion today because I believe that it is important in evaluating our results.

Under the reserving methodology utilized by the property and casualty insurance segment, IBNR loss reserves, bulk case loss reserves and settlement expense reserves are all established independently and in total, and the total is then allocated to the various accident years. During the year-end allocation process, a portion of these total reserves may be reallocated from the current accident year to prior accident years, or from prior accident years to the current accident year, to achieve the actuarial department's desired reserve levels by accident year. When reserves are moved to, or from, prior accident years, the change is reported as development on prior years' reserves. This type of development is "mechanical" in nature, and does not have an impact on earnings because the total amount of carried reserves did not change. Therefore, we identify, quantify and disclose this "mechanical" development so that users of the Company's financial statements can better understand how development on prior years' reserves impacts the Company's results of operations.

So when we look at the reported development amounts for the fourth quarter, we had $9.9 million of favorable development in 2014, compared to $5.2 million in 2013. However, included in these amounts are $2.2 million and $6.5 million of favorable development in 2014 and 2013, respectively, that resulted solely from the reallocation of bulk reserves between the current and prior accident years in the property and casualty insurance segment, which had no impact on earnings. When the reported development amounts are adjusted to exclude these “mechanical” development amounts, the resulting implied amounts of development that had an impact on earnings are approximately $7.7 million of favorable development in the fourth quarter of 2014, compared to approximately $1.4 million of adverse development in the fourth quarter of 2013. So it is important to understand the difference between the 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.

I also want to stress that this reallocation of reserves between the current and prior accident years only occurs at year-end. Therefore, the development amounts reported for the first three quarters of the year are not impacted. The consolidated statements of income contained in the press release show how the implied amounts of development that have an impact on earnings are calculated.

The change in fourth quarter implied development is primarily attributed to the reinsurance segment, which experienced favorable development of $7.9 million in the fourth quarter of 2014, compared to $1.8 million in 2013. For the year ended December 31, 2014, the implied amount of favorable development increased to approximately $18.6 million from $6.3 million in 2013. Both the property and casualty insurance segment and the reinsurance segment experienced increases in favorable development for the year. The increase in the property and casualty segment is primarily due to better than expected outcomes on claims reported in prior years, and favorable development on prior years’ settlement expenses. The increase in the reinsurance segment is primarily due to a decline in carried reserves for accident years prior to 2010.

Development amounts can vary significantly from quarter to quarter and year to year depending on a number of factors, including the number of claims settled and the settlement terms, and should therefore not be considered a reliable factor in assessing the adequacy of the Company’s carried reserves. The most recent actuarial analysis of the Company’s carried reserves indicates that carried reserves remain within the top quartile of the range of reasonable reserves.

Employee Retirement Plans: Results for the fourth quarter of 2014 reflect a significant reduction in the amount of pension and postretirement benefit costs allocated to the Company. Pension benefit cost declined to $170,000 in the fourth quarter of 2014 from $753,000 in the same period in 2013. This decline reflects an increase in the expected return on plan assets, due to an increase in plan assets, and a decline in the amount of net actuarial loss amortized into expense. Postretirement benefit cost changed significantly as a result of the plan amendment that was announced in the fourth quarter of 2013. The Company recognized postretirement benefit income of $771,000 in the fourth quarter of 2014, compared to postretirement benefit expense of $728,000 in the same period in 2013. The plan amendment created a large prior service credit that is being amortized into expense over 10 years. In addition, the service cost and interest cost components of the revised plan’s benefit cost are significantly lower than those of the prior plan.

We are aware that other property and casualty insurance companies have reported an adverse impact to book value resulting from the 2014 actuarial valuations of their defined benefit pension and postretirement plans. The funded status of Employers Mutual's plans declined in 2014, due to a decline in the discount rate assumption and a change in the mortality assumption; however, the plans remain in an overfunded position. We expect similar amounts of pension expense and postretirement benefit income in 2015 as experienced in 2014.

Investment Results: Turning to our investment results, net investment income increased 9.4 percent for the quarter and 8 percent for the year. These increases primarily reflect a higher average invested balance in fixed maturity securities and a significant increase in dividend income. The average coupon rate on our fixed maturity portfolio, excluding interest-only securities, declined slightly to 3.9 percent at year-end 2014 from 4 percent at year-end 2013. The effective duration of the fixed maturity portfolio, excluding interest only securities, decreased to 4.6 from 5.7 at the end of 2013. Duration contracted as interest rates declined.

Total return on the equity portfolio was 6.7 percent for the quarter and 16.6 percent for the year, compared to 4.9 percent and 13.7 percent for the S&P 500. During the first quarter of 2014, we invested in a limited partnership designed to help protect the Company from a sudden and significant decline in the value of its equity portfolio. The carrying value of this limited partnership declined approximately $0.5 million and $1.9 million after tax during the fourth quarter and for the year. These declines are reported as realized investment losses for those periods.

Capital Management: No shares have been repurchased under the Company's $15 million stock repurchase program that was authorized in November of 2011.

At this time, we are ready to open the call for questions.

Operator
Our first question today is coming from Paul Newsome with Sandler O'Neill & Partners.

<Q>: First off just a quick accounting question. Was there a trigger for why you did a study for the earned premium in the reinsurance business?

Mark Reese – Senior Vice President and Chief Financial Officer
Paul, I can't say there was a trigger per say. It was something that we had been wanting to look at for some time and the actuarial department has been quite busy with other projects, so the time became available this year. It was kind of an extensive project; it spanned over a couple of quarters. You recall that we did make an adjustment during the third quarter on two of our large facility contracts and then during the fourth quarter we completed the project and the adjustments that we reported is a culmination of those efforts.

<Q>: Then could you talk maybe broadly about the competitive environment as you see it towards the year-end? Where are you seeing the most competition; where are you seeing the least in your major markets?

Jason Bogart – Senior Vice President, Branch Operations
We're seeing that as the year progressed that there was more and more rate competition, but a lot of also what we're seeing is that in the states where we write workers' compensation the bureaus and boards are lowering the rates in those states. So that does have a dampening impact on our ability overall to get rate increase. That happened last year, and that's continuing forward in that line this year. So we're not seeing any dramatic softening in any of our locations overall in the marketplace.

Operator
We do have a question coming from John Deysher from Pinnacle.

<Q>: I was just curious on that last comment about workers' comp. What percentage of the business is workers' comp at this point in time?

Jason Bogart – Senior Vice President, Branch Operations
It's about 25 percent.

<Q>: 25 percent of premiums earned?

Mark Reese – Senior Vice President and Chief Financial Officer
Yes, that would be on the P&C segment— 25 percent of the P&C segment's earned premium.

<Q>: The commercial, yes. So 25 percent of the P&C segment— is it represented in the reinsurance business as well?

Ron Hallenbeck – Vice President, EMC Reinsurance President and COO
We have some excess work comp covers. I wouldn't say it is that significant; perhaps less than $500,000.

<Q>: So the bulk of it is in P&C side. Do you expect that to increase or to remain constant or what's the outlook as a percentage of the total P&C business going forward?

Jason Bogart – Senior Vice President, Branch Operations
We expect that to continue to stay at roughly that percentage.

Operator
If there are no further questions at this time I'd like to turn the floor back over to management for any further or closing comments.

Steve Walsh – Director, Investor Relations
Thank you ladies and gentlemen. This concludes today's conference call. I'd like to remind you that a webcast of this call will be available on the Company's investor relations page of the our website at www.emcins.com/ir until May 13, 2015 and a transcript of this conference call will be available for one year, which can also be accessed from our Investor Relations page.

We appreciate your interest in EMC Insurance Group. Have a great day.