

Edgar Filing: National Interstate CORP - Form 10-Q

National Interstate CORP
Form 10-Q
August 05, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2015

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____
Commission File Number: 000-51130

National Interstate Corporation
(Exact name of registrant as specified in its charter)

Ohio (State or other jurisdiction of incorporation or organization)	34-1607394 (I.R.S. Employer Identification No.)
3250 Interstate Drive, Richfield, OH (Address of principal executives offices)	44286-9000 (Zip Code)

(330) 659-8900
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer <input type="checkbox"/>	Accelerated Filer <input checked="" type="checkbox"/>
Non-Accelerated Filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller Reporting Company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares outstanding of the registrant's sole class of common shares as of August 3, 2015 was 19,840,650.

Table of Contents

National Interstate Corporation
Table of Contents

	Page
<u>Part I – Financial Information</u>	<u>3</u>
<u>Item 1. Financial Statements</u>	<u>3</u>
<u>Consolidated Balance Sheets</u>	<u>3</u>
<u>Consolidated Statements of Income (Loss)</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income (Loss)</u>	<u>5</u>
<u>Consolidated Statements of Shareholders' Equity</u>	<u>6</u>
<u>Consolidated Statements of Cash Flows</u>	<u>7</u>
<u>Notes to Consolidated Financial Statements</u>	<u>8</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>24</u>
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>37</u>
<u>Item 4. Controls and Procedures</u>	<u>37</u>
<u>Part II – Other Information</u>	<u>38</u>
<u>Item 1. Legal Proceedings</u>	<u>38</u>
<u>Item 1A. Risk Factors</u>	<u>38</u>
<u>Item 6. Exhibits</u>	<u>38</u>

Table of Contents

PART I—FINANCIAL INFORMATION

ITEM 1. Financial Statements

National Interstate Corporation and Subsidiaries

Consolidated Balance Sheets

(In thousands, except per share data)

	June 30, 2015 (Unaudited)	December 31, 2014
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost – \$992,307 and \$945,956, respectively)	\$1,016,358	\$974,746
Equity securities available-for-sale, at fair value (amortized cost – \$80,149 and \$76,352, respectively)	88,048	85,228
Other invested assets	48,666	46,786
Total investments	1,153,072	1,106,760
Cash and cash equivalents	80,239	53,583
Accrued investment income	8,863	8,724
Premiums receivable, net of allowance for doubtful accounts of \$2,289 and \$2,627, respectively	282,613	271,336
Reinsurance recoverable on paid and unpaid losses	199,704	180,332
Prepaid reinsurance premiums	56,636	47,013
Deferred policy acquisition costs	25,843	22,654
Deferred federal income taxes	23,278	23,150
Property and equipment, net	23,714	24,538
Funds held by reinsurer	4,457	4,335
Intangible assets, net	7,650	7,791
Prepaid expenses and other assets	3,321	4,517
Total assets	\$1,869,390	\$1,754,733
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$947,252	\$883,078
Unearned premiums and service fees	313,523	311,255
Long-term debt	12,000	12,000
Amounts withheld or retained for accounts of others	110,933	101,799
Reinsurance balances payable	43,419	31,069
Accounts payable and other liabilities	52,972	33,402
Commissions payable	16,944	15,392
Assessments and fees payable	4,598	4,649
Total liabilities	1,501,641	1,392,644
Shareholders' equity:		
Preferred shares – no par value		
Authorized – 10,000 shares		
Issued – 0 shares	—	—
Common shares – \$0.01 par value		
Authorized – 50,000 shares		
Issued – 23,350 shares, including 3,511 and 3,557 shares, respectively, in treasury	234	234
Additional paid-in capital	60,124	59,386
Retained earnings	291,605	283,031

Edgar Filing: National Interstate CORP - Form 10-Q

Accumulated other comprehensive income	20,767	24,483
Treasury shares	(4,981) (5,045
Total shareholders' equity	367,749	362,089
Total liabilities and shareholders' equity	\$1,869,390	\$1,754,733
See notes to consolidated financial statements.		

3

Table of Contents

National Interstate Corporation and Subsidiaries
Consolidated Statements of Income (Loss)
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenues:				
Premiums earned	\$ 143,892	\$ 139,139	\$ 281,715	\$ 272,642
Net investment income	9,828	8,783	19,484	17,485
Net realized gains on investments (*)	431	1,067	1,500	3,672
Other	886	786	1,716	1,546
Total revenues	155,037	149,775	304,415	295,345
Expenses:				
Losses and loss adjustment expenses	113,543	133,585	222,324	236,165
Commissions and other underwriting expenses	23,364	23,886	46,347	46,424
Other operating and general expenses	6,874	5,425	13,117	10,885
Transaction expenses	—	153	—	2,163
Expense on amounts withheld	1,652	1,426	3,153	2,981
Interest expense	49	58	96	132
Total expenses	145,482	164,533	285,037	298,750
Income (loss) before income taxes	9,555	(14,758)	19,378	(3,405)
Provision (benefit) for income taxes	2,913	(4,015)	5,627	(717)
Net income (loss)	\$6,642	\$(10,743)	\$13,751	\$(2,688)
Net income (loss) per share – basic	\$0.33	\$(0.54)	\$0.69	\$(0.14)
Net income (loss) per share – diluted	\$0.33	\$(0.54)	\$0.69	\$(0.14)
Weighted average of common shares outstanding – basic	19,839	19,764	19,837	19,729
Weighted average of common shares outstanding – diluted	19,890	19,764	19,885	19,729
Cash dividends per common share	\$0.13	\$0.12	\$0.26	\$0.24
(*) Consists of the following:				
Net realized gains before impairment losses	\$ 1,790	\$ 1,198	\$ 2,874	\$ 4,037
Total losses on securities with impairment charges	(1,359)	(90)	(1,359)	(135)
Non-credit portion recognized in other comprehensive income	—	(41)	(15)	(230)
Net impairment charges recognized in earnings	(1,359)	(131)	(1,374)	(365)
Net realized gains on investments	\$431	\$1,067	\$1,500	\$3,672
See notes to consolidated financial statements.				

Table of Contents

National Interstate Corporation and Subsidiaries
 Consolidated Statements of Comprehensive Income (Loss)
 (Unaudited)
 (Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income (loss)	\$6,642	\$(10,743)	\$13,751	\$(2,688)
Other comprehensive (loss) income, before tax:				
Net unrealized holding gains on available-for-sale securities:				
Net unrealized holding (losses) gains on securities arising during the period	(10,041)	7,986	(5,016)	17,594
Reclassification adjustment for net realized gains included in net income (loss)	(137)	(547)	(700)	(1,156)
Total other comprehensive (loss) income, before tax	(10,178)	7,439	(5,716)	16,438
Deferred income tax (benefit) expense on other comprehensive (loss) income	(3,562)	2,604	(2,000)	5,753
Other comprehensive (loss) income, net of tax	(6,616)	4,835	(3,716)	10,685
Total comprehensive income (loss)	\$26	\$(5,908)	\$10,035	\$7,997
See notes to consolidated financial statements.				

Table of Contents

National Interstate Corporation and Subsidiaries
Consolidated Statements of Shareholders' Equity
(Unaudited)
(Dollars in thousands)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance at January 1, 2015	\$234	\$59,386	\$283,031	\$ 24,483	\$(5,045)	\$362,089
Net income			13,751			13,751
Other comprehensive loss, net of tax				(3,716)		(3,716)
Dividends on common stock			(5,177)			(5,177)
Issuance of 45,784 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		338			64	402
Net tax effect from exercise/vesting of stock-based compensation		(39)				(39)
Stock-based compensation expense		439				439
Balance at June 30, 2015	\$234	\$60,124	\$291,605	\$ 20,767	\$(4,981)	\$367,749
Balance at January 1, 2014	\$234	\$56,481	\$281,518	\$ 19,281	\$(5,230)	\$352,284
Net loss			(2,688)			(2,688)
Other comprehensive income, net of tax				10,685		10,685
Dividends on common stock			(4,750)			(4,750)
Issuance of 119,473 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		1,971			167	2,138
Net tax effect from exercise/vesting of stock-based compensation		37				37
Stock-based compensation expense		389				389
Balance at June 30, 2014	\$234	\$58,878	\$274,080	\$ 29,966	\$(5,063)	\$358,095

See notes to consolidated financial statements.

Table of Contents

National Interstate Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Six Months Ended June 30,	
	2015	2014
Operating activities		
Net income (loss)	\$13,751	\$(2,688)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	1,435	2,278
Provision for depreciation and amortization	2,765	2,097
Net realized gains on investment securities	(1,500)	(3,672)
Deferred federal income taxes	1,872	380
Stock-based compensation expense	439	389
Increase in deferred policy acquisition costs, net	(3,189)	(2,551)
Increase in reserves for losses and loss adjustment expenses	64,174	42,330
Increase in premiums receivable	(11,277)	(28,275)
Increase in unearned premiums and service fees	2,268	23,508
Decrease (increase) in interest receivable and other assets	935	(5,444)
Increase in prepaid reinsurance premiums	(9,623)	(19,245)
Increase in accounts payable, commissions and other liabilities and assessments and fees payable	7,433	3,036
Increase in amounts withheld or retained for accounts of others	9,134	7,456
(Increase) decrease in reinsurance recoverable	(19,372)	1,655
Increase in reinsurance balances payable	12,350	19,276
Other	678	31
Net cash provided by operating activities	72,273	40,561
Investing activities		
Purchases of fixed maturities	(122,487)	(69,887)
Purchases of equity securities	(10,182)	(13,619)
Proceeds from sale of fixed maturities	8,353	13,529
Proceeds from sale of equity securities	3,959	3,244
Proceeds from maturities and redemptions of investments	82,507	60,945
Change in other investments, net	(475)	(614)
Capital expenditures	(2,478)	(2,024)
Net cash used in investing activities	(40,803)	(8,426)
Financing activities		
Net tax effect from exercise/vesting of stock-based compensation	(39)	37
Issuance of common shares from treasury	402	2,138
Cash dividends paid on common shares	(5,177)	(4,750)
Net cash used in financing activities	(4,814)	(2,575)
Net increase in cash and cash equivalents	26,656	29,560
Cash and cash equivalents at beginning of period	53,583	35,684
Cash and cash equivalents at end of period	\$80,239	\$65,244
See notes to consolidated financial statements.		

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the “Company”) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and the instructions to Form 10-Q.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries, National Interstate Insurance Company (“NIIC”), Vanliner Insurance Company (“VIC”), National Interstate Insurance Company of Hawaii, Inc. (“NIIC-HI”), Hudson Indemnity, Ltd. (“HIL”), Triumpher Casualty Company (“TCC”), Hudson Management Group, Ltd., Vanliner Reinsurance Limited, National Interstate Insurance Agency, Inc. (“NIIA”), American Highways Insurance Agency, Inc., TransProtection Service Company, Explorer RV Insurance Agency, Inc. and Safety, Claims and Litigation Services, LLC. Significant intercompany transactions have been eliminated.

These interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature. Operating results for the six month period ended June 30, 2015 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2015.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

2. Recent Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis (“ASU 2015-02”). The FASB issued ASU 2015-02 to simplify consolidation accounting by reducing the number of consolidation models and to provide more useful information to stakeholders. The Update affects reporting entities that are required to evaluate whether they should consolidate certain entities. The main provisions affect limited partnerships and similar legal entities as variable interest entities or voting interest entities; the evaluation of fees paid to a decision maker as a variable interest; the effect of fee arrangements on the primary beneficiary determination; and a scope exception for certain investment funds. The updated guidance is effective for annual and interim periods beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. The adoption of this guidance is not expected to have a material effect on the Company’s results of operations or financial position.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs (“ASU 2015-03”). ASU 2015-03 simplifies the presentation of debt issuance costs by requiring reporting entities to present such costs on the balance sheet as a deduction from the related debt liability, similar to the presentation of debt discounts. Amortization of the costs will continue to be reported as interest expense. The updated guidance is effective for fiscal years beginning after December 15, 2015 and interim periods within those fiscal years. Early adoption is permitted. The adoption of this guidance is not expected to have a material effect on the Company’s results of operations or financial position.

In May 2015, the FASB issued ASU No. 2015-09, Financial Services - Insurance (Topic 944): Disclosures about Short-Duration Contracts (“ASU 2015-09”). The FASB issued ASU 2015-09 to enhance disclosure requirements for short-duration insurance contracts and to increase transparency regarding significant estimates made in measuring liabilities for unpaid claims and claim adjustment expenses. The ASU is also intended to improve comparability by requiring consistent disclosure information as well as provide financial statement users with additional information to facilitate analysis of the amount, timing, and uncertainty of claims cash flows. The new disclosures will be effective for fiscal years beginning after December 15, 2015 and interim periods within annual periods beginning after December 15, 2016. Early adoption is permitted. The Company will incorporate the required disclosures upon

adoption of this guidance. The adoption of this guidance is not expected to have a material effect on the Company's results of operations or financial position.

3. Fair Value Measurements

The Company must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and

Table of Contents

the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value.

Pricing services use a variety of observable inputs to estimate the fair value of fixed maturities that do not trade on a daily basis. These inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data and measures of volatility. Included in the pricing of mortgage-backed securities are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Inputs from brokers and independent financial institutions include, but are not limited to, yields or spreads of comparable investments which have recent trading activity, credit quality, duration, credit enhancements, collateral value and estimated cash flows based on inputs including delinquency rates, estimated defaults and losses and estimates of the rate of future prepayments. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company's internal and affiliated investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, the Company's internal investment professionals, who report to the Chief Investment Officer, compare the valuation received to independent third party pricing sources and consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. If the Company believes that significant discrepancies exist, the Company will perform additional procedures, which may include specific inquiry of the pricing source, to resolve the discrepancies.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability. Level 1 consists of publicly traded equity securities and highly liquid, direct obligations of the U.S. Government whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government agency securities, fixed maturity investments and nonredeemable preferred stocks that are not actively traded. Included in Level 2 are \$178.7 million of securities, which are valued based upon a non-binding broker quote and validated with other observable market data by management. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes. The Company believes these estimates reflect fair value, but the Company is unable to verify inputs to the valuation methodology. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. The Company's internal and affiliated investment professionals review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.

Table of Contents

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of June 30, 2015:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. Government and government agency obligations	\$4,121	\$146,340	\$—	\$150,461
State and local government obligations	—	317,959	2,919	320,878
Residential mortgage-backed securities	—	176,587	—	176,587
Commercial mortgage-backed securities	—	14,121	—	14,121
Corporate obligations	—	191,475	7,152	198,627
Other debt obligations	—	144,572	6,815	151,387
Redeemable preferred stocks	3,799	—	498	4,297
Total fixed maturities	7,920	991,054	17,384	1,016,358
Equity securities:				
Common stocks	60,323	987	2,778	64,088
Nonredeemable preferred stocks	20,879	3,081	—	23,960
Total equity securities	81,202	4,068	2,778	88,048
Total fixed maturities and equity securities	89,122	995,122	20,162	1,104,406
Cash and cash equivalents	80,239	—	—	80,239
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$169,361	\$995,122	\$20,162	\$1,184,645

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of December 31, 2014:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. Government and government agency obligations	\$2,911	\$110,535	\$—	\$113,446
State and local government obligations	—	338,694	2,887	341,581
Residential mortgage-backed securities	—	192,555	—	192,555
Commercial mortgage-backed securities	—	16,998	—	16,998
Corporate obligations	—	192,314	7,100	199,414
Other debt obligations	—	102,454	3,995	106,449
Redeemable preferred stocks	3,808	—	495	4,303
Total fixed maturities	6,719	953,550	14,477	974,746
Equity securities:				
Common stocks	58,839	—	3,988	62,827
Nonredeemable preferred stocks	16,887	5,514	—	22,401
Total equity securities	75,726	5,514	3,988	85,228
Total fixed maturities and equity securities	82,445	959,064	18,465	1,059,974
Cash and cash equivalents	53,583	—	—	53,583
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$136,028	\$959,064	\$18,465	\$1,113,557

Table of Contents

The previous tables exclude other invested assets of \$48.7 million and \$46.8 million at June 30, 2015 and December 31, 2014, respectively. Other invested assets include investments in limited partnerships which are accounted for under the equity method. Equity method investments are not reported at fair value.

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the six months ended June 30, 2015, the Company transferred three nonredeemable preferred stocks, totaling \$1.5 million (including one in the second quarter totaling \$1.0 million), from Level 2 to Level 1 due to increases in trading activity. Conversely, during the three and six months ended June 30, 2015, the Company transferred one common stock at \$0.9 million and one nonredeemable preferred stock at \$0.1 million, from Level 1 to Level 2 due to decreases in trading activity.

During the six months ended June 30, 2014, there were six nonredeemable preferred stocks, totaling \$5.0 million (including one in the second quarter totaling \$0.1 million) that transferred from Level 1 to Level 2 due to decreases in trading activity.

Table of Contents

The following tables present a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three and six months ended June 30, 2015 and 2014. The transfers in and out of Level 3 were due to changes in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Three Months Ended June 30, 2015				
	State and Local Government Obligations	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stock	Common Stock
	(Dollars in thousands)				
Beginning balance at April 1, 2015	\$2,923	\$7,150	\$2,462	\$497	\$2,839
Total gains or (losses):					
Included in earnings	—	—	—	—	(278)
Included in other comprehensive income	(4)	41	3	1	217
Purchases and issuances	—	—	3,388	—	—
Sales, settlements and redemptions	—	(39)	(38)	—	—
Transfers in and/or (out) of Level 3	—	—	1,000	—	—
Ending balance at June 30, 2015	\$2,919	\$7,152	\$6,815	\$498	\$2,778
The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date	\$—	\$—	\$—	\$—	\$—