

National Interstate CORP  
Form 10-Q  
May 07, 2010

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**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 March 31, 2010**

**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, Ohio 44286-9000  
(330) 659-8900**

*(Address and telephone number of principal executive offices)*

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 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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer       Accelerated Filer       Non-Accelerated Filer       Smaller Reporting Company

*(Do not check if a smaller reporting company)*

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 May 4, 2010 was 19,431,840.



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**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)

	<b>March 31,</b>	<b>December</b>
	<b>2010</b>	<b>31, 2009</b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost \$580,707 and \$565,753, respectively)	\$ 585,860	\$ 566,901
Equity securities available-for-sale, at fair value (amortized cost \$26,265 and \$26,203, respectively)	29,851	28,673
Short-term investments, at cost which approximates fair value	810	811
Total investments	616,521	596,385
Cash and cash equivalents	23,988	18,589
Accrued investment income	5,478	4,926
Premiums receivable, net of allowance for doubtful accounts of \$1,097 and \$963, respectively	114,580	98,679
Reinsurance recoverable on paid and unpaid losses	151,617	149,949
Prepaid reinsurance premiums	32,443	25,163
Deferred policy acquisition costs	20,223	17,833
Deferred federal income taxes	16,674	18,178
Property and equipment, net	21,745	21,747
Funds held by reinsurer	2,709	3,441
Prepaid expenses and other assets	1,337	863
Total assets	\$ 1,007,315	\$ 955,753

**LIABILITIES AND SHAREHOLDERS EQUITY**

Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 426,882	\$ 417,260
Unearned premiums and service fees	168,086	149,509
Long-term debt	15,000	15,000
Amounts withheld or retained for accounts of others	51,685	51,359
Reinsurance balances payable	17,796	10,540
Accounts payable and other liabilities	31,022	29,371
Commissions payable	8,972	8,164
Assessments and fees payable	3,383	3,233
Total liabilities	722,826	684,436
Shareholders equity:		
Preferred shares no par value		
Authorized 10,000 shares		

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Issued 0 shares		
Common shares \$0.01 par value		
Authorized 50,000 shares		
Issued 23,350 shares, including 4,007 and 4,048 shares, respectively, in treasury	234	234
Additional paid-in capital	50,022	49,264
Retained earnings	234,224	225,195
Accumulated other comprehensive income	5,681	2,353
Treasury shares	(5,672)	(5,729)
Total shareholders equity	284,489	271,317
Total liabilities and shareholders equity	\$ 1,007,315	\$ 955,753

See notes to consolidated financial statements.

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

	<b>Three Months Ended March</b>	
	<b>2010</b>	<b>2009</b>
		<b>31,</b>
<b>Revenues:</b>		
Premiums earned	\$ 70,181	\$ 69,439
Net investment income	4,959	5,010
Net realized gains on investments (*)	882	23
Other	818	788
<b>Total revenues</b>	<b>76,840</b>	<b>75,260</b>
<b>Expenses:</b>		
Losses and loss adjustment expenses	43,104	39,326
Commissions and other underwriting expenses	14,836	13,019
Other operating and general expenses	3,626	3,292
Expense on amounts withheld	809	867
Interest expense	12	120
<b>Total expenses</b>	<b>62,387</b>	<b>56,624</b>
Income before income taxes	14,453	18,636
Provision for income taxes	3,867	5,990
<b>Net income</b>	<b>\$ 10,586</b>	<b>\$ 12,646</b>
Net income per share basic	\$ 0.55	\$ 0.66
Net income per share diluted	\$ 0.55	\$ 0.65
Weighted average of common shares outstanding basic	19,328	19,300
Weighted average of common shares outstanding diluted	19,409	19,353
Cash dividends per common share	\$ 0.08	\$ 0.07

(\*) Consists of the following:

Net realized gains before impairment losses	\$ 882	\$ 630
Total losses on securities with impairment charges		(607)

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Non-credit portion in other comprehensive income

Net impairment charges recognized in earnings (607)

Net realized gains on investments \$ 882 \$ 23

See notes to consolidated financial statements.

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

	<b>Common Stock</b>	<b>Additional Paid-In Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Treasury Stock</b>	<b>Total</b>
Balance at January 1, 2010	\$ 234	\$ 49,264	\$ 225,195	\$ 2,353	\$ (5,729)	\$ 271,317
Net income			10,586			10,586
Unrealized appreciation of investment securities, net of tax expense of \$1.8 million				3,328		3,328
Comprehensive income						13,914
Dividends on common stock			(1,557)			(1,557)
Issuance of 41,217 treasury shares upon exercise of options, stock award grants and restricted stock issued, net of forfeitures		380			57	437
Tax shortfall realized from exercise of stock options		(50)				(50)
Stock compensation expense		428				428
Balance at March 31, 2010	\$ 234	\$ 50,022	\$ 234,224	\$ 5,681	\$ (5,672)	\$ 284,489
Balance at January 1, 2009	\$ 234	\$ 48,004	\$ 184,187	\$ (10,613)	\$ (5,738)	\$ 216,074
Net income			12,646			12,646
Unrealized depreciation of investment securities, net of tax benefit of \$0.8 million				(2,755)		(2,755)
Comprehensive income						9,891
Dividends on common stock			(1,360)			(1,360)
Issuance of 5,152 treasury shares from		(70)			7	(63)

vesting of restricted  
stock, net of forfeitures  
Stock compensation  
expense

365

365

Balance at March 31,  
2009

\$ 234    \$ 48,299    \$ 195,473    \$ (13,368)    \$ (5,731)    \$ 224,907

See notes to consolidated financial statements.

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

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2010</b>	<b>2009</b>
<b>Operating activities</b>		
Net income	\$ 10,586	\$ 12,646
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	841	555
Provision for depreciation and amortization	550	453
Net realized gains on investment securities	(882)	(23)
Deferred federal income taxes	(288)	15
Stock compensation expense	428	365
Increase in deferred policy acquisition costs, net	(2,390)	(2,935)
Increase (decrease) in reserves for losses and loss adjustment expenses	9,622	(833)
Increase in premiums receivable	(15,901)	(31,931)
Increase in unearned premiums and service fees	18,577	29,046
(Increase) decrease in interest receivable and other assets	(294)	674
Increase in prepaid reinsurance premiums	(7,280)	(9,946)
Increase in accounts payable, commissions and other liabilities and assessments and fees payable	2,609	266
Increase in amounts withheld or retained for accounts of others	326	3,049
(Increase) decrease in reinsurance recoverable	(1,668)	2,373
Increase in reinsurance balances payable	7,256	10,993
Other	(47)	
 Net cash provided by operating activities	 22,045	 14,767
 <b>Investing activities</b>		
Purchases of fixed maturities	(132,722)	(125,372)
Purchases of equity securities		(86)
Proceeds from sale of fixed maturities	9,033	18,010
Proceeds from sale of equity securities	111	320
Proceeds from maturities and redemptions of investments	108,603	89,825
Capital expenditures	(551)	(1,096)
 Net cash used in investing activities	 (15,526)	 (18,399)
 <b>Financing activities</b>		
Decrease in securities lending collateral		16,231
Decrease in securities lending obligation		(16,231)
Issuance of common shares from treasury upon exercise of stock options or stock award grants	437	(63)

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Cash dividends paid on common shares	(1,557)	(1,360)
Net cash used in financing activities	(1,120)	(1,423)
Net increase (decrease) in cash and cash equivalents	5,399	(5,055)
Cash and cash equivalents at beginning of period	18,589	77,159
Cash and cash equivalents at end of period	\$ 23,988	\$ 72,104

See notes to consolidated financial statements.

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**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 the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

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

These interim 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, 2009. 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 three month period ended March 31, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

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 January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2010-06, *Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 amends Accounting Standard Codification (ASC) 820, *Fair Value Measurements and Disclosures*. ASU 2010-06 requires expanded disclosures around significant transfers between levels of the fair value hierarchy and valuation techniques and inputs used in fair value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009. The Company adopted the expanded disclosures required by ASU 2010-06 for the quarter ended March 31, 2010.

In June 2009, the FASB updated ASC 810, *Consolidation*, which amended the guidance for determining whether an enterprise is the primary beneficiary of a variable interest entity (VIE) by requiring a qualitative analysis to determine if an enterprise's variable interest results in a controlling financial interest. ASC 810 is effective for annual reporting periods beginning after November 15, 2009 and interim and annual periods thereafter. The Company adopted ASC 810 on January 1, 2010 and such adoption did not have a material impact on financial condition, results of operations or liquidity.

**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 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. Fair values for the Company's investment portfolio are reviewed by company personnel using data from nationally recognized pricing services as well as non-binding broker quotes on a limited basis.

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,

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estimated defaults and losses, and estimates of the rate of future prepayments. Valuation techniques utilized by pricing services and values obtained from brokers and independent financial institutions are reviewed by company personnel who are familiar with the securities being priced and the markets in which they trade to ensure that the fair value determination is representative of an exit price, as defined by accounting standards.

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 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 and government agency securities, fixed maturity investments, perpetual preferred stock and certain publicly traded common stocks and other equity securities that are not actively traded. Included in Level 2 are \$4.9 million of securities, which are valued based upon a non-binding broker quote and validated by management by observable market data. 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, for which the Company believes reflects fair value, but are unable to verify inputs to the valuation methodology. The Company obtained 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. Management reviews 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.

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of March 31, 2010:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
<b>Fixed maturities:</b>				
U.S. Government and government agency obligations	\$	\$ 213,265	\$	\$ 213,265
State and local government obligations		153,863	6,387	160,250
Residential mortgage-backed securities		117,428	2,367	119,795
Commercial mortgage-backed securities		3,439		3,439
Corporate obligations		71,525	5,840	77,365
Redeemable preferred stocks	8,921	457	2,368	11,746
Total fixed maturities	8,921	559,977	16,962	585,860
<b>Equity securities:</b>				
Perpetual preferred stock	890	151	396	1,437
Common stock	15,298	13,116		28,414
Total equity securities	16,188	13,267	396	29,851
Short-term investments		810		810
Total investments	25,109	574,054	17,358	616,521
Cash and cash equivalents	23,988			23,988
Total investments and cash and cash equivalents	\$ 49,097	\$ 574,054	\$ 17,358	\$ 640,509





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The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of December 31, 2009:

	Level 1	Level 2 (Dollars in thousands)	Level 3	Total
<b>Fixed maturities:</b>				
U.S. Government and government agency obligations	\$	\$ 212,538	\$	\$ 212,538
State and local government obligations		148,594	6,369	154,963
Residential mortgage-backed securities		114,329	2,384	116,713
Commercial mortgage-backed securities		3,935		3,935
Corporate obligations		61,582	5,842	67,424
Redeemable preferred stocks	8,297	678	2,353	11,328
<b>Total fixed maturities</b>	<b>8,297</b>	<b>541,656</b>	<b>16,948</b>	<b>566,901</b>
<b>Equity securities:</b>				
Perpetual preferred stock	857	167	396	1,420
Common stock	14,270	12,983		27,253
<b>Total equity securities</b>	<b>15,127</b>	<b>13,150</b>	<b>396</b>	<b>28,673</b>
Short-term investments		811		811
<b>Total investments</b>	<b>23,424</b>	<b>555,617</b>	<b>17,344</b>	<b>596,385</b>
Cash and cash equivalents	18,589			18,589
<b>Total investments and cash and cash equivalents</b>	<b>\$ 42,013</b>	<b>\$ 555,617</b>	<b>\$ 17,344</b>	<b>\$ 614,974</b>

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. There were no significant transfers between Level 1 and Level 2 during the three months ended March 31, 2010. The following table presents 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 period:

**Three Months Ended March 31, 2**