

State Auto Financial CORP
Form 10-Q
November 05, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2008

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 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

31-1324304
(I.R.S. Employer
Identification No.)

518 East Broad Street, Columbus, Ohio
(Address of principal executive offices)

43215-3976
(Zip Code)

Registrant's telephone number, including area code: (614) 464-5000

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

On October 31, 2008, the Registrant had 39,556,849 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

PART I FINANCIAL STATEMENTS**Item 1. Condensed Consolidated Balance Sheets**

(\$ millions, except per share amount)

	September 30 2008 (unaudited)	December 31 2007 (see note 1)
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,812.1 and \$1,722.9, respectively)	\$ 1,756.0	1,745.4
Equity securities, available-for-sale, at fair value (cost \$179.1 and \$210.2, respectively)	191.7	254.2
Other invested assets, available-for-sale, at fair value (cost \$44.0 and \$20.1, respectively)	36.2	20.3
Other invested assets	1.1	1.3
<i>Total investments</i>	1,985.0	2,021.2
Cash and cash equivalents	89.1	70.9
Accrued investment income and other assets	43.5	42.1
Deferred policy acquisition costs	125.8	105.8
Pension asset	7.8	2.7
Reinsurance recoverable on losses and loss expenses payable (affiliates \$0.8 and \$1.2, respectively)	29.2	11.2
Prepaid reinsurance premiums	7.0	6.0
Due from affiliate	6.7	19.4
Current federal income taxes	41.4	
Deferred federal income taxes	94.2	46.1
Property and equipment, at cost (net of accumulated depreciation of \$6.1 and \$5.6, respectively)	12.5	12.5
Total assets	\$ 2,442.2	2,337.9
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliates \$367.1 and \$257.2, respectively)	\$ 845.8	658.3
Unearned premiums (affiliates \$174.7 and \$119.5, respectively)	520.1	436.0
Notes payable (affiliates \$15.5 and \$15.5, respectively)	117.7	118.0
Postretirement benefits	128.8	125.2
Current federal income taxes		7.8
Other liabilities	42.0	57.1
Total liabilities	1,654.4	1,402.4
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		

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Class B Preferred stock, without par value. Authorized 2.5 shares; none issued

Common stock, without par value. Authorized 100.0 shares; 46.3 and 46.0 shares

issued, respectively, at stated value of \$2.50 per share

115.7

115.0

Treasury stock, 6.8 and 5.5 shares, respectively, at cost

(115.5)

(81.0)

Additional paid-in capital

107.1

98.2

Accumulated other comprehensive loss

(75.3)

(3.3)

Retained earnings

755.8

806.6

Total stockholders' equity

787.8

935.5

Total liabilities and stockholders' equity

\$ 2,442.2

2,337.9

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

(\$ millions, except per share amounts)

	Three months ended September 30	
(unaudited)	2008	2007
Earned premiums (ceded to affiliates \$175.4 and \$174.1, respectively)	\$ 280.7	252.1
Net investment income	23.0	21.1
Net realized (losses) gains on investments	(4.3)	6.4
Other income (affiliates \$0.8 and \$0.8, respectively)	1.2	1.3
Total revenues	300.6	280.9
Losses and loss expenses (ceded to affiliates \$126.7 and \$115.4, respectively)	231.2	164.6
Acquisition and operating expenses	94.9	82.6
Interest expense (affiliates \$0.3 and \$0.4, respectively)	1.8	1.9
Other expenses, net	2.9	3.2
Total expenses	330.8	252.3
(Loss) income before federal income taxes	(30.2)	28.6
Federal income tax (benefit) expense	(15.5)	5.4
Net (loss) income	(14.7)	23.2
(Loss) earnings per common share:		
Basic	\$ (0.37)	0.56
Diluted	\$ (0.37)	0.55
Dividends paid per common share	\$ 0.15	0.15

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

(\$ millions, except per share amounts)

	Nine months ended September 30	
(unaudited)	2008	2007
Earned premiums (ceded to affiliates \$522.2 and \$520.6, respectively)	\$ 841.0	757.3
Net investment income	67.7	63.0
Net realized (losses) gains on investments	(3.7)	11.1
Other income (affiliates \$2.4 and \$2.4, respectively)	3.6	3.7
Total revenues	908.6	835.1
Losses and loss expenses (ceded to affiliates \$421.4 and \$315.9, respectively)	681.9	468.0
Acquisition and operating expenses	280.9	254.0
Interest expense (affiliates \$0.9 and \$1.1, respectively)	5.5	5.6
Other expenses, net	9.7	9.2
Total expenses	978.0	736.8
(Loss) income before federal income taxes	(69.4)	98.3
Federal income tax (benefit) expense	(38.9)	20.9
Net (loss) income	\$ (30.5)	77.4
(Loss) earnings per common share:		
Basic	\$ (0.77)	1.88
Diluted	\$ (0.77)	1.86
Dividends paid per common share	\$ 0.45	0.35

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Cash Flows

(\$ millions)	Nine months ended September 30	
(unaudited)	2008	2007
Cash flows from operating activities:		
Net (loss) income	\$ (30.5)	77.4
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization, net	6.4	8.3
Share-based compensation	4.8	4.9
Net realized losses (gains) on investments	3.7	(11.1)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(7.2)	(3.9)
Accrued investment income and other assets	(2.0)	(1.1)
Postretirement and pension benefit assets	4.0	2.4
Other liabilities and due to/from affiliates, net	(2.8)	(18.5)
Reinsurance recoverable on losses and loss expenses		
payable and prepaid reinsurance premiums	(19.0)	1.5
Losses and loss expenses payable	136.2	16.0
Unearned premiums	30.5	19.8
Excess tax benefits on share based awards	0.4	0.2
Federal income taxes	(59.0)	(18.8)
Cash provided from Pooling Arrangement Amendment effective January 1, 2008	92.0	
Net cash provided by operating activities	157.5	77.1
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	(253.9)	(280.6)
Purchases of equity securities available-for-sale	(27.2)	(34.9)
Purchases of other invested assets	(24.7)	(0.7)
Maturities, calls and pay downs of fixed maturities available-for-sale	41.3	68.6
Sales of fixed maturities available-for-sale	119.3	148.0
Sales of equity securities available-for-sale	53.0	77.5
Sales of other invested assets	0.9	1.7
Net additions of property and equipment	(0.4)	(0.4)
Net cash used in investing activities	(91.7)	(20.8)
Cash flows from financing activities:		
Proceeds from issuance of common stock	3.1	2.5
Payments to acquire treasury shares	(33.2)	(2.7)
Excess tax benefits on share based awards	0.4	0.2
Payment of dividends	(17.9)	(14.5)

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<i>Net cash used in financing activities</i>	(47.6)	(14.5)
Net increase in cash and cash equivalents	18.2	41.8
Cash and cash equivalents at beginning of period	70.9	73.4
Cash and cash equivalents at end of period	\$ 89.1	115.2
<u>Supplemental disclosures:</u>		
Federal income taxes paid	\$ 18.0	39.3
Interest paid (to affiliates \$0.9 and \$1.1, respectively)	\$ 4.1	4.2

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation (State Auto Financial or the Company) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required for complete financial statements. In the opinion of the Company's management, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ended December 31, 2008. The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2007 (the 2007 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2007 Form 10-K.

Adoption of Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158) that requires employers of defined benefit pension and postretirement benefit plans other than pensions (collectively benefit plans) to recognize the funded status of their benefit plans in their balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the year-end balance sheet date thereby eliminating the use of an earlier measurement date and provide additional disclosures. The new measurement date requirement was not effective until fiscal years ending after December 15, 2008. The Company adopted the recognition and disclosures provision on December 31, 2006. Effective January 1, 2008, the Company adopted the measurement date requirement under transition alternative method one, as defined in SFAS 158. This transition method resulted in a one-time adjustment that decreased beginning retained earnings by \$2.4 million, net of tax. The combined impact of the measurement date transition and re-measurement of plan assets and obligations on January 1, 2008, increased beginning accumulated comprehensive income by \$3.5 million, net of tax.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. The Statement imposes no new requirements for additional fair-value measures in financial statements. The Company adopted the provisions of SFAS 157 on January 1, 2008. The adoption of SFAS 157 did not require any adjustments to the Company's previously reported financial statements. See Note 2 for interim period required disclosures.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 expands the standards under SFAS 157 to provide entities a one-time election to measure financial instruments and certain other items at fair value. SFAS 159 also amends SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities to require a specific presentation of investments categorized as available-for-sale. This Statement is effective for the first year that begins after November 15, 2007. The Company adopted this guidance effective January 1, 2008 and did not elect the fair value option for any of its eligible assets or liabilities as of this date.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Pending Adoption of Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS 141(R)). This Statement replaces SFAS No. 141, *Business Combinations* (SFAS 141) and establishes the principles and requirements for how the acquirer in a business combination: (a) measures and recognizes the identifiable assets acquired, liabilities assumed, and any noncontrolling interests in the acquired entity, (b) measures and recognizes positive goodwill acquired or a gain from bargain purchase (negative goodwill), and (c) determines the disclosure information that is decision-useful to users of financial statements in evaluating the nature and financial effects of the business combination. SFAS 141(R) is effective for and shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period after December 15, 2008, with earlier adoption prohibited. Assets and liabilities that arose from business combinations with acquisition dates prior to the SFAS 141(R) effective date shall not be adjusted upon adoption of SFAS 141(R) with certain exceptions for acquired deferred tax assets and acquired income tax positions. The Company plans to adopt this guidance effective January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160). This Statement amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51). Noncontrolling interest refers to the minority interest portion of the equity of a subsidiary that is not attributable directly or indirectly to a parent. SFAS 160 establishes accounting and reporting standards that require for-profit entities that prepare consolidated financial statements to: (a) present noncontrolling interests as a component of equity, separate from the parent's equity, (b) separately present the amount of consolidated net income attributable to noncontrolling interests in the income statement, (c) consistently account for changes in a parent's ownership interests in a subsidiary in which the parent entity has a controlling financial interest as equity transactions, (d) require an entity to measure at fair value its remaining interest in a subsidiary that is deconsolidated, (e) require an entity to provide sufficient disclosures that identify and clearly distinguish between interests of the parent and interests of noncontrolling owners. SFAS 160 applies to all for-profit entities that prepare consolidated financial statements, and affects those for-profit entities that have outstanding noncontrolling interests in one or more subsidiaries or that deconsolidate a subsidiary. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 with earlier adoption prohibited. The Company does not expect the adoption of this Statement to have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161 *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). This Statement amends FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 applies to all entities that have derivatives within the scope of SFAS 133. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company plans to adopt this guidance effective January 1, 2009.

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