

State Auto Financial CORP
Form 10-Q
November 09, 2011
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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, 2011

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 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, 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 November 1, 2011, the Registrant had 40,274,009 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 2011 (unaudited)	December 31 2010 (see note 1)
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,936.1 and \$1,862.3, respectively)	\$ 2,041.1	1,900.7
Equity securities, available-for-sale, at fair value (cost \$173.5 and \$200.2, respectively)	182.4	256.2
Other invested assets, available-for-sale, at fair value (cost \$56.7 and \$64.4, respectively)	65.3	79.7
Other invested assets	0.5	0.5
Note receivable from affiliate	70.0	70.0
<i>Total investments</i>	2,359.3	2,307.1
Cash and cash equivalents	186.7	88.3
Accrued investment income and other assets	31.2	38.0
Deferred policy acquisition costs	172.3	150.2
Reinsurance recoverable on losses and loss expenses payable (affiliates none)	30.3	18.8
Prepaid reinsurance premiums (affiliates none)	8.2	7.6
Due from affiliate		6.5
Current federal income taxes	12.9	7.6
Net deferred federal income taxes	0.5	86.3
Property and equipment, at cost	10.4	11.6
Total assets	\$ 2,811.8	2,722.0
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliates \$570.4 and \$375.8, respectively)	\$ 1,140.8	893.0
Unearned premiums (affiliates \$310.5 and \$234.6, respectively)	693.9	613.2
Notes payable (affiliates \$15.5 and \$15.5, respectively)	116.5	116.8
Postretirement and pension benefits	185.5	186.9
Due to affiliate	20.4	
Other liabilities	53.5	60.3
Total liabilities	2,210.6	1,870.2
Stockholders' equity:		

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Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 47.0 and 46.9 shares issued, respectively, at stated value of \$2.50 per share	117.6	117.3
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(115.8)	(115.8)
Additional paid-in capital	125.7	122.1
Accumulated other comprehensive income (loss)	3.0	(7.9)
Retained earnings	470.7	736.1
<i>Total stockholders equity</i>	601.2	851.8
<i>Total liabilities and stockholders equity</i>	\$ 2,811.8	2,722.0

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)

(unaudited)	Three months ended September 30	
	2011	2010
Earned premiums (ceded to affiliates \$198.7 and \$205.7, respectively)	\$ 356.8	318.3
Net investment income (affiliate \$1.3 and \$1.3, respectively)	20.3	19.3
Net realized gain on investments:		
Total other-than-temporary impairment losses	(4.4)	(0.6)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains	14.6	3.4
Total net realized gain on investments	10.2	2.8
Other income (affiliates \$0.7 and \$0.3, respectively)	0.7	0.3
Total revenues	388.0	340.7
Losses and loss expenses (ceded to affiliates \$182.0 and \$146.3, respectively)	315.3	232.6
Acquisition and operating expenses	121.4	104.3
Interest expense (affiliates \$0.1 and \$0.2, respectively)	1.9	1.7
Other expenses	1.4	2.3
Total expenses	440.0	340.9
Loss before federal income taxes	(52.0)	(0.2)
Federal income tax expense (benefit)	6.7	(0.4)
Net (loss) income	\$ (58.7)	0.2
(Loss) income per common share:		
Basic	\$ (1.46)	0.01
Diluted	\$ (1.46)	0.00
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)

(unaudited)	Nine months ended September 30	
	2011	2010
Earned premiums (ceded to affiliates \$606.6 and \$612.0, respectively)	\$ 1,059.4	929.9
Net investment income (affiliate \$3.7 and \$3.7, respectively)	66.5	60.6
Net realized gain on investments:		
Total other-than-temporary impairment losses	(5.3)	(3.1)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains	30.2	9.4
Total net realized gain on investments	24.9	6.3
Other income (affiliates \$1.8 and \$1.2, respectively)	1.8	1.4
Total revenues	1,152.6	998.2
Losses and loss expenses (ceded to affiliates \$590.9 and \$439.9, respectively)	959.5	684.7
Acquisition and operating expenses	355.6	309.8
Interest expense (affiliates \$0.5 and \$0.5, respectively)	5.4	5.3
Other expenses	6.3	8.0
Total expenses	1,326.8	1,007.8
Loss before federal income taxes	(174.2)	(9.6)
Federal income tax expense	73.2	3.5
Net loss	\$ (247.4)	(13.1)
Loss per common share:		
Basic	\$ (6.15)	(0.33)
Diluted	\$ (6.15)	(0.33)
Dividends paid per common share	\$ 0.45	0.45

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

<i>(\$ millions)</i>	Nine months ended September 30	
(unaudited)	2011	2010
Cash flows from operating activities:		
Net loss	\$ (247.4)	(13.1)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization, net	2.9	6.5
Share-based compensation	2.2	2.9
Net realized gain on investments	(24.9)	(6.3)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(13.8)	(23.2)
Accrued investment income and other assets	(1.8)	0.7
Postretirement and pension benefits	2.8	5.7
Other liabilities and due to/from affiliates, net	13.0	0.1
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(12.0)	(0.6)
Losses and loss expenses payable	123.2	55.2
Unearned premiums	46.4	77.5
Excess tax benefits on share based awards		0.3
Federal income taxes	74.7	(12.0)
Cash provided from pooling change, January 1, 2011 and 2010 (Note 4)	69.1	3.7
<i>Net cash provided by operating activities</i>	34.4	97.4
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	(338.5)	(326.8)
Purchases of equity securities available-for-sale	(88.1)	(78.2)
Purchases of other invested assets	(0.8)	(20.6)
Maturities, calls and pay downs of fixed maturities available-for-sale	246.2	218.2
Sales of fixed maturities available-for-sale	101.7	70.2
Sales of equity securities available-for-sale	136.0	63.0
Sales of other invested assets	10.7	0.6
Sale of subsidiary	13.2	
<i>Net cash provided by (used in) investing activities</i>	80.4	(73.6)
Cash flows from financing activities:		
Proceeds from issuance of common stock	1.6	2.2
Payment of dividends	(18.0)	(18.0)
<i>Net cash used in financing activities</i>	(16.4)	(15.8)

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Net increase in cash and cash equivalents	98.4	8.0
Cash and cash equivalents at beginning of period	88.3	90.3
Cash and cash equivalents at end of period	\$ 186.7	98.3
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.5 and \$0.5, respectively)	\$ 3.7	3.7
Federal income taxes (received) paid	\$ (1.5)	15.2

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, Continued (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (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 by U.S. generally accepted accounting principles (GAAP) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The balance sheet at December 31, 2010 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP 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, 2010 (the 2010 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2010 Form 10-K.

Adoption of Accounting Pronouncements

Improving Disclosures about Fair Value Measurements

In January 2010, the Financial Accounting Standards Board (FASB) issued guidance to improve the disclosures related to fair value measurements. The guidance requires the information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements to be presented separately on a gross basis, rather than as one net number. The Company adopted this guidance effective January 1, 2011. The disclosures required by this guidance are provided in the accompanying Note 3.

Pending Adoption of Accounting Pronouncements

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. The new guidance is effective on a prospective basis for fiscal years beginning after December 15, 2011, with early adoption permitted. Retrospective application is also permitted, but not required. The Company is still assessing the impact the provisions of the new guidance will have on its consolidated financial statements.

Comprehensive Income

In June 2011, the FASB issued updated guidance to improve the presentation of comprehensive income. In this guidance an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Regardless of how an entity chooses to present comprehensive income, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The new guidance is effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. Retrospective application is required. The adoption of this new guidance is not expected to have a material impact on the consolidated

financial statements.

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS

In May 2011, the FASB issued amendments to its Fair Value Measurement Topic that is expected to result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards (IFRS). Consequently, the amendments in the guidance change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in the guidance to result in a change in the application of the requirements in the Fair Value Measurements Topic. The guidance also clarifies the FASB's intent about the application of existing fair value measurement requirements as well as changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The new guidance is effective on a prospective basis for fiscal years and interim

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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)

periods beginning after December 15, 2011. The adoption of this new guidance is not expected to have a material impact on the financial statements.

Testing Goodwill for Impairment

In September 2011, the FASB issued updated guidance in relation to testing goodwill for impairment. The amendments in the update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment. The more-likely-than-not threshold is defined as having a likelihood of a more than 50 percent. Previous guidance under Topic 350 (Intangibles - Goodwill and Other), required an entity to test goodwill for impairment on an annual basis. Under this updated guidance, the test for impairment should be performed on an annual basis unless an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. If the fair value of a reporting unit is less than its carrying amount, the second step of the test must be performed to measure the amount of the impairment loss, if any. However, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The new guidance is effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. The adoption of this new guidance is not expected to have a material impact on the Company's 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, Continued (Unaudited)

2. Investments

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at September 30, 2011 and December 31, 2010:

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
At September 30, 2011:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 478.6	30.1	(0.1)	508.6
Obligations of states and political subdivisions	812.0	44.9		856.9
Corporate securities	240.5	11.9	(0.6)	251.8
U.S. government agencies residential mortgage-backed securities	405.0	19.5	(0.7)	423.8
<i>Total fixed maturities</i>	1,936.1	106.4	(1.4)	2,041.1
Equity securities:				
Large-cap securities	138.6	14.2	(9.9)	142.9
Small-cap securities	34.9	4.6		39.5
<i>Total equity securities</i>	173.5	18.8	(9.9)	182.4
Other invested assets	56.7	8.6		65.3
<i>Total available-for-sale securities</i>	\$ 2,166.3	133.8	(11.3)	2,288.8

(\$ millions)

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
At December 31, 2010:				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 450.5	12.9	(2.3)	461.1
Obligations of states and political subdivisions	916.6	23.6	(6.6)	933.6
Corporate securities	136.3	6.2	(0.1)	142.4
U.S. government agencies residential mortgage-backed securities	358.9	8.4	(3.7)	363.6
<i>Total fixed maturities</i>	1,862.3	51.1	(12.7)	1,900.7
Equity securities:				
Large-cap securities	167.1	45.5	(1.5)	211.1

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Small-cap securities	33.1	12.0		45.1
<i>Total equity securities</i>	200.2	57.5	(1.5)	256.2
Other invested assets	64.4	15.3		79.7
<i>Total available-for-sale securities</i>	\$ 2,126.9	123.9	(14.2)	2,236.6

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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)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at September 30, 2011 and December 31, 2010:

(\$ millions, except # of positions)

	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
At September 30, 2011:									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$ 12.0	\$ (0.1)	4	\$	\$		\$ 12.0	\$ (0.1)	4
Obligations of states and political subdivisions	5.5		3				5.5		3
Corporate securities	50.4	(0.6)	14				50.4	(0.6)	14
U.S. government agencies residential mortgage-backed securities	34.5	(0.2)	10	15.3	(0.5)	7	49.8	(0.7)	17
<i>Total fixed maturities</i>	102.4	(0.9)	31	15.3	(0.5)	7	117.7	(1.4)	38
Large-cap equity securities:	51.6	(9.3)	22	5.9	(0.6)	2	57.5	(9.9)	24
Other invested assets:	4.4		1				4.4		1
<i>Total temporarily impaired securities</i>	\$ 158.4	\$ (10.2)	54	\$ 21.2	\$ (1.1)	9	\$ 179.6	\$ (11.3)	63

(\$ millions, except # of positions)

	Less than 12 months			12 months or more			Total
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Number