National Interstate CORP
Form 10-Q
August 05, 2011

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**Form 10-Q**

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended June 30, 2011**

**OR**

o **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** | **34-1607394** |
| *(State or other jurisdiction of incorporation or organization)* | *(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. þ Yes o 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). þ Yes o 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. (Check One):

| | | | |
|---|---|---|---|
| Large Accelerated Filer o | Accelerated Filer þ | Non-Accelerated Filer o (Do not check if a smaller reporting company) | Smaller Reporting Company o |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). oYes þ No
The number of shares outstanding of the registrant s sole class of common shares as of August 3, 2011 was 19,442,191.

**National Interstate Corporation**
**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, 2011 (Unaudited) | December 31, 2010 |
|---|---|---|
| **ASSETS** | | |
| Investments: | | |
| Fixed maturities available-for-sale, at fair value (amortized cost $897,887 and $901,209, respectively) | $ 914,698 | $ 907,575 |
| Equity securities available-for-sale, at fair value (amortized cost $20,351 and $13,424, respectively) | 22,829 | 16,675 |
| Other investments | 27,362 | 13,833 |
| Short-term investments, at cost which approximates fair value | 68 | 67 |
| Total investments | 964,957 | 938,150 |
| Cash and cash equivalents | 39,427 | 27,054 |
| Accrued investment income | 9,330 | 8,650 |
| Premiums receivable, net of allowance for doubtful accounts of $1,785 and $1,435, respectively | 202,929 | 162,906 |
| Reinsurance recoverable on paid and unpaid losses | 201,351 | 208,590 |
| Prepaid reinsurance premiums | 39,996 | 35,065 |
| Deferred policy acquisition costs | 30,453 | 23,488 |
| Deferred federal income taxes | 24,452 | 27,333 |
| Property and equipment, net | 23,827 | 24,469 |
| Funds held by reinsurer | 3,847 | 3,788 |
| Intangible assets, net | 8,816 | 8,972 |
| Amounts refundable on estimated purchase price of Vanliner | | 14,256 |
| Prepaid expenses and other assets | 3,405 | 5,884 |
| Total assets | $ 1,552,790 | $ 1,488,605 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses | $ 795,396 | $ 798,645 |
| Unearned premiums and service fees | 259,257 | 221,903 |
| Long-term debt | 22,000 | 20,000 |
| Amounts withheld or retained for accounts of others | 60,561 | 58,691 |
| Reinsurance balances payable | 28,135 | 16,180 |
| Accounts payable and other liabilities | 40,040 | 49,605 |
| Commissions payable | 11,914 | 9,295 |
| Assessments and fees payable | 5,046 | 4,708 |
| Total liabilities | 1,222,349 | 1,179,027 |

| | | |
|---|---|---|
| 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 3,982 and 3,993 shares, respectively, in treasury | 234 | 234 |
| Additional paid-in capital | 50,604 | 50,273 |
| Retained earnings | 272,702 | 258,473 |
| Accumulated other comprehensive income | 12,538 | 6,251 |
| Treasury shares | (5,637) | (5,653) |
| Total shareholders equity | 330,441 | 309,578 |
| Total liabilities and shareholders equity | $ 1,552,790 | $ 1,488,605 |

See notes to consolidated financial statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2011** | **2010** | **2011** | **2010** |
| **Revenues:** | | | | |
| Premiums earned | $ 106,464 | $ 69,233 | $ 211,603 | $ 139,414 |
| Net investment income | 7,796 | 5,012 | 14,698 | 9,971 |
| Net realized gains on investments (*) | 1,316 | 1,669 | 2,516 | 2,551 |
| Other | 854 | 976 | 1,970 | 1,794 |
| Total revenues | 116,430 | 76,890 | 230,787 | 153,730 |
| **Expenses:** | | | | |
| Losses and loss adjustment expenses | 78,570 | 46,032 | 153,229 | 89,136 |
| Commissions and other underwriting expenses | 21,196 | 14,735 | 41,521 | 29,571 |
| Other operating and general expenses | 4,095 | 3,996 | 8,636 | 7,622 |
| Expense on amounts withheld | 979 | 926 | 1,819 | 1,735 |
| Interest expense | 55 | 92 | 109 | 104 |
| Total expenses | 104,895 | 65,781 | 205,314 | 128,168 |
| Income before income taxes | 11,535 | 11,109 | 25,473 | 25,562 |
| Provision for income taxes | 3,332 | 3,491 | 7,742 | 7,358 |
| Net income | $ 8,203 | $ 7,618 | $ 17,731 | $ 18,204 |
| Net income per share basic | $ 0.42 | $ 0.39 | $ 0.92 | $ 0.94 |
| Net income per share diluted | $ 0.42 | $ 0.39 | $ 0.91 | $ 0.94 |
| Weighted average of common shares outstanding basic | 19,368 | 19,343 | 19,367 | 19,336 |
| Weighted average of common shares outstanding diluted | 19,482 | 19,456 | 19,479 | 19,424 |
| Cash dividends per common share | $ 0.09 | $ 0.08 | $ 0.18 | $ 0.16 |

(*) Consists of the following:
Consolidated Statements of Income

| | | | | |
|---|---|---|---|---|
| Net realized gains before impairment losses | $ 1,316 | $ 1,770 | $ 2,516 | $ 2,652 |

| | | | | |
|---|---|---|---|---|
| Total losses on securities with impairment charges | | | | |
| Non-credit portion in other comprehensive income | | (101) | | (101) |
| Net impairment charges recognized in earnings | | (101) | | (101) |
| Net realized gains on investments | $ 1,316 | $ 1,669 | $ 2,516 | $ 2,551 |

See notes to consolidated financial statements.

**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 (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| Balance at January 1, 2011 | $ 234 | $ 50,273 | $ 258,473 | $ 6,251 | $ (5,653) | $ 309,578 |
| Net income | | | 17,731 | | | 17,731 |
| Unrealized appreciation of investment securities, net of tax of $3.4 million | | | | 6,287 | | 6,287 |
| Comprehensive income | | | | | | 24,018 |
| Dividends on common stock | | | (3,502) | | | (3,502) |
| Issuance of 11,502 treasury shares upon exercise of options and restricted stock issued, net of forfeitures | | (136) | | | 16 | (120) |
| Net tax effect from exercise/vesting of stock-based compensation | | 54 | | | | 54 |
| Stock compensation expense | | 413 | | | | 413 |
| Balance at June 30, 2011 | $ 234 | $ 50,604 | $ 272,702 | $ 12,538 | $ (5,637) | $ 330,441 |
| Balance at January 1, 2010 | $ 234 | $ 49,264 | $ 225,195 | $ 2,353 | $ (5,729) | $ 271,317 |
| Net income | | | 18,204 | | | 18,204 |
| Unrealized appreciation of investment securities, net of tax of $2.4 million | | | | 4,375 | | 4,375 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Comprehensive income | | | | | | 22,579 |
| Dividends on common stock | | | (3,115) | | | (3,115) |
| Issuance of 41,579 treasury shares upon exercise of options, stock award grants and restricted stock issued, net of forfeitures | | 387 | | | 57 | 444 |
| Net tax effect from exercise/vesting of stock-based compensation | | (50) | | | | (50) |
| Stock compensation expense | | 485 | | | | 485 |
| Balance at June 30, 2010 | $ 234 | $ 50,086 | $ 240,284 | $ 6,728 | $ (5,672) | $ 291,660 |

See notes to consolidated financial statements.

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

| | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|---|
| **Operating activities** | | |
| Net income | $ 17,731 | $ 18,204 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of bond premiums and discounts | 4,999 | 1,368 |
| Provision for depreciation and amortization | 1,806 | 1,112 |
| Net realized gains on investment securities | (2,516) | (2,551) |
| Deferred federal income taxes | (504) | (1,522) |
| Stock compensation expense | 413 | 485 |
| Increase in deferred policy acquisition costs, net | (6,965) | (4,669) |
| (Decrease) increase in reserves for losses and loss adjustment expenses | (3,249) | 5,858 |
| Increase in premiums receivable | (40,023) | (41,315) |
| Increase in unearned premiums and service fees | 37,354 | 42,413 |
| Decrease in interest receivable and other assets | 1,740 | 981 |
| Increase in prepaid reinsurance premiums | (4,931) | (14,325) |
| (Decrease) increase in accounts payable, commissions and other liabilities and assessments and fees payable | (6,608) | 6,005 |
| Increase in amounts withheld or retained for accounts of others | 1,870 | 647 |
| Decrease in reinsurance recoverable | 7,239 | 4,919 |
| Increase in reinsurance balances payable | 11,955 | 11,786 |
| Other | (69) | (58) |
| Net cash provided by operating activities | 20,242 | 29,338 |
| **Investing activities** | | |
| Purchases of fixed maturities | (158,400) | (191,247) |
| Purchases of equity securities | (10,814) | |
| Proceeds from sale of fixed maturities | 10,022 | 70,911 |
| Proceeds from sale of equity securities | 5,164 | 156 |
| Proceeds from maturities and redemptions of investments | 147,410 | 216,940 |
| Change in other investments, net | (13,000) | |
| Collection of amounts refundable on purchase price of Vanliner | 14,256 | |
| Deposit in advance of acquisition | | (128,059) |
| Capital expenditures | (939) | (1,131) |
| Net cash used in investing activities | (6,301) | (32,430) |
| **Financing activities** | | |
| Excess tax benefit realized from vesting of restricted stock | 54 | |
| Additional long-term borrowings | 2,000 | 30,000 |
| | (120) | 444 |

| | | |
|---|---|---|
| Issuance of common shares from treasury upon exercise of stock options or stock award grants | | |
| Cash dividends paid on common shares | (3,502) | (3,115) |
| Net cash (used in) provided by financing activities | (1,568) | 27,329 |
| Net increase in cash and cash equivalents | 12,373 | 24,237 |
| Cash and cash equivalents at beginning of period | 27,054 | 18,589 |
| Cash and cash equivalents at end of period | $ 39,427 | $ 42,826 |

See notes to consolidated financial statements.

**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 unaudited 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 ), Triumphe Casualty Company ( TCC ), National Interstate Insurance Agency, Inc. ( NIIA ), Hudson Management Group, Ltd. ( HMG ), Vanliner Group Inc. ( Vanliner ), Vanliner Insurance Company ( VIC ), Vanliner Reinsurance Company ( VRC ), American Highways Insurance Agency, Inc., Safety, Claims and Litigation Services, Inc., Explorer RV Insurance Agency, Inc., Safety, Claims and Litigation Services, LLC and TransProtection Service Company. 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, 2010. 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 and six month periods ended June 30, 2011 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2011.

The unaudited consolidated financial statements include the results of operations and cash flows of Vanliner and its subsidiaries for the three and six months ended June 30, 2011, as Vanliner was acquired on July 1, 2010. As such, Vanliner and its subsidiaries are not included in the results of operations and cash flows for the three and six months ended June 30, 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. Certain reclassifications have been made to financial information presented for prior years to conform to the current year s presentation.

**2. Recent Accounting Pronouncements**

In October 2010, the FASB issued Accounting Standards Update No. 2010-26, *Financial Services - Insurance* ( ASU 2010-26 ). ASU 2010-26 amends ASC 944, *Financial Services Insurance*, limiting the capitalization of costs incurred in the acquisition of new and renewal contracts to incremental direct costs of contract acquisition and certain costs related directly to certain acquisition activities performed by the insurer of the contract. ASU 2010-26 is effective for interim and annual reporting periods beginning after December 15, 2011, with retrospective application permitted, but not required. The Company will adopt ASU 2010-26 on January 1, 2012. This guidance will result in fewer acquisition costs being capitalized by the Company. Management is still in the process of evaluating the impact such adoption will have on financial condition, results of operations and liquidity.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* ( ASU 2011-05 ). ASU 2011-05 eliminates the option to report other comprehensive income and its components in the statement of shareholders equity. ASU 2011-05 requires that all non-owner changes in shareholders equity be presented in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 is effective for interim and annual reporting periods beginning after December 15, 2011. The Company will adopt ASU 2011-05 on January 1, 2012. The updated guidance only requires a change in the format of information already disclosed; the adoption will not impact our cash flows, financial condition, or net income.

**3. Fair Value Measurements**

The Company must determine the appropriate level in the fair value hierarchy for each applicable fair value 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, 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 that are not actively traded. Included in Level 2 are $6.0 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, for which the Company believes reflects fair value, but for which 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. 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 June 30, 2011:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | | (Dollars in thousands) | | |
| **Fixed maturities:** | | | | |
| U.S. Government and government agency obligations | $ | $ 130,943 | $ | $ 130,943 |
| Foreign government obligations | | 5,713 | | 5,713 |
| State and local government obligations | | 287,152 | 4,301 | 291,453 |
| Residential mortgage-backed securities | | 198,911 | | 198,911 |
| Commercial mortgage-backed securities | | 7,724 | | 7,724 |
| Corporate obligations | | 267,510 | 2,216 | 269,726 |
| Redeemable preferred stocks | 9,638 | 143 | 447 | 10,228 |

| | | | | |
|---|---|---|---|---|
| Total fixed maturities | 9,638 | 898,096 | 6,964 | 914,698 |
| **Equity securities:** | | | | |
| Common stocks | 21,195 | 16 | | 21,211 |
| Perpetual preferred stocks | 325 | 897 | 396 | 1,618 |
| Total equity securities | 21,520 | 913 | 396 | 22,829 |
| Short-term investments | | 68 | | 68 |
| Total investments | 31,158 | 899,077 | 7,360 | 937,595 |
| Cash and cash equivalents | 39,427 | | | 39,427 |
| Total investments and cash and cash equivalents at fair value | $ 70,585 | $ 899,077 | $ 7,360 | $ 977,022 |

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, 2010:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| **Fixed maturities:** | | | | |