MERCURY GENERAL CORP
Form 10-Q
July 31, 2018
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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 Quarter Ended June 30, 2018
Commission File No. 001-12257

MERCURY GENERAL CORPORATION
(Exact name of registrant as specified in its charter)

California	95-2211612
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4484 Wilshire Boulevard, Los Angeles, California	90010
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (323) 937-1060

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 ý No o

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 ý No o

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

Large accelerated filer	ý	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o
Emerging growth company	o		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

At July 26, 2018, the Registrant had issued and outstanding an aggregate of 55,332,077 shares of its Common Stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost $2,925,678; $2,823,230)	$2,949,236	$ 2,892,777
Equity securities (cost $554,647; $474,197)	614,336	537,240
Short-term investments (cost $270,914; $302,693)	270,584	302,711
Total investments	3,834,156	3,732,728
Cash	243,751	291,413
Receivables:		
Premium	527,280	474,060
Accrued investment income	45,657	39,368
Other	6,152	6,658
Total receivables	579,089	520,086
Reinsurance recoverables	47,837	56,349
Deferred policy acquisition costs	209,275	198,151
Fixed assets (net of accumulated depreciation $350,007; $340,523)	148,214	145,223
Current income taxes	51,855	61,257
Goodwill	42,796	42,796
Other intangible assets, net	18,256	20,728
Other assets	29,242	32,592
Total assets	$5,204,471	$ 5,101,323
LIABILITIES AND SHAREHOLDERS' EQUITY		
Loss and loss adjustment expense reserves	$1,549,850	$ 1,510,613
Unearned premiums	1,190,766	1,101,927
Notes payable	371,535	371,335
Accounts payable and accrued expenses	133,293	108,252
Deferred income taxes	8,807	22,932
Other liabilities	240,362	224,877
Total liabilities	3,494,613	3,339,936
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value: Authorized 70,000 shares; issued and outstanding 55,332; 55,332	97,586	97,523
Retained earnings	1,612,272	1,663,864
Total shareholders' equity	1,709,858	1,761,387
Total liabilities and shareholders' equity	$5,204,471	$ 5,101,323

See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues:				
Net premiums earned	$833,959	$797,666	$1,642,043	$1,587,436
Net investment income	34,786	31,901	66,296	63,070
Net realized investment gains (losses)	14,290	21,156	(44,445)	45,616
Other	2,356	2,124	4,681	4,229
Total revenues	885,391	852,847	1,668,575	1,700,351
Expenses:				
Losses and loss adjustment expenses	605,547	588,595	1,237,781	1,195,260
Policy acquisition costs	141,520	137,839	282,504	280,438
Other operating expenses	60,822	53,432	126,221	118,620
Interest	4,256	4,229	8,522	6,682
Total expenses	812,145	784,095	1,655,028	1,601,000
Income before income taxes	73,246	68,752	13,547	99,351
Income tax expense (benefit)	13,066	17,119	(4,026)	20,738
Net income	$60,180	$51,633	$17,573	$78,613
Net income per share:				
Basic	$1.09	$0.93	$0.32	$1.42
Diluted	$1.09	$0.93	$0.32	$1.42
Weighted average shares outstanding:				
Basic	55,332	55,311	55,332	55,304
Diluted	55,335	55,323	55,335	55,318
Dividends paid per share	$0.6250	$0.6225	$1.2500	$1.2450

See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$17,573	$78,613
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	28,572	27,525
Net realized investment losses (gains)	44,445	(45,616)
Increase in premiums receivable	(53,220)	(9,929)
Decrease in reinsurance recoverables	8,512	1,419
Changes in current and deferred income taxes	(4,723)	13,674
(Increase) decrease in deferred policy acquisition costs	(11,124)	1,756
Increase in loss and loss adjustment expense reserves	39,237	36,715
Increase in unearned premiums	88,839	19,157
Increase in accounts payable and accrued expenses	25,546	9,068
Share-based compensation	64	56
Other, net	354	42,307
Net cash provided by operating activities	184,075	174,745
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturity securities available for sale in nature:		
Purchases	(393,898)	(440,294)
Sales	118,477	65,211
Calls or maturities	155,614	258,782
Equity securities available for sale in nature:		
Purchases	(497,459)	(368,896)
Sales	417,663	303,574
Calls	—	7,100
Changes in securities payable and receivable	12,263	(29,674)
Change in short-term investments and purchased options	31,789	96,406
Purchase of fixed assets	(13,148)	(10,557)
Other, net	6,127	1,387
Net cash used in investing activities	(162,572)	(116,961)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(69,165)	(68,859)
Proceeds from stock options exercised	—	1,171
Net proceeds from issuance of senior notes	—	371,011
Payoff of principal on loan and credit facilities	—	(320,000)
Net cash used in financing activities	(69,165)	(16,677)
Net (decrease) increase in cash	(47,662)	41,107
Cash:		
Beginning of the year	291,413	220,318
End of period	$243,751	$261,425
SUPPLEMENTAL CASH FLOW DISCLOSURE		

Interest paid	$8,250	$1,292
Income taxes paid, net	$697	$7,063

See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General

Consolidation and Basis of Presentation

The interim consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the "Company"). For the list of the Company's subsidiaries, see Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These interim financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP"), which differ in some respects from those filed in reports to insurance regulatory authorities. The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company's financial position at June 30, 2018 and the results of operations and cash flows for the periods presented. All intercompany transactions and balances have been eliminated.

Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, but that is not required for interim reporting purposes, has been omitted from the accompanying interim consolidated financial statements and related notes. Readers are urged to review the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for more complete descriptions and discussions. Operating results and cash flows for the six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about the effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates. See Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Earnings per Share

Potentially dilutive securities representing approximately 85,000 and 71,000 shares of common stock were excluded from the computation of diluted earnings per common share for the three and six months ended June 30, 2018, respectively, because their effect would have been anti-dilutive. There were no potentially dilutive securities with anti-dilutive effect for the three and six months ended June 30, 2017.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company’s deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was $141.5 million and $137.8 million for the three months ended June 30, 2018 and 2017, respectively, and $282.5 million and $280.4 million for the six months ended June 30, 2018 and 2017, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expense of approximately $23 million and $20 million for the six months ended June 30, 2018 and 2017, respectively.

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Revenue from Contracts with Customers

On January 1, 2018, the Company adopted Topic 606, Revenue from Contracts with Customers, using the modified retrospective transition method. The Company had no cumulative-effect adjustment and its consolidated financial statement line items were not impacted as a result of the adoption, mostly because the accounting for insurance contracts was outside of the scope of Topic 606 and the application of the key aspects of revenue recognition of Topic 606 to the Company's in-scope transactions, such as the timing of recognition of revenue (at a point in time vs. over time) and the estimation of refund liability, resulted in recognition of revenues and related expenses consistent with that under the legacy accounting guide, Topic 605.

The Company's total revenue from contracts with customers that are in scope of Topic 606 amounted to approximately $15.2 million with related expenses of $10.2 million for the year ended December 31, 2017. This revenue represents the commission income that the Company's 100% owned insurance agencies, Auto Insurance Specialists LLC ("AIS") and PoliSeek AIS Insurance Solutions, Inc. ("Poliseek"), earned from third-party insurers, and accounted for approximately 0.4% of the total consolidated revenue in 2017. The Company's commission income from third-party insurers was approximately $8.3 million and $7.7 million representing approximately 0.5% and 0.5% of the consolidated total revenue, with related expenses of $5.4 million and $5.3 million, for the six months ended June 30, 2018 and 2017, respectively. Due to the immateriality of the Company's commission income and its related expenses to the overall consolidated financial statements, the commission income, net of related expenses, is included in other revenues in the Company's consolidated statements of operations, and in other income of the Property and Casualty business segment in the Company's segment reporting in accordance with Topic 280, Segment Reporting (see Note 13. Segment Information).

AIS and PoliSeek are primarily engaged in the marketing and sales of insurance policies in private passenger automobile, commercial automobile and homeowners lines of business. Their revenues primarily consist of commission income received from property and casualty insurers. Approximately 80% of their total revenue is generated from sales of policies issued by the Company's insurance subsidiaries, which are eliminated as intercompany transactions in consolidation, with the remaining from sales of policies issued by third-party property and casualty insurers. The primary performance obligation of AIS and Poliseek in return for the commission income from the insurers is to complete the sale of the policy and deliver the control of the policy to the insurer prior to the policy effective date. In addition, AIS and PoliSeek provide administrative services to the insurer or the policyholder subsequent to the sale of the policy as needed, including processing of endorsements, collection of premiums, and answering general questions concerning the policyholder's account. The administrative services and the costs to perform such services are deemed immaterial in the context of the contract and to the Company's consolidated financial statements, and hence, such services are not identified as a separate performance obligation and the costs to perform such services are not accrued at the time of the sale of the policy but are expensed as incurred as part of the overall operating expenses.

The total revenue from the sale of a policy is recognized when the sale is complete and the policy is effective as all the material aspects of the performance obligation are satisfied and the insurer is deemed to obtain control of the insurance policy at that time. The commission income is constrained such that the revenue is recognized only to the extent that the commission income received is not likely to be returned to the insurers due to policy cancellations. Any commission income not received when the sale is complete is recognized as commission income receivable, which is included in other receivables in the Company's consolidated balance sheets. The commission income receivable at June 30, 2018 and December 31, 2017 was $1.1 million and $1.2 million, respectively.

A refund liability is recorded for the expected amount of the commission income that has to be returned to the insurers based on estimated policy cancellations. The refund liability is computed for the entire portfolio of contracts as a practical expedient, rather than for each contract or performance obligation. The estimated policy cancellations and the resulting refund liability are computed using the expected value method based on all relevant information, including historical data. The refund liability at June 30, 2018 and December 31, 2017 was $0.7 million, which was included in other liabilities in the Company's consolidated balance sheets.

As of June 30, 2018 and December 31, 2017, the Company had no contract assets, contract liabilities, or capitalized costs to obtain or fulfill a contract, associated with revenues from contracts with customers.

2. Recently Issued Accounting Standards

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment." ASU 2017-04 removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of Step 2 of the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary.

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ASU 2017-04 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company does not anticipate that ASU 2017-04 will have a material impact on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of occurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. ASU 2016-13 will be effective for the Company beginning January 1, 2020. While the Company is in the process of evaluating the impact of ASU 2016-13, it does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures as most of its financial instruments with potential exposure to material credit losses are accounted for at fair value through net income.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases." ASU 2016-02 requires a lessee to recognize lease assets and lease liabilities resulting from all leases. ASU 2016-02 retains the distinction between a finance lease and an operating lease. Lessor accounting is largely unchanged from ASC 840. ASU 2016-02 will be effective for the Company beginning January 1, 2019. While the Company is in the process of evaluating the impact of ASU 2016-02, it does not expect this ASU to have a material impact on its consolidated financial statements, except for recognizing right-of-use assets and lease liabilities for its operating leases and adding additional required disclosures. The Company's lease obligations under various non-cancellable operating lease agreements amounted to approximately $31.9 million at December 31, 2017.

3. Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, options sold, total return swap, accounts payable, and unsecured notes payable. Due to their short-term maturities, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried at fair value in the consolidated balance sheets.

The following table presents the fair values of financial instruments:

	June 30, 2018	December 31, 2017
	(Amounts in thousands)	
Assets		
Investments	$3,834,156	$ 3,732,728
Note receivable	5,516	5,565
Liabilities		
Total return swap	$1,393	$ 1,200
Options sold	780	123
Unsecured notes	364,736	385,583

Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment gains (losses) in the Company's consolidated statements of operations. See Note 4. Fair Value Option for additional information.

In the normal course of investing activities, the Company either forms or enters into relationships with variable interest entities ("VIEs"). A VIE is an entity that either has investors that lack certain essential characteristics of a controlling financial interest, such as simple majority kick-out rights, or lacks sufficient funds to finance its own activities without financial support provided by other entities. The Company performs ongoing qualitative assessments of the VIEs to determine whether the Company has a controlling financial interest in the VIE and therefore is the primary beneficiary. The Company is deemed to have a controlling financial interest when it has both the ability to direct the activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant to the

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VIE. Based on the Company's assessment, if it determines it is the primary beneficiary, the Company consolidates the VIE in its consolidated financial statements.

The Company forms special purpose investment vehicles to facilitate its investment activities involving derivative instruments such as total return swaps, or limited partnerships such as private equity funds. These special purpose investment vehicles are consolidated VIEs as the Company has determined it is the primary beneficiary of such VIEs. Creditors have no recourse against the Company in the event of default by these VIEs. The Company had no implied or unfunded commitments to these VIEs at June 30, 2018 and December 31, 2017. The Company's financial or other support provided to these VIEs and its loss exposure are limited to its collateral and original investment.

The Company also invests directly in limited partnerships such as private equity funds. These investments are non-consolidated VIEs as the Company has determined it is not the primary beneficiary. The Company's maximum exposure to loss is limited to the total carrying value that is included in equity securities in the Company's consolidated balance sheets. At June 30, 2018 and December 31, 2017, the Company had no outstanding unfunded commitments to these VIEs whereby the Company may be called by the partnerships during the commitment period to fund the purchase of new investments and the expenses of the partnerships.

Note Receivable

In August 2017, the Company completed the sale of approximately six acres of land located in Brea, California (the "Property"), for a total sale price of approximately \$12.2 million. Approximately \$5.7 million of the total sale price was received in the form of a promissory note (the "Note") and the remainder in cash. The Note is secured by a first trust deed and an assignment of rents on the Property, and bears interest at an annual rate of 3.5%, payable in monthly installments. The Note matures in August 2020. The Company elected to apply the fair value option to this security at the time it was first recognized. The fair value of note receivable is included in other assets in the Company's consolidated balance sheets, while the changes in fair value of note receivable are included in net realized investment gains or losses in the Company's consolidated statements of operations.

Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company as realized gains from investments on the expiration date. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options are included in other liabilities in the Company's consolidated balance sheets.

Total Return Swap

The fair value of the total return swap reflects the estimated amount that, upon termination of the contract, would be received for selling an asset or paid to transfer a liability in an orderly transaction.

Unsecured Notes

The fair value of the Company’s publicly traded \$375 million unsecured notes at June 30, 2018 and December 31, 2017 was obtained from a third party pricing service.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 5. Fair Value Measurements.

4. Fair Value Option

The Company applies the fair value option to all fixed maturity and equity investment securities and short-term investments at the time an eligible item is first recognized. In addition, the Company elected to apply the fair value option to the note receivable recognized as part of the sale of land in August 2017. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

Gains or losses due to changes in fair value of financial instruments measured at fair value pursuant to application of the fair value option are included in net realized investment gains or losses in the Company’s consolidated statements of operations.

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Interest and dividend income on investment holdings are recognized on an accrual basis at each measurement date and are included in net investment income in the Company's consolidated statements of operations, while interest earned on the note receivable is included in other revenues in the Company's consolidated statements of operations.

The following table presents gains (losses) due to changes in fair value of investments and the note receivable that are measured at fair value pursuant to the application of the fair value option:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(Amounts in thousands)			
Fixed maturity securities	$224	$25,622	$(45,988)	$35,909
Equity securities	8,533	(5,080)	(3,354)	6,462
Short-term investments	44	(267)	(347)	(240)
Total investments	$8,801	$20,275	$(49,689)	$42,131
Note receivable	(8)	—	(49)	—
Total gains (losses)	$8,793	$20,275	$(49,738)	$42,131

5. Fair Value Measurements

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price. Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair values and the level of market price observability, as follows:

Level 1	Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.
Level 2	Pricing inputs are other than quoted prices in active markets, which are based on the following: • Quoted prices for similar assets or liabilities in active markets; • Quoted prices for identical or similar assets or liabilities in non-active markets; or • Either directly or indirectly observable inputs as of the reporting date.
Level 3	Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company’s fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 98.1% of its investment portfolio from an independent pricing service. For a private equity fund that was classified as Level 3 and included in equity securities at June 30, 2018 and December 31, 2017, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value. The fair value of the private equity fund was $1.5 million at June 30, 2018 and December 31, 2017.

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Level 1 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.
U.S. government bonds /Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.
Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.
Money market instruments: Valued based on unadjusted quoted prices for identical assets in active markets.
Options sold: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on unadjusted quoted prices for identical instruments in active markets.
Level 2 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.
Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.
Mortgage-backed securities: Comprised of securities that are collateralized by residential and commercial mortgage loans valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of $25.3 million and $19.3 million in commercial mortgage-backed securities at June 30, 2018 and December 31, 2017, respectively.
Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.
Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.
Total return swap: Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.
Collateralized loan obligations ("CLOs"): Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.
Other asset-backed securities: Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.
Note receivable: Valued based on observable inputs, such as benchmark yields, and considering any premium or discount for the differential between the stated interest rate and market interest rates, based on quoted market prices of similar instruments.
Level 3 measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.
Private equity fund: Private equity fund, excluding a private equity fund measured at net asset value ("NAV"), is valued based on underlying investments of the fund or assets similar to such investments in active markets, taking into consideration specific unadjusted broker quotes based on net fund value and unobservable inputs from at least one knowledgeable outside security broker related to liquidity assumptions.
Fair value measurement using NAV practical expedient - The fair value of the Company's investment in private equity fund measured at net asset value is determined using NAV as advised by the external fund manager and the third party administrator. The NAV of the Company's limited partnership interest in this fund is based on the manager's and the

administrator's valuation of the underlying holdings in accordance with the fund's governing documents and GAAP. In accordance with applicable accounting guidance, this investment, measured at fair value using the NAV practical expedient, is not classified in the fair value hierarchy. The strategy of the fund is to provide current income to investors by investing mainly in equity tranches and sub-investment grade rated debt tranches of CLO issuers in the new and secondary markets, and equity interests in vehicles established to purchase and

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warehouse loans in anticipation of a CLO closing or to satisfy regulatory risk retention requirements associated with certain CLOs. The Company has made all of its capital contributions in the fund and had no outstanding unfunded commitments at June 30, 2018 with respect to this fund. The underlying assets of the fund are expected to be liquidated over the period of approximately one to five years from June 30, 2018. The Company does not have the contractual option to redeem but will receive distributions based on the liquidation of the underlying assets and the interest proceeds from the underlying assets. In addition, the Company does not have the ability to withdraw from the fund, or to sell, assign, pledge or transfer its investment, without the consent from the general partner of the fund.
The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains or losses in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

	June 30, 2018			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds	$13,333	$—	$—	$13,333
Municipal securities	—	2,616,770	—	2,616,770
Mortgage-backed securities	—	32,214	—	32,214
Corporate securities	—	116,401	—	116,401
Collateralized loan obligations	—	135,453	—	135,453
Other asset-backed securities	—	35,065	—	35,065
Total fixed maturity securities	13,333	2,935,903	—	2,949,236
Equity securities:				
Common stock	507,504	—	—	507,504
Non-redeemable preferred stock	—	34,343	—	34,343
Private equity fund	—	—	1,450	1,450
Private equity fund measured at net asset value (1)				71,039
Total equity securities	507,504	34,343	1,450	614,336
Short-term investments:				
Short-term bonds	29,952	22,714	—	52,666
Money market instruments	217,918	—	—	217,918
Total short-term investments	247,870	22,714	—	270,584
Other assets:				
Note receivable	—	5,516	—	5,516
Total assets at fair value	$768,707	$2,998,476	$1,450	$3,839,672
Liabilities				
Other liabilities:				
Total return swap	$—	$1,393	$—	$1,393
Options sold	780	—	—	780
Total liabilities at fair value	$780	$1,393	$—	$2,173

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	December 31, 2017			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds	$13,236	$—	$—	$13,236
Municipal securities	—	2,556,532	—	2,556,532
Mortgage-backed securities	—	27,165	—	27,165
Corporate securities	—	137,542	—	137,542
Collateralized loan obligations	—	105,202	—	105,202
Other asset-backed securities	—	53,100	—	53,100
Total fixed maturity securities	13,236	2,879,541	—	2,892,777
Equity securities:				
Common stock	429,367	—	—	429,367
Non-redeemable preferred stock	—	34,869	—	34,869
Private equity fund	—	—	1,481	1,481
Private equity fund measured at net asset value [(1)]				71,523
Total equity securities	429,367	34,869	1,481	537,240
Short-term investments:				
Short-term bonds	29,998	2,020	—	32,018
Money market instruments	270,693	—	—	270,693
Total short-term investments	300,691	2,020	—	302,711
Other assets:				
Note receivable	—	5,565	—	5,565
Total assets at fair value	$743,294	$2,921,995	$1,481	$3,738,293
Liabilities				
Other liabilities:				
Total return swap	$—	$1,200	$—	$1,200
Options sold	123	—	—	123
Total liabilities at fair value	$123	$1,200	$—	$1,323

(1) The fair value is measured using the NAV practical expedient; therefore, it is not categorized within the fair value hierarchy. The fair value amount is presented in this table to permit reconciliation of the fair value hierarchy to the amounts presented in the Company's consolidated balance sheets.

The following table presents a summary of changes in fair value of Level 3 financial assets and financial liabilities:

	Private Equity Funds			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(Amounts in thousands)			
Beginning balance	$1,450	$9,018	$1,481	$9,068
Realized losses included in earnings	—	(254)	(31)	(304)
Ending balance	$1,450	$8,764	$1,450	$8,764
The amount of total losses for the period included in earnings attributable to assets still held at June 30	$—	$(254)	$(31)	$(304)

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the six months ended June 30, 2018 and 2017.
At June 30, 2018, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

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Financial Instruments Disclosed, But Not Carried, at Fair Value

The following tables present the carrying value and fair value of the Company's financial instruments disclosed, but not carried, at fair value, and the level within the fair value hierarchy at which such instruments are categorized:

	June 30, 2018				
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(Amounts in thousands)				
Liabilities					
Notes payable:					
Unsecured notes	$371,535	$364,736	$ —	$364,736	$ —

	December 31, 2017				
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(Amounts in thousands)				
Liabilities					
Notes payable:					
Unsecured notes	$371,335	$385,583	$ —	$385,583	$ —

Unsecured Notes

The fair value of the Company's publicly traded $375 million unsecured notes at June 30, 2018 and December 31, 2017 was based on the spreads above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and broker-dealer quotes.

See Note 11. Notes Payable for additional information on unsecured notes.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is equity price risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately $30 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 128 basis points prior to the renewal of the agreement in January 2018 and LIBOR plus 120 basis points subsequent to the January 2018 renewal through July 2018, on approximately $111 million and $108 million of underlying obligations as of June 30, 2018 and December 31, 2017, respectively. The agreement had an initial term of one year, subject to periodic renewal. In July 2018, the agreement was renewed through January 24, 2020, and the interest rate was changed to LIBOR plus 105 basis points.

On August 9, 2013, Animas Funding LLC ("AFL"), a special purpose investment vehicle formed and consolidated by the Company, entered into a three-year total return swap agreement with Citibank, which was renewed for an additional one-year term through February 17, 2018. The total portfolio of underlying obligations was liquidated during June 2017, and the total return swap agreement between AFL and Citibank was terminated on July 7, 2017. Under the agreement, AFL received the income equivalent on underlying obligations due to Citibank and paid to

Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap was secured by approximately $40 million of U.S. Treasuries as collateral, which were included in short-term investments on the consolidated balance sheets. The Company paid interest, which was equal to LIBOR plus 135 basis points prior to the amendment of the agreement in January 2017 and LIBOR plus 128 basis points subsequent to the amendment until June 2017, on approximately $152 million of underlying obligations as of December 31, 2016.

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The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains or losses in the consolidated statements of operations:

	Derivative Fair Values	
	June 30, 2018	December 31, 2017
	(Amount in thousands)	
Options sold - Other liabilities	$780	$ 123
Total return swap - Other liabilities	1,393	1,200
Total derivatives	$2,173	$ 1,323

	(Losses) Gains Recognized in Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(Amounts in thousands)			
Total return swap - Net realized investment gains (losses)	$(320)	$(1,634)	$280	$(2,654)
Options sold - Net realized investment gains (losses)	2,807	1,005	5,731	1,301
Total	$2,487	$(629)	$6,011	$(1,353)

Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company’s insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. See Note 5. Fair Value Measurements for additional disclosures regarding options sold.

7. Goodwill and Other Intangible Assets

Goodwill

There were no changes in the carrying amount of goodwill during the three and six months ended June 30, 2018 and 2017. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and six months ended June 30, 2018 and 2017. All of the Company's goodwill is associated with the Property and Casualty business segment (See Note 13. Segment Information for additional information on the reportable business segment).

Other Intangible Assets

The following table presents the components of other intangible assets:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of June 30, 2018:				
Customer relationships	$53,035	$ (45,698)	$ 7,337	11
Trade names	15,400	(6,096)	9,304	24
Technology	4,300	(4,085)	215	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	$74,135	$ (55,879)	$ 18,256	
As of December 31, 2017:				
Customer relationships	$52,890	$ (43,617)	$ 9,273	11
Trade names	15,400	(5,775)	9,625	24

Technology	4,300	(3,870)	430	10
Insurance license	1,400	—	1,400	Indefinite
Total other intangible assets, net	$73,990	$ (53,262)	$ 20,728	

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three and six months ended June 30, 2018 and 2017.

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Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was $1.4 million and $1.3 million for the three months ended June 30, 2018 and 2017, respectively, and $2.7 million for the six months ended June 30, 2018 and 2017.

The following table presents the estimated future amortization expense related to other intangible assets as of June 30, 2018:

Year	Amortization Expense
	(Amounts in thousands)
Remainder of 2018	$ 2,732
2019	5,035
2020	887
2021	867
2022	844
Thereafter	6,491
Total	$ 16,856

8. Share-Based Compensation

Share-based compensation expenses for all stock options granted or modified are based on their estimated grant-date fair values. These compensation costs are recognized on a straight-line basis over the requisite service period of the award. The Company estimates forfeitures expected to occur in determining the amount of compensation cost to be recognized in each period. As of June 30, 2018, all outstanding stock options have a term of ten years from the date of grant and become exercisable in four equal installments on the first through fourth anniversaries of the grant date. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.
The fair value of each restricted stock unit ("RSU") grant is determined based on the market price of the Company's common stock on the grant date for awards classified as equity and on each reporting date for awards classified as liability. The RSUs vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company’s performance during the performance period achieves the threshold established by the Compensation Committee of the Company’s Board of Directors. Performance thresholds are based on the Company’s cumulative underwriting income, annual underwriting income, and net earned premium growth. Compensation cost is recognized based on management’s best estimate of the performance goals that will be achieved at the end of the performance period, taking into account expected forfeitures. If the minimum performance goals are not expected to be met, no compensation cost will be recognized and any recognized compensation cost will be reversed.

In February 2015, the Company's Board of Directors adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan which expired in January 2015. The 2015 Plan was approved at the Company's Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock are authorized for issuance under the 2015 Plan upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of RSU or deferred stock awards. As of June 30, 2018, the Company had 77,250 RSUs and 80,000 stock options granted and outstanding and 4,742,750 shares of common stock available for future grant under the 2015 Plan.

In February 2018, the Compensation Committee of the Company's Board of Directors awarded a total of 80,000 stock options to four senior executives under the 2015 Plan which will vest over the four-year requisite service period. The fair values of these stock options were estimated on the date of grant using a closed-form option valuation model (Black-Scholes).

The following table provides the assumptions used in the calculation of grant-date fair values of these stock options based on the Black-Scholes option pricing model:

Weighted-average grant-date fair value	$8.09
Expected volatility	33.18 %
Risk-free interest rate	2.62 %
Expected dividend yield	5.40 %
Expected term in months	72

Expected volatilities are based on historical volatility of the Company's stock over the term of the stock options. The Company estimated the expected term of stock options, which represents the period of time that stock options granted are expected to be

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outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk-free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

As of June 30, 2018, the Company had $0.6 million of unrecognized compensation expense related to stock options awarded under the 2015 Plan, which will be recognized ratably over the remaining vesting period of approximately 3.6 years.

As of June 30, 2018, the Company had the following RSU awards outstanding. These awards were granted to the Company’s senior management and key employees and will vest based upon the Company's performance during the three-year performance period:

Grant year	2016
Three-year performance period ending December 31,	2018
Vesting shares, target (net of forfeited)	77,250
Vesting shares, maximum (net of forfeited)	144,844

In March 2018, based on certification by the Compensation Committee of the Company's Board of Directors of the results of the three-year performance period ended December 31, 2017, all of the outstanding RSUs granted in 2015 expired unvested because the Company did not meet the minimum three-year performance threshold.

In March 2017, a total of approximately $3.6 million was paid upon vesting of 61,445 RSUs awarded in 2014 resulting from the attainment of performance goals above the target threshold during the three-year performance period ended December 31, 2016.

As of June 30, 2018, 18,500 target RSUs granted in 2016 have been forfeited because the recipients were no longer employed by the Company.

No RSUs were awarded during the six months ended June 30, 2018.

9. Income Taxes

For financial statement purposes, the Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, the positions are “more-likely-than-not” sustainable. Once this threshold has been met, the Company’s measurement of its expected tax benefits is recognized in its consolidated financial statements.

There was a $48,000 increase to the total amount of unrecognized tax benefits related to tax uncertainties during the six months ended June 30, 2018. The increase was the result of tax positions taken regarding federal tax credits and state tax apportionment issues based on management’s best judgment given the facts, circumstances, and information available at the reporting date. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2014 through 2016 for federal taxes and 2011 through 2016 for California state taxes. For tax years 2003 through 2010, the Company achieved a resolution with the Franchise Tax Board (“FTB”) in December 2017 and paid a $4.6 million negotiated settlement amount in accordance with the settlement agreement provided by the FTB and signed by the Company. The Company believes that the resolution of tax years 2003 through 2010 has the potential to establish guidance for future audit assessments proposed by the FTB for future tax years.

The Company is currently under examination for tax years 2011 through 2016. For tax years 2011 through 2013, the FTB issued Notices of Proposed Assessments ("NPAs") to the Company, which the Company formally protested. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the FTB, an appeal with the California Office of Tax Appeals, or litigation in Superior Court. For tax years 2014 through 2016, the FTB commenced its audit in December 2017.

The Company believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company’s assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will

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be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized in earnings in the period that includes the enactment date.

At June 30, 2018, the Company’s deferred income taxes were in a net liability position, which included a combination of ordinary and capital deferred tax expenses or benefits. In assessing the Company’s ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company’s deferred tax assets will be realized.

As a result of the Tax Cuts and Jobs Act of 2017 (the "Act"), the Company’s deferred tax assets and liabilities were remeasured as of December 31, 2017 using the new corporate tax rate of 21% that is effective for tax years beginning January 1, 2018, rather than the pre-enactment corporate tax rate of 35%. Additionally, the Company’s alternative minimum tax credit ("AMT") carryforward balance of $57.9 million at December 31, 2017 was reclassified to current income taxes receivable as a refundable credit. The Company believes it will realize the full benefit of the AMT credit no later than the tax year ending December 31, 2021.

In computing taxable income, property and casualty insurers reduce underwriting income by losses and loss adjustment expenses incurred. The amount of the deduction for losses incurred associated with unpaid losses is discounted at the interest rates and for the loss payment patterns prescribed by the U.S. Treasury. The changes included in the Act related to discounting of unpaid losses are broad and complex. The Act changes the prescribed interest rates to rates based on corporate bond yield curves and extends the applicable time periods for the loss payment pattern. These changes are effective for tax years beginning after 2017 and are subject to a transition rule that spreads the additional tax payments resulting from applying these changes over the subsequent eight years beginning in 2018.

The amounts of income tax adjustments resulting from the Act related to AMT credits and loss reserve discounting are provisional amounts based on reasonable estimates of the Company’s tax obligations using the latest information available and are subject to changes as additional information becomes available. The Securities Exchange Commission issued Staff Accounting Bulletin No. 118 ("SAB 118") that expresses views of the staff regarding application of Topic 740, Income Taxes. SAB 118 allows for a measurement period of up to one year after the enactment date of the Act to finalize the recording of the related tax impacts. The transitional impact of the Act will be finalized and recorded by the end of the measurement period.

During the six months ended June 30, 2018, the Company conducted further analysis of the provisional amounts recorded at December 31, 2017 and did not recognize any adjustments to those amounts. The Company will continue to monitor any additional guidance released by the U.S. Treasury on AMT credits and loss reserve discounting during the measurement period, which may impact the provisional amounts.

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