

National Interstate CORP
Form 10-Q
November 04, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2009

OR

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from _____ to _____.

Commission File Number 000-51130

National Interstate Corporation

(Exact name of registrant as specified in its charter)

Ohio

*(State or other jurisdiction of
incorporation or organization)*

34-1607394

*(I.R.S. Employer
Identification No.)*

**3250 Interstate Drive
Richfield, Ohio 44286-9000
(330) 659-8900**

(Address and telephone number of principal executive offices)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer ☐ Accelerated Filer ☒ Non-Accelerated Filer ☐ Smaller Reporting
(Do not check if a smaller reporting company) Company ☐

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

The number of shares outstanding of the registrant's sole class of common shares as of November 2, 2009 was 19,393,261.

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National Interstate Corporation and Subsidiaries
Consolidated Balance Sheets
(In thousands, except per share data)

	September 30, 2009 (Unaudited)	December 31, 2008
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost \$521,089 and \$462,562, respectively)	\$ 523,742	\$ 459,237
Equity securities available-for-sale, at fair value (cost \$25,363 and \$30,143, respectively)	28,013	27,233
Short-term investments, at cost which approximates fair value	86	85
 Total investments	 551,841	 486,555
Cash and cash equivalents	57,750	77,159
Securities lending collateral (cost \$0 and \$94,655, respectively)		84,670
Accrued investment income	4,837	5,161
Premiums receivable, net of allowance for doubtful accounts of \$769 and \$587, respectively	118,274	95,610
Reinsurance recoverables on paid and unpaid losses	151,739	150,791
Prepaid reinsurance premiums	32,730	28,404
Deferred policy acquisition costs	20,124	19,245
Deferred federal income taxes	12,733	18,324
Property and equipment, net	21,693	20,406
Funds held by reinsurer	3,346	3,073
Prepaid expenses and other assets	2,321	1,414
 Total assets	 \$ 977,388	 \$ 990,812
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 417,786	\$ 400,001
Unearned premiums and service fees	170,995	156,598
Long-term debt	15,000	15,000
Amounts withheld or retained for account of others	53,013	48,357
Reinsurance balances payable	15,877	10,267
Securities lending obligation		95,828
Accounts payable and other liabilities	31,679	35,813
Commissions payable	9,088	9,274
Assessments and fees payable	4,040	3,600
 Total liabilities	 717,478	 774,738
Shareholders' equity:		
Preferred shares - no par value		

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Authorized 10,000 shares

Issued 0 shares

Common shares \$0.01 par value

Authorized 50,000 shares

Issued 23,350 shares, including 4,049 and 4,055 shares, respectively, in treasury

Additional paid-in capital

Retained earnings

Accumulated other comprehensive income (loss)

Treasury shares

Total shareholders equity

Total liabilities and shareholders equity

234	234
48,942	48,004
213,017	184,187
3,447	(10,613)
(5,730)	(5,738)

259,910	216,074
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\$	977,388	\$	990,812
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See notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenues:				
Premiums earned	\$ 70,825	\$ 75,058	\$ 209,927	\$ 214,521
Net investment income	4,501	5,498	14,430	16,793
Net realized gains (losses) on investments (*)	760	(8,457)	1,831	(10,768)
Other	879	605	2,627	2,199
Total revenues	76,965	72,704	228,815	222,745
Expenses:				
Losses and loss adjustment expenses	48,286	51,995	127,052	144,097
Commissions and other underwriting expenses	15,189	18,529	43,565	46,685
Other operating and general expenses	3,085	3,241	9,580	9,786
Expense on amounts withheld	811	1,001	2,578	3,261
Interest expense	71	133	403	704
Total expenses	67,442	74,899	183,178	204,533
Income (loss) before federal income taxes	9,523	(2,195)	45,637	18,212
Provision for federal income taxes	1,367	2,033	12,726	8,499
Net income (loss)	\$ 8,156	\$ (4,228)	\$ 32,911	\$ 9,713
Net income (loss) per common share basic	\$ 0.42	\$ (0.22)	\$ 1.71	\$ 0.50
Net income (loss) per common share diluted	\$ 0.42	\$ (0.22)	\$ 1.70	\$ 0.50
Weighted average of common shares outstanding basic	19,301	19,293	19,301	19,281
Weighted average of common shares outstanding diluted	19,384	19,293	19,360	19,375
Cash dividends per common share	\$ 0.07	\$ 0.06	\$ 0.21	\$ 0.18

(*) Consists of the following:

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Realized gains (losses) before impairment
losses

\$ 2,035

\$ (498)

\$ 4,339

\$ (252)

See notes to consolidated financial statements.

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

					Accumulated Other		
	Common	Additional Paid-In	Retained	Comprehensive	Treasury	Total	
	Stock	Capital	Earnings	Income (Loss)	Stock		
Balance at January 1, 2009	\$ 234	\$ 48,004	\$ 184,187	\$ (10,613)	\$ (5,738)	\$ 216,074	
Net income			32,911			32,911	
Unrealized appreciation of investment securities, net of tax expense of \$7.5 million				14,060		14,060	
Comprehensive income						46,971	
Dividends on common stock			(4,081)			(4,081)	
Issuance of 6,089 treasury shares from restricted stock issued, net of forfeitures		(56)			8	(48)	
Stock compensation expense		994				994	
Balance at September 30, 2009	\$ 234	\$ 48,942	\$ 213,017	\$ 3,447	\$ (5,730)	\$ 259,910	
Balance at January 1, 2008	\$ 234	\$ 45,566	\$ 178,190	\$ (5,321)	\$ (5,863)	\$ 212,806	
Net income			9,713			9,713	
Unrealized depreciation of investment securities, net of tax benefit of \$4.4 million				(16,444)		(16,444)	
Comprehensive loss						(6,731)	
Dividends on common stock			(3,497)			(3,497)	
Issuance of 89,723 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		706			125	831	
Tax benefit realized from exercise of stock options		396				396	
Stock compensation expense		1,012				1,012	
Balance at September 30, 2008	\$ 234	\$ 47,680	\$ 184,406	\$ (21,765)	\$ (5,738)	\$ 204,817	

See notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2009	2008
Operating activities		
Net income	\$ 32,911	\$ 9,713
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	1,940	1,251
Provision for depreciation and amortization	1,350	1,017
Net realized (gains) losses on investment securities	(1,831)	10,768
Deferred federal income taxes	(1,871)	(2,877)
Stock compensation expense	994	1,012
Increase in deferred policy acquisition costs, net	(879)	(4,488)
Increase in reserves for losses and loss adjustment expenses	17,785	86,627
Increase in premiums receivable	(22,664)	(34,046)
Increase in unearned premiums and service fees	14,397	40,281
Increase in interest receivable and other assets	(856)	(80)
Increase in prepaid reinsurance premiums	(4,326)	(15,260)
(Decrease) increase in accounts payable, commissions and other liabilities and assessments and fees payable	(3,880)	8,283
Increase in amounts withheld or retained for account of others	4,656	9,674
Increase in reinsurance recoverable	(948)	(40,425)
Increase in reinsurance balances payable	5,610	9,845
Other	(45)	(3)
Net cash provided by operating activities	42,343	81,292
Investing activities		
Purchases of fixed maturities	(271,708)	(342,290)
Purchases of equity securities	(4,756)	(3,387)
Proceeds from sale of fixed maturities	39,467	1,148
Proceeds from sale of equity securities	12,135	10,115
Proceeds from maturities and redemptions of investments	216,345	278,896
Capital expenditures	(2,592)	(1,359)
Net cash used in investing activities	(11,109)	(56,877)
Financing activities		
Decrease in securities lending collateral	49,314	54,416
Decrease in securities lending obligation	(95,828)	(54,416)
Additional long-term borrowings		15,000
Reductions of long-term debt		(15,464)
Tax benefit realized from exercise of stock options		396
	(48)	831

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Issuance of common shares from treasury upon exercise of stock options or stock award grants		
Cash dividends paid on common shares	(4,081)	(3,497)
Net cash used in financing activities	(50,643)	(2,734)
Net (decrease) increase in cash and cash equivalents	(19,409)	21,681
Cash and cash equivalents at beginning of period	77,159	43,069
Cash and cash equivalents at end of period	\$ 57,750	\$ 64,750

See notes to consolidated financial statements.

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**NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

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

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. 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 nine month period ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

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. Securities Lending Program

Prior to June 2009, the Company participated in a securities lending program whereby certain fixed maturity and equity securities from the Company's investment portfolio were loaned to other institutions for short periods of time. The Company required collateral equal to 102% of the market value of the loaned securities plus accrued interest. The collateral was invested by the lending agent generating investment income, net of applicable fees. The Company was not permitted to sell or re-pledge the collateral on the securities lending program. The Company accounted for this program as a secured borrowing and recorded the collateral held and corresponding liability to return the collateral on the Company's Consolidated Balance Sheets at fair value. The securities loaned remained a recorded asset of the Company. Prior to 2008, collateral could be invested in investments with maturities beyond the loan term, including asset backed securities and corporate obligations. However, in light of the market turmoil, beginning in 2008, new cash collateral was only invested in overnight investments.

In June 2009, the Company terminated its securities lending program. During 2009, and prior to the program's termination, approximately \$22.1 million of investments within the Company's securities lending collateral matured and were used to pay down a corresponding amount of the Company's securities lending obligation. Upon the program's termination, the Company used cash on hand and securities lending collateral to pay the \$73.7 million securities lending obligation. Securities lending collateral that had a fair value of \$35.8 million and an unrealized loss of \$9.1 million at the termination date were retained by the Company and are included in the Company's fixed maturities portfolio. Other-than-temporary impairments of \$1.6 million had previously been taken on these fixed maturities.

During its participation in the program, the Company examined the securities lending collateral held for possible other-than-temporary declines in value. During 2009, and prior to termination of the program, the Company recorded a \$0.4 million other-than-temporary impairment on one fixed maturity investment within the Company's securities lending collateral portfolio, compared to \$1.1 million recorded during the nine months ended September 30, 2008.

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	September 30, 2009 (Dollars in thousands)	December 31, 2008 (Dollars in thousands)
Collateral obligation	\$	\$ 95,828
Pretax unrealized loss on fair value of collateral held		(9,985)
Cumulative other-than-temporary impairment charges		(1,173)
Fair value of collateral held		84,670
Fair value of securities lent plus accrued interest		94,265

3. Fair Value Measurements

Under fair value accounting, the Company must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. Fair values for the Company's investment portfolio are reviewed by company personnel using data from nationally recognized pricing services as well as non-binding broker quotes.

The 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. Valuation techniques utilized by pricing services and prices obtained from 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 fair value accounting.

Effective April 1, 2009, the Company adopted revised accounting guidance on estimating the fair value of an asset or liability when there is no active market and on identifying transactions that are not orderly. This did not change the objective of fair value measurements. Adoption of this change in the accounting guidance did not have a material impact on the Company's consolidated financial position or results of operations.

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 by management by observable market data. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes, for which the Company believes reflects fair value, but are unable to verify inputs to the valuation methodology. The Company obtained one quote or price per instrument from its brokers and pricing services and did not adjust any quotes or prices that it obtained. Management reviews these broker quotes using information such as the market prices of similar investments.

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The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2009:

		September 30, 2009		
	Level 1	Level 2	Level 3	Total
		(Dollars in thousands)		
Fixed maturities:				
U.S. government and government agency obligations	\$	\$ 177,159	\$	\$ 177,159
State and local government obligations		162,887	6,373	169,260
Residential mortgage-backed securities		120,217	2,494	122,711
Commercial mortgage-backed securities		3,751		3,751
Corporate obligations		33,756	5,878	39,634
Redeemable preferred stocks	8,231	650	2,346	11,227
Total fixed maturities	8,231	498,420	17,091	523,742
Equity securities:				
Perpetual preferred stock	848	246	396	1,490
Common stock	14,551	11,972		26,523
Total equity securities	15,399	12,218	396	28,013
Short-term investments		86		86
Total investments	23,630	510,724	17,487	551,841
Cash and cash equivalents	57,750			57,750
Total investments and cash and cash equivalents	\$ 81,380	\$ 510,724	\$ 17,487	\$ 609,591

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three months ended September 30, 2009: