National Interstate CORP
Form 10-Q
August 06, 2009

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, 2009

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 (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). o 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). o Yes þ No
The number of shares outstanding of the registrant s sole class of common shares as of August 4, 2009 was 19,392,833.

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PART I FINANCIAL INFORMATION

ITEM 1. ***Financial Statements***

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

	June 30, 2009 (Unaudited)	December 31, 2008
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost $495,228 and $462,562, respectively)	$ 485,780	$ 459,237
Equity securities available-for-sale, at fair value (cost $29,309 and $30,143, respectively)	29,834	27,233
Short-term investments, at cost which approximates fair value	86	85
Total investments	515,700	486,555
Cash and cash equivalents	57,288	77,159
Securities lending collateral (cost $0 and $94,655, respectively)		84,670
Accrued investment income	4,395	5,161
Premiums receivable, net of allowance for doubtful accounts of $577 and $587, respectively	139,448	95,610
Reinsurance recoverables on paid and unpaid losses	147,843	150,791
Prepaid reinsurance premiums	40,452	28,404
Deferred policy acquisition costs	22,126	19,245
Deferred federal income taxes	15,689	18,324
Property and equipment, net	21,303	20,406
Funds held by reinsurer	3,007	3,073
Prepaid expenses and other assets	1,992	1,414
Total assets	$ 969,243	$ 990,812
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	$ 404,986	$ 400,001
Unearned premiums and service fees	190,644	156,598
Long-term debt	15,000	15,000
Amounts withheld or retained for account of others	51,318	48,357
Reinsurance balances payable	21,245	10,267
Securities lending obligation		95,828
Accounts payable and other liabilities	28,614	35,813
Commissions payable	9,980	9,274
Assessments and fees payable	3,909	3,600
Total liabilities	725,696	774,738
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 4,049 and 4,055 shares, respectively, in treasury	234	234
Additional paid-in capital	48,621	48,004
Retained earnings	206,222	184,187
Accumulated other comprehensive loss	(5,800)	(10,613)
Treasury shares	(5,730)	(5,738)
Total shareholders equity	243,547	216,074
Total liabilities and shareholders equity	$ 969,243	$ 990,812

See notes to consolidated financial statements.

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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,	
	2009	**2008**	**2009**	**2008**
Revenues:				
Premiums earned	$ 69,663	$ 71,813	$ 139,102	$ 139,463
Net investment income	4,919	5,451	9,929	11,295
Net realized gains (losses) on investments (*)	1,048	(1,724)	1,071	(2,311)
Other	960	757	1,748	1,594
Total revenues	76,590	76,297	151,850	150,041
Expenses:				
Losses and loss adjustment expenses	39,440	50,417	78,766	92,102
Commissions and other underwriting expenses	15,357	15,195	28,376	28,156
Other operating and general expenses	3,203	3,313	6,495	6,545
Expense on amounts withheld	900	1,002	1,767	2,260
Interest expense	212	225	332	571
Total expenses	59,112	70,152	115,736	129,634
Income before federal income taxes	17,478	6,145	36,114	20,407
Provision for federal income taxes	5,369	1,775	11,359	6,466
Net income	$ 12,109	$ 4,370	$ 24,755	$ 13,941
Net income per common share basic	$ 0.63	$ 0.23	$ 1.28	$ 0.72
Net income per common share diluted	$ 0.63	$ 0.23	$ 1.28	$ 0.72
Weighted average of common shares outstanding basic	19,301	19,288	19,301	19,275
Weighted average of common shares outstanding diluted	19,359	19,375	19,351	19,400
Cash dividends per common share	$ 0.07	$ 0.06	$ 0.14	$ 0.12

(*) Consists of the following:

Realized gains (losses) before impairment losses	$	1,674	$	(96)	$	2,304	$	246
Total losses on securities with impairment charges		(3,640)		(1,628)		(4,247)		(2,557)
Non-credit portion in other comprehensive income		3,014				3,014		
Net impairment charges recognized in earnings		(626)		(1,628)		(1,233)		(2,557)
Net realized gains (losses) on investments	$	1,048	$	(1,724)	$	1,071	$	(2,311)

See notes to consolidated financial statements.

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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, 2009	$ 234	$ 48,004	$ 184,187	$ (10,613)	$ (5,738)	$ 216,074
Net income			24,755			24,755
Unrealized appreciation of investment securities, net of tax benefit of $2.5 million				4,813		4,813
Comprehensive income						29,568
Dividends on common stock			(2,720)			(2,720)
Issuance of 5,595 treasury shares from restricted stock issued, net of forfeitures		(63)			8	(55)
Stock compensation expense		680				680
Balance at June 30, 2009	$ 234	$ 48,621	$ 206,222	$ (5,800)	$ (5,730)	$ 243,547
Balance at January 1, 2008	$ 234	$ 45,566	$ 178,190	$ (5,321)	$ (5,863)	$ 212,806
Net income			13,941			13,941
Unrealized depreciation of investment securities, net of tax benefit of $2.3 million				(9,094)		(9,094)
Comprehensive income						4,847
Dividends on common stock			(2,331)			(2,331)
Issuance of 87,315 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		698			121	819
Tax benefit realized from exercise of stock options		381				381
Stock compensation expense		694				694
Balance at June 30, 2008	$ 234	$ 47,339	$ 189,800	$ (14,415)	$ (5,742)	$ 217,216

See notes to consolidated financial statements.

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

	Six Months Ended June 30, 2009	2008
Operating activities		
Net income	$ 24,755	$ 13,941
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	1,280	758
Provision for depreciation and amortization	922	688
Net realized (gains) losses on investments	(1,071)	2,311
Deferred federal income taxes	152	(2,304)
Stock compensation expense	680	694
Increase in deferred policy acquisition costs, net	(2,881)	(6,042)
Increase in reserves for losses and loss adjustment expenses	4,985	54,239
Increase in premiums receivable	(43,838)	(54,774)
Increase in unearned premiums and service fees	34,046	58,569
Decrease in interest receivable and other assets	254	977
Increase in prepaid reinsurance premiums	(12,048)	(20,936)
(Decrease) increase in accounts payable, commissions and other liabilities and assessments and fees payable	(6,184)	6,874
Increase in amounts withheld or retained for account of others	2,961	4,591
Decrease (increase) in reinsurance recoverable	2,948	(23,066)
Increase in reinsurance balances payable	10,978	18,576
Net cash provided by operating activities	17,939	55,096
Investing activities		
Purchases of fixed maturities	(204,681)	(305,489)
Purchases of equity securities	(4,392)	(3,150)
Proceeds from sale of fixed maturities	37,029	483
Proceeds from sale of equity securities	6,189	9,175
Proceeds from maturities and redemptions of investments	179,154	244,140
Capital expenditures	(1,819)	(751)
Net cash provided by (used in) investing activities	11,480	(55,592)
Financing activities		
Decrease in securities lending collateral	49,313	25,967
Decrease in securities lending obligation	(95,828)	(25,967)
Additional long-term borrowings		15,000
Reductions of long-term debt		(15,464)
Tax benefit realized from exercise of stock options		381
Issuance of common shares from treasury upon exercise of stock options or stock award grants	(55)	819
Cash dividends paid on common shares	(2,720)	(2,331)

Net cash used in financing activities	(49,290)	(1,595)
Net decrease in cash and cash equivalents	(19,871)	(2,091)
Cash and cash equivalents at beginning of period	77,159	43,069
Cash and cash equivalents at end of period	$ 57,288	$ 40,978

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), Triumphe 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 six month period ended June 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. 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 ($46.5 million book value) 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. Additionally, during 2009, and prior to the programs 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.

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During its participation in the program, the Company examined the securities lending collateral held for possible other-than-temporary declines in value. During the first six months of 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 $0.6 million recorded during the same period in 2008.

	June 30, 2009	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

On January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Under SFAS No. 157, the Company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS No. 157 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, which is consistent with SFAS No. 157.

Effective April 1, 2009, the Company adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) Financial Accounting Standard (FAS) 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. This standard provides 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. The standard did not change the objective of fair value measurements. Adoption of this FSP 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 SFAS No. 157 hierarchy in which the fair value measurements fall at June 30, 2009:

	June 30, 2009			
	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. government and government agency obligations	$	$ 154,248	$	$ 154,248
State and local government obligations		151,990	6,338	158,328
Residential mortgage-backed securities		102,491	2,705	105,196
Commercial mortgage-backed securities		3,574		3,574
Corporate obligations		47,972	5,825	53,797
Redeemable preferred stocks	7,710	628	2,299	10,637
Total fixed maturities	7,710	460,903	17,167	485,780
Equity securities:				
Perpetual preferred stock	763	142	396	1,301
Common stock	17,272	11,261		28,533
Total equity securities	18,035	11,403	396	29,834
Short-term investments		86		86
Total investments	25,745	472,392	17,563	515,700
Cash and cash equivalents	57,288			57,288
Total investments and cash and cash equivalents	$ 8			