National Interstate CORP
Form 10-Q
November 06, 2007

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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 September 30, 2007
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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):
Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer 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 November 1, 2007 was 19,227,547.

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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)

	September 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost $347,914 and $332,552, respectively)	$ 345,443	$ 327,449
Equity securities available-for-sale, at fair value (cost $51,194 and $33,476, respectively)	49,507	34,095
Short-term investments, at cost which approximates fair value	47,480	22,744
Total investments	442,430	384,288
Cash and cash equivalents	30,109	22,166
Securities lending collateral	147,198	158,928
Accrued investment income	4,619	4,321
Premiums receivable, net of allowance for doubtful accounts of $589 and $522, respectively	103,305	77,076
Reinsurance recoverables on paid and unpaid losses	108,947	90,070
Prepaid reinsurance premiums	32,186	21,272
Deferred policy acquisition costs	19,656	15,035
Deferred federal income taxes	11,075	10,731
Property and equipment, net	19,283	18,586
Funds held by reinsurer	3,574	2,340
Other assets	1,925	1,435
Total assets	$ 924,307	$ 806,248
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	$ 309,869	$ 265,966
Unearned premiums and service fees	161,929	127,723
Long-term debt	15,464	15,464
Amounts withheld or retained for account of others	35,390	27,885
Reinsurance balances payable	10,542	7,156
Securities lending obligation	147,741	158,928
Accounts payable and other liabilities	25,980	19,676
Commissions payable	8,456	6,347
Assessments and fees payable	4,307	3,340
Total liabilities	719,678	632,485
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 4,145 and 4,191 shares, respectively, in treasury		234		234
Additional paid-in capital		45,286		43,921
Retained earnings		168,028		138,450
Accumulated other comprehensive loss		(3,056)		(2,915)
Treasury shares		(5,863)		(5,927)
Total shareholders equity		204,629		173,763
Total liabilities and shareholders equity	$	924,307	$	806,248

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 September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Revenue:				
Premiums earned	$ 66,187	$ 56,619	$ 189,742	$ 159,363
Net investment income	5,690	4,528	16,421	12,703
Realized (losses) gains on investments	(319)	199	(47)	714
Other	1,564	586	3,384	1,603
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Total revenues	73,122	61,932	209,500	174,383
Expenses:				
Losses and loss adjustment expenses	39,844	38,092	112,564	98,426
Commissions and other underwriting expenses	13,803	11,283	36,348	29,982
Other operating and general expenses	3,792	2,766	11,631	8,865
Interest expense	393	389	1,160	1,132
Total expenses	57,832	52,530	161,703	138,405
Income before federal income taxes	15,290	9,402	47,797	35,978
Provision for federal income taxes	5,145	2,859	15,327	11,706
Net income	$ 10,145	$ 6,543	$ 32,470	$ 24,272
Net income per common share basic	$ 0.53	$ 0.34	$ 1.69	$ 1.27
Net income per common share diluted	$ 0.52	$ 0.34	$ 1.67	$ 1.26
Weighted average of common shares outstanding basic	19,199	19,146	19,189	19,128
Weighted average of common shares outstanding diluted	19,459	19,354	19,401	19,292
Cash dividends per common share	$ 0.05	$ 0.04	$ 0.15	$ 0.12

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 Loss	Treasury Stock	Total
Balance at January 1, 2007	$ 234	$ 43,921	$ 138,450	$ (2,915)	$ (5,927)	$ 173,763
Net Income			32,470			32,470
Unrealized depreciation of investment securities, net of tax benefit of $76				(141)		(141)
Comprehensive income						32,329
Dividends on common stock			(2,892)			(2,892)
Issuance of 45,847 treasury shares upon exercise of stock options and stock award grants		388			64	452
Tax benefit realized from exercise of stock options		201				201
Stock compensation expense		776				776
Balance at September 30, 2007	$ 234	$ 45,286	$ 168,028	$ (3,056)	$ (5,863)	$ 204,629
Balance at January 1, 2006	$ 234	$ 42,257	$ 105,826	$ (2,712)	$ (6,072)	$ 139,533
Net income			24,272			24,272
Unrealized depreciation of investment securities, net of tax benefit of $196				(363)		(363)
Comprehensive income						23,909
Dividends on common stock			(2,307)			(2,307)
Issuance of 100,000 treasury shares upon exercise of stock options and stock award grants		293			139	432
Tax benefit realized from exercise of stock options		536				536
		582				582

Stock compensation expense						
Balance at September 30, 2006	$ 234	$ 43,668	$ 127,791	$ (3,075)	$ (5,933)	$ 162,685

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, 2007	Nine Months Ended September 30, 2006
Operating activities		
Net income	$ 32,470	$ 24,272
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	253	185
Provision for depreciation and amortization	948	827
Net realized losses (gains) on investment securities	47	(714)
Deferred federal income taxes	(268)	(689)
Stock compensation expense	776	582
Increase in deferred policy acquisition costs, net	(4,621)	(4,115)
Increase in reserves for losses and loss adjustment expenses	43,903	37,647
Increase in premiums receivable	(26,229)	(38,404)
Increase in unearned premiums and service fees	34,206	39,870
(Increase) decrease in interest receivable and other assets	(2,089)	1,819
Increase in prepaid reinsurance premiums	(10,914)	(9,255)
Increase in accounts payable, commissions and other liabilities and assessments and fees payable	9,380	4,022
Increase in amounts withheld or retained for account of others	7,505	7,072
Increase in reinsurance recoverable	(18,877)	(11,009)
Increase in reinsurance balances payable	3,386	5,564
Other		2
Net cash provided by operating activities	69,876	57,676
Investing activities		
Purchases of fixed maturities	(127,238)	(57,095)
Purchases of equity securities	(57,143)	(44,864)
Proceeds from sale of fixed maturities		1,917
Proceeds from sale of equity securities	14,593	23,213
Proceeds from maturity of investments	111,672	27,983
Additional cash paid for purchase of subsidiary		(1,246)
Cash and cash equivalents of business acquired		5,585
Capital expenditures	(1,578)	(858)
Net cash used in investing activities	(59,694)	(45,365)
Financing activities		
Repayment of long-term debt		(833)
Decrease (increase) in securities lending collateral	11,187	(159,219)

(Decrease) increase in securities lending obligation	(11,187)	159,219
Tax benefit realized from exercise of stock options	201	536
Issuance of common shares from treasury upon exercise of stock options	452	432
Cash dividends paid on common shares	(2,892)	(2,307)
Net cash used in financing activities	(2,239)	(2,172)
Net increase in cash and cash equivalents	7,943	10,139
Cash and cash equivalents at beginning of period	22,166	7,461
Cash and cash equivalents at end of period	$ 30,109	$ 17,600

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, 2006. 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, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates. Certain reclassifications have been made to financial information presented for prior years to conform to the current year s presentation.

2. Recent Accounting Pronouncements

The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to elect to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159, an entity may elect the fair value option for eligible items that exist at the adoption date. Subsequent to the initial adoption, the election of the fair value option should only be made at the initial recognition of the asset or liability or upon a re-measurement event that gives rise to the new-basis of accounting. All subsequent changes in fair value for that instrument are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be recorded at fair value nor does it eliminate disclosure requirements included in other accounting standards. SFAS No. 159 is effective as of January 1, 2008. The Company is currently evaluating the impact, if any, that the adoption of SFAS No. 159 will have on its results of operations and financial condition.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company has not yet determined the impact SFAS No. 157 will have on its financial statements, but expects the impact, if any, to be immaterial.

Accounting for Uncertainty in Income Taxes

In June 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* an interpretation of SFAS No. 109. FIN 48 clarifies the recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN 48 on

January 1, 2007. There is no impact of this interpretation on the Company s results of operations, financial condition and liquidity for the three and nine months ended September 30, 2007.

The Company recognized no liability for unrecognized tax benefits at January 1, 2007. In addition, the Company has not accrued for interest and penalties related to unrecognized tax benefits. However, if interest and penalties would need to be accrued related to unrecognized tax benefits, such amounts would be recognized as a component of the provision for federal income taxes.

The Company files income tax returns in the U.S. federal jurisdiction and various state and U.S. territory jurisdictions. The Company is no longer subject to U.S. federal income tax examination by tax authorities for years before 2003. The Company is no longer subject to state income tax examination for years before 2003. There are no ongoing examinations of income tax returns by federal or state tax authorities.

3. Shareholders Equity

The Company grants options and other awards to officers of the Company under the Long Term Incentive Plan (LTIP). At September 30, 2007, there were 990,853 of the Company s common shares reserved for issuance upon exercise of stock options or other awards under the LTIP and options for 655,050 shares were outstanding. In March 2007, the Company granted a restricted stock award and stock bonus award under the LTIP. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Compensation Committee of the Board of Directors may accelerate vesting and exercisability of options. The Compensation Committee of the Board of Directors must approve all grants.

On January 1, 2006, the Company adopted SFAS No. 123(R) (revised version of SFAS No. 123), Accounting for Stock-Based Compensation, which requires measurement of compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the requisite service period of stock-based awards. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company s valuation methodology used for all options granted since the Company s initial public offering in 2005 for purposes of its footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method for awards issued subsequent to the Company s initial public offering, which provides for no retroactive application to prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards, as the required services are rendered. The Company has adopted SFAS No. 123(R) using the prospective method for awards issued prior to the Company s initial public offering. Awards issued prior to the initial public offering were valued for disclosure purposes using the minimum value method. No compensation cost will be recognized for future vesting of these awards.

For both the three months ended September 30, 2007 and 2006, the Company recognized stock compensation expense related to SFAS 123(R) of $0.2 million and related income tax benefits of approximately $30,000. For both the nine months ended September 30, 2007 and 2006, the Company recognized stock compensation expense related to SFAS 123(R) of $0.6 million and related income tax benefits of approximately $0.1 million. The Company also recognized compensation expense of $0.3 million related to the stock bonus award and restricted stock award in the first nine months of 2007. Stock compensation expense is included in the Other operating and general expenses line item of the Company s Consolidated Statements of Income.

The Company paid dividends of $0.05 and $0.04, and $0.15 and $0.12 per common share for the three and nine months ended September 30, 2007 and 2006, respectively.

4. Transactions with Related Parties

The Company s principal insurance subsidiary, NIIC, is involved in both the cession and assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA, a wholly-owned subsidiary of the Company, is a party to an underwriting management agreement with Great American Insurance Company (Great American). As of September 30, 2007, Great American owned 53.0% of the outstanding shares of the Company. Great American is a wholly-owned subsidiary of American Financial Group, Inc. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American s net premiums written for public transportation and recreational vehicle risks. NIIA provides administrative services to Great American in connection with Great American s underwriting of these risks. The Company also cedes premiums through reinsurance agreements with Great American to reduce exposure in certain of its property-casualty insurance programs.

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The table below summarizes the reinsurance balance and activity with Great American:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(Dollars in thousands)		(Dollars in thousands)	
Assumed premiums written	$ 1,288	$ 1,203	$ 4,901	$ 3,551
Assumed premiums earned	1,467	1,081	4,060	3,062
Assumed losses and loss adjustment expense incurred	2,123	1,262	4,581	2,777
Ceded premiums written	658	719	3,410	3,244
Ceded premiums earned	1,013	967	2,966	3,015
Ceded losses and loss adjustment expense recoveries	146	790	1,186	2,038
Payable to Great American as of period end	725	1,569	725	1,569

Great American or its parent, American Financial Group, Inc., performs certain services for the Company without charge including, without limitation, actuarial services and on a consultative basis, as needed, internal audit, legal, accounting and other support services. If Great American no longer controlled a majority of the Company s common shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to us. This could impact our personnel resources, require us to hire additional professional staff and generally increase our operating expenses. Management believes, based on discussions with Great American, that these services will continue to be provided by the affiliated entity in future periods and the relative impact on operating results is not material.

In addition, NIIC is party to a reinsurance agreement with Validus Reinsurance, Ltd. The total amount ceded under this agreement was $0.2 million and $0.1 million for the nine months ended 2007 and 2006, respectively. The contract terms were negotiated on an arms-length basis. Validus Reinsurance, Ltd. is a subsidiary of Validus Holdings, Ltd., whose chief financial officer, Mr. Joseph E. (Jeff) Consolino, is one of the Company s directors and the Company s Audit Committee Chairman.

NIIC entered into a limited partnership with Clutterbuck Funds, LLC and other partners to invest in CF Special Situation Fund I, LP (Clutterbuck) during the third quarter of 2006. As of September 30, 2007 the Company owned approximately 13% of Clutterbuck. In September 2007, the Chairman and Chief Executive Officer of the Company, Mr. Alan Spachman, entered into an agreement to exchange 150,000 of the Company s common shares at $30 per share with Clutterbuck in return for a limited partnership interest in the fund. This transaction was conducted out of Mr. Spachman s individual investment portfolio. Through September 30, 2007, Clutterbuck sold on the open market the Company s 150,000 common shares exchanged by Mr. Spachman. As of September 30, 2007, both the Company and Mr. Spachman held a limited partnership interest in Clutterbuck.

5. Reinsurance

Premiums and reinsurance activity consisted of the following:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2007		2006		2007		2006	
	Written	Earned	Written	Earned	Written	Earned	Written	Earned
	(Dollars in thousands)				(Dollars in thousands)			
Direct	$ 67,867	$ 79,700	$ 59,924	$ 68,697	$ 265,626	$ 231,713	$ 234,631	$ 193,652
Assumed	4,190	3,878	1,803	2,971	9,244	8,952	9,362	9,611
Ceded	(12,786)	(17,391)	(10,705)	(15,049)	(61,837)	(50,923)	(54,042)	(43,900)
Net Premium	$ 59,271	$ 66,187	$ 51,022	$ 56,619	$ 213,033	$ 189,742	$ 189,951	$ 159,363

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property-casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the three months ended September 30, 2007 and 2006 were $8.9 million and $6.3 million, respectively, and were $25.6 million and $22.2 million for the nine months ended September 30, 2007 and 2006, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company and regularly evaluates the financial condition of its reinsurers.

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6. Commitments and Contingencies

The Company and its subsidiaries are subject at times to various claims, lawsuits and legal proceedings arising in the ordinary course of business. All legal actions relating to claims made under insurance policies are considered in the establishment of our loss and loss adjustment expense reserves. In addition, regulatory bodies, such as state insurance departments, the Securities and Exchange Commission, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning our compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended.

The Company s insurance companies also have lawsuits pending in which the plaintiff seeks extra-contractual damages from us in addition