

National Interstate CORP
Form 10-Q
May 04, 2012
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2012

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)

Edgar Filing: National Interstate CORP - Form 10-Q

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 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 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 Accelerated Filer

Non-Accelerated Filer (Do not check if a smaller reporting company) Smaller Reporting 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 May 2, 2012 was 19,474,594.

Table of Contents

National Interstate Corporation

Table of Contents

	Page
<u>Part I - Financial Information</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Income</u>	4
<u>Consolidated Statements of Comprehensive Income</u>	5
<u>Consolidated Statements of Shareholders' Equity</u>	6
<u>Consolidated Statements of Cash Flows</u>	7
<u>Notes to Consolidated Financial Statements</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	29
<u>Item 4. Controls and Procedures</u>	29
<u>Part II - Other Information</u>	29
<u>Item 1. Legal Proceedings</u>	29
<u>Item 1A. Risk Factors</u>	29
<u>Item 6. Exhibits</u>	30

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. Financial Statements****National Interstate Corporation and Subsidiaries****Consolidated Balance Sheets****(In thousands, except per share data)**

	March 31, 2012 (Unaudited)	December 31, 2011
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost \$921,878 and \$911,363, respectively)	\$ 953,915	\$ 937,619
Equity securities available-for-sale, at fair value (amortized cost \$30,992 and \$30,987, respectively)	35,542	31,750
Other invested assets	30,512	28,061
Total investments	1,019,969	997,430
Cash and cash equivalents	27,559	23,674
Accrued investment income	9,172	9,160
Premiums receivable, net of allowance for doubtful accounts of \$2,341 and \$2,662, respectively	172,330	171,518
Reinsurance recoverable on paid and unpaid losses	192,993	199,081
Prepaid reinsurance premiums	36,493	33,225
Deferred policy acquisition costs	25,428	24,603
Deferred federal income taxes	21,118	26,241
Property and equipment, net	24,672	24,419
Funds held by reinsurer	2,626	3,427
Intangible assets, net	8,582	8,660
Prepaid expenses and other assets	2,058	1,940
Total assets	\$ 1,543,000	\$ 1,523,378
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 781,845	\$ 776,576
Unearned premiums and service fees	232,370	232,548
Debt	22,000	22,000
Amounts withheld or retained for accounts of others	62,591	62,531
Reinsurance balances payable	22,693	23,593
Accounts payable and other liabilities	40,521	41,640
Commissions payable	12,765	10,785
Assessments and fees payable	5,169	4,806
Total liabilities	1,179,954	1,174,479
Shareholders' equity:		
Preferred shares - no par value		
Authorized - 10,000 shares		
Issued - 0 shares		
Common shares - \$0.01 par value		
Authorized - 50,000 shares		
Issued - 23,350 shares, including 3,936 and 3,952 shares, respectively, in treasury	234	234

Edgar Filing: National Interstate CORP - Form 10-Q

Additional paid-in capital	51,403	51,295
Retained earnings	293,201	285,403
Accumulated other comprehensive income	23,781	17,561
Treasury shares	(5,573)	(5,594)
Total shareholders' equity	363,046	348,899
Total liabilities and shareholders' equity	\$ 1,543,000	\$ 1,523,378

See notes to consolidated financial statements.

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

	Three Months Ended March 31,	
	2012	2011
Revenues:		
Premiums earned	\$ 110,125	\$ 105,139
Net investment income	9,183	6,902
Net realized gains on investments (*)	1,742	1,200
Other	829	1,116
Total revenues	121,879	114,357
Expenses:		
Losses and loss adjustment expenses	80,553	74,659
Commissions and other underwriting expenses	21,534	20,495
Other operating and general expenses	4,930	4,541
Expense on amounts withheld	1,040	840
Interest expense	62	54
Total expenses	108,119	100,589
Income before income taxes	13,760	13,768
Provision for income taxes	4,014	4,350
Net income	\$ 9,746	\$ 9,418
Net income per share basic	\$ 0.50	\$ 0.49
Net income per share diluted	\$ 0.50	\$ 0.48
Weighted average of common shares outstanding basic	19,409	19,366
Weighted average of common shares outstanding diluted	19,543	19,475
Cash dividends per common share	\$ 0.10	\$ 0.09

(*) Consists of the following:

Net realized gains before impairment losses	\$ 1,822	\$ 1,200
Total losses on securities with impairment charges	(80)	
Non-credit portion recognized in other comprehensive income		
Net impairment charges recognized in earnings	(80)	

Edgar Filing: National Interstate CORP - Form 10-Q

Net realized gains on investments	\$	1,742	\$	1,200
-----------------------------------	----	-------	----	-------

See notes to consolidated financial statements.

Table of Contents

National Interstate Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2012	2011
Net income	\$ 9,746	\$ 9,418
Other comprehensive income (loss), before tax:		
Net unrealized gains on available-for-sale securities:		
Net unrealized holding gains on securities arising during the period	9,901	524
Reclassification adjustment for net realized gains included in net income	(332)	(988)
Total net unrealized gains (losses) on available-for-sale securities	9,569	(464)
Other comprehensive income (loss), before tax	9,569	(464)
Deferred income taxes on other comprehensive income (loss)	3,349	(162)
Other comprehensive income (loss), net of tax	6,220	(302)
Total comprehensive income	\$ 15,966	\$ 9,116

See notes to consolidated financial statements.

Table of Contents**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, 2012	\$ 234	\$ 51,295	\$ 285,403	\$ 17,561	\$ (5,594)	\$ 348,899
Net income			9,746			9,746
Unrealized appreciation of investment securities, net of tax of \$3.3 million				6,220		6,220
Comprehensive income						15,966
Dividends on common stock			(1,948)			(1,948)
Issuance of 15,629 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		(139)			21	(118)
Net tax effect from exercise/vesting of stock-based compensation		46				46
Stock compensation expense		201				201
Balance at March 31, 2012	\$ 234	\$ 51,403	\$ 293,201	\$ 23,781	\$ (5,573)	\$ 363,046
Balance at January 1, 2011	\$ 234	\$ 50,273	\$ 258,473	\$ 6,251	\$ (5,653)	\$ 309,578
Cumulative effect of accounting change			(1,612)			(1,612)
Balance at January 1, 2011, as adjusted	234	50,273	256,861	6,251	(5,653)	307,966
Net income			9,418			9,418
Unrealized depreciation of investment securities, net of tax of (\$0.2) million				(302)		(302)
Comprehensive income						9,116
Dividends on common stock			(1,751)			(1,751)
Issuance of 10,643 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		(149)			15	(134)
Net tax effect from exercise/vesting of stock-based compensation		54				54
Stock compensation expense		273				273
Balance at March 31, 2011	\$ 234	\$ 50,451	\$ 264,528	\$ 5,949	\$ (5,638)	\$ 315,524

See notes to consolidated financial statements.

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

	Three Months Ended March 31,	
	2012	2011
Operating activities		
Net income	\$ 9,746	\$ 9,418
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	1,624	2,680
Provision for depreciation and amortization	1,063	918
Net realized gains on investment securities	(1,742)	(1,200)
Deferred federal income taxes	1,774	596
Stock compensation expense	201	273
Increase in deferred policy acquisition costs, net	(825)	(3,262)
Increase (decrease) in reserves for losses and loss adjustment expenses	5,269	(86)
Increase in premiums receivable	(812)	(802)
(Decrease) increase in unearned premiums and service fees	(178)	8,049
Decrease in interest receivable and other assets	671	596
Increase in prepaid reinsurance premiums	(3,268)	(2,979)
Increase (decrease) in accounts payable, commissions and other liabilities and assessments and fees payable	1,224	(10,225)
Increase in amounts withheld or retained for accounts of others	60	1,509
Decrease in reinsurance recoverable	6,088	2,765
(Decrease) increase in reinsurance balances payable	(900)	2,412
Other	(14)	(7)
Net cash provided by operating activities	19,981	10,655
Investing activities		
Purchases of fixed maturities	(56,182)	(98,335)
Purchases of equity securities	(580)	(5,422)
Proceeds from sale of fixed maturities	8,618	6,779
Proceeds from sale of equity securities	557	2,468
Proceeds from maturities and redemptions of investments	35,834	80,053
Change in other investments, net	(1,100)	(10,000)
Collection of amounts refundable on purchase price of Vanliner		14,256
Capital expenditures	(1,223)	(665)
Net cash used in investing activities	(14,076)	(10,866)
Financing activities		
Net tax effect from exercise/vesting of stock-based compensation	46	54
Issuance of common shares from treasury upon exercise of stock options or stock award grants	(118)	(134)
Cash dividends paid on common shares	(1,948)	(1,751)
Net cash used in financing activities	(2,020)	(1,831)
Net increase (decrease) in cash and cash equivalents	3,885	(2,042)
Cash and cash equivalents at beginning of period	23,674	27,054

Edgar Filing: National Interstate CORP - Form 10-Q

Cash and cash equivalents at end of period	\$ 27,559	\$ 25,012
--	-----------	-----------

See notes to consolidated financial statements.

Table of Contents**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 U.S. generally accepted accounting principles and the instructions to Form 10-Q.

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

These interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. 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 month period ended March 31, 2012 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2012.

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. All adjustments to financial information for prior years pertain to the retrospective adoption of Accounting Standards Update No. 2010-26, *Financial Services - Insurance* (ASU 2010-26), as discussed in Note 2 - Recent Accounting Pronouncements.

2. Recent Accounting Pronouncements

Effective January 1, 2012, the Company retrospectively adopted ASU 2010-26. ASU 2010-26 amends Accounting Standard Codification 944, *Financial Services - Insurance*, limiting the capitalization of costs incurred in the acquisition of new and renewal contracts to incremental direct costs of contract acquisition and certain costs related directly to certain acquisition activities performed by the insurer of the contract, which primarily consist of commissions, premium taxes and assessments. The retrospective adoption of ASU 2010-26 resulted in fewer acquisition costs being capitalized by the Company.

The impact of adoption on amounts previously reported is shown in the tables below (in thousands, except per share data):

	December 31, 2011
Deferred policy acquisition costs	
As previously reported	\$ 27,205
As adjusted	24,603
Deferred federal income taxes	
As previously reported	\$ 25,330
As adjusted	26,241
Shareholders' equity	
As previously reported	\$ 350,590
As adjusted	348,899

Table of Contents

	2011				
	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter	Full Year
Commissions and other underwriting expenses					
As previously reported	\$ 20,325	\$ 21,196	\$ 23,103	\$ 23,113	\$ 87,737
As adjusted	20,495	21,417	23,134	22,814	87,860
Net income					
As previously reported	\$ 9,528	\$ 8,203	\$ 5,849	\$ 12,048	\$ 35,628
As adjusted	9,418	8,059	5,829	12,242	35,548
Net income per share diluted					
As previously reported	\$ 0.49	\$ 0.42	\$ 0.30	\$ 0.62	\$ 1.83
As adjusted	0.48	0.41	0.30	0.63	1.82

Effective January 1, 2012, the Company retrospectively adopted Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 eliminates the option to report other comprehensive income and its components in the statement of shareholders' equity. As permitted by the standard, comprehensive income is presented herein in a separate statement immediately following the Statement of Income. As the updated guidance only requires a change in the format of information already disclosed, the adoption did not have an impact on the Company's cash flows, financial condition, net income or comprehensive income.

Effective January 1, 2012, the Company adopted Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS* (ASU 2011-04). ASU 2011-04 clarifies the application of existing fair value measurement and amends certain disclosure requirements. Disclosures required by the guidance are included in Note 3 Fair Value Measurements. The impact of adoption was not material to the Company's results of operations or financial position.

3. Fair Value Measurements

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. The Company's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value.

Pricing services use a variety of observable inputs to estimate the fair value of fixed maturities that do not trade on a daily basis. These inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data and measures of volatility. Included in the pricing of mortgage-backed securities are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Inputs from brokers and independent financial institutions include, but are not limited to, yields or spreads of comparable investments which have recent trading activity, credit quality, duration, credit enhancements, collateral value and estimated cash flows based on inputs including delinquency rates, estimated defaults and losses, and estimates of the rate of future prepayments. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company's internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, the Company's internal investment professionals compared the valuation received to an independent third party pricing source and considered widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. If the Company believes that significant discrepancies exist, the Company will perform additional procedures, which may include specific inquiry of the pricing service, to resolve the discrepancies.

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 and highly liquid, direct obligations of the U.S. Government 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 agency

Table of Contents

securities, fixed maturity investments, and perpetual preferred stocks that are not actively traded. Included in Level 2 are \$5.5 million of securities, which are valued based upon a non-binding broker quote and validated with other observable market data by management. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes, for which the Company believes reflects fair value, but for which the Company is unable to verify inputs to the valuation methodology. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. Management reviews these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of March 31, 2012:

	Level 1	Level 2 (Dollars in thousands)	Level 3	Total
Fixed maturities:				
U.S. Government and government agency obligations	\$ 2,605	\$ 101,138	\$	\$ 103,743
Foreign government obligations		5,708		5,708
State and local government obligations		345,703	1,665	347,368
Residential mortgage-backed securities		225,482		225,482
Commercial mortgage-backed securities		31,848		31,848
Corporate obligations		224,344	7,121	231,465
Redeemable preferred stocks	7,831		470	8,301
Total fixed maturities	10,436	934,223	9,256	953,915
Equity securities:				
Common stocks	34,165			34,165
Perpetual preferred stocks	891	90	396	1,377
Total equity securities	35,056	90	396	35,542
Total fixed maturities and equity securities	45,492	934,313	9,652	989,457
Cash and cash equivalents	27,559			27,559
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$ 73,051	\$ 934,313	\$ 9,652	\$ 1,017,016

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of December 31, 2011:

	Level 1	Level 2 (Dollars in thousands)	Level 3	Total
Fixed maturities:				
U.S. Government and government agency obligations	\$ 2,637	\$ 101,370	\$	\$ 104,007
Foreign government obligations		5,723		5,723
State and local government obligations		338,675	1,572	340,247
Residential mortgage-backed securities		225,026		225,026
Commercial mortgage-backed securities		23,484		23,484
Corporate obligations		222,263	7,256	229,519
Redeemable preferred stocks	8,983	158	472	9,613
Total fixed maturities	11,620	916,699	9,300	937,619
Equity securities:				

Edgar Filing: National Interstate CORP - Form 10-Q

Common stocks	30,323			30,323
Perpetual preferred stocks	955	76	396	1,427
Total equity securities	31,278	76	396	31,750
Total fixed maturities and equity securities	42,898	916,775	9,696	969,369
Cash and cash equivalents	23,674			23,674
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$ 66,572	\$ 916,775	\$ 9,696	\$ 993,043

The tables above exclude investments in limited partnerships accounted for under the equity method of \$30.5 million and \$28.1 million (included in other invested assets) at March 31, 2012 and December 31, 2011, respectively. Equity method investments are not reported at fair value.

Table of Contents

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the three months ended March 31, 2012 there was a \$0.2 million redeemable preferred stock that transferred from Level 2 to Level 1 due to increased trading activity. 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 March 31, 2012.

	Three Months Ended March 31, 2012			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
Beginning balance at January 1, 2012	\$ 1,572	\$ 7,256	\$ 472	\$ 396
Total gains or (losses):				
Included in earnings				
Included in other comprehensive income	93	(87)	(2)	
Purchases and issuances				
Sales, settlements and redemptions		(48)		
Transfers in and/or (out) of Level 3				
Ending balance at March 31, 2012	\$ 1,665	\$ 7,121	\$ 470	\$ 396
The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date	\$	\$	\$	\$

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 March 31, 2011.

	Three Months Ended March 31, 2011			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
Beginning balance at January 1, 2011	\$ 3,992	\$ 2,290	\$ 2,429	\$ 396
Total gains or (losses):				
Included in earnings				
Included in other comprehensive income	218	50	(6)	
Purchases and issuances				
Sales, settlements and redemptions		(72)		
Transfers in and/or (out) of Level 3				
Ending balance at March 31, 2011	\$ 4,210	\$ 2,268	\$ 2,423	\$ 396
The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date	\$	\$	\$	\$

At March 31, 2012 the Company had eight securities with a fair value of \$9.7 million that are included in Level 3, which represented less than 1% of its total investments. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. The Company's internal investment professionals, who report to the Chief

Edgar Filing: National Interstate CORP - Form 10-Q

Investment Officer, review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The significant unobservable inputs used by the brokers and pricing services in establishing fair values of the Company's Level 3 securities are primarily spreads to U.S. Treasury rates and discounts to comparable securities. The specifics of such spreads and discounts were not made available to the Company, but have been corroborated via the Company's internal investment professionals' valuation review procedures. Significant increases (decreases) on spreads to U.S. Treasury rates and discount spreads to comparable securities would result in lower (higher) fair value measurements. Generally, a change in the assumption used for determining a spread is accompanied by market factors that warrant an adjustment for the credit risk and liquidity premium of the security. As the total fair value of Level 3 securities is less than 3% of the Company's shareholders' equity at March 31, 2012, any change in unobservable inputs would not have a material impact on the Company's financial position.

Table of Contents**4. Investments**

Under current other-than-temporary impairment accounting guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then an entity may separate the other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income (loss)). The credit related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge recorded in earnings is required to reduce the amortized cost of that security to fair value.

The cost or amortized cost and fair value of investments in fixed maturities and equity securities are as follows:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(Dollars in thousands)				
March 31, 2012:				
Fixed Maturities:				
U.S. Government and government agency obligations	\$ 97,565	\$ 6,191	\$ (13)	\$ 103,743
Foreign government obligations	5,645	63		5,708
State and local government obligations	334,124	13,795	(551)	347,368
Residential mortgage-backed securities	222,768	5,186	(2,472)	225,482
Commercial mortgage-backed securities	31,168	773	(93)	31,848
Corporate obligations	222,252	9,946	(733)	231,465
Redeemable preferred stocks	8,356	120	(175)	8,301
Total fixed maturities	921,878	36,074	(4,037)	953,915
Equity securities:				
Common stocks	29,684	4,798	(317)	34,165
Perpetual preferred stocks	1,308	81	(12)	1,377
Total equity securities	30,992	4,879	(329)	35,542
Total fixed maturities and equity securities	\$ 952,870	\$ 40,953	\$ (4,366)	\$ 989,457
December 31, 2011:				
Fixed Maturities:				
U.S. Government and government agency obligations	\$ 97,445	\$ 6,566	\$ (4)	\$ 104,007
Foreign government obligations	5,664	65	(6)	5,723
State and local government obligations	327,459	13,272	(484)	340,247
Residential mortgage-backed securities	223,960	4,815	(3,749)	225,026
Commercial mortgage-backed securities	23,104	464	(84)	23,484
Corporate obligations	223,563	7,774	(1,818)	229,519
Redeemable preferred stocks	10,168	182	(737)	9,613
Total fixed maturities	911,363	33,138	(6,882)	937,619
Equity securities:				
Common stocks	29,678	1,765	(1,120)	30,323
Perpetual preferred stocks	1,309	142	(24)	1,427
Total equity securities	30,987	1,907	(1,144)	31,750
Total fixed maturities and equity securities	\$ 942,350	\$ 35,045	\$ (8,026)	\$ 969,369

Edgar Filing: National Interstate CORP - Form 10-Q

The table above excludes investments in limited partnerships accounted for under the equity method of \$30.5 million and \$28.1 million (included in other invested assets) at March 31, 2012 and December 31, 2011, respectively. Equity method investments are not reported at fair value.

The amortized cost and fair value of fixed maturities at March 31, 2012, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 3.7 years in the Company's investment portfolio.

Table of Contents

Amortized cost and fair value of the fixed maturities in the Company's investment portfolio were as follows:

	Amortized Cost (Dollars in thousands)	Fair Value
Due in one year or less	\$ 16,300	\$ 16,796
Due after one year through five years	177,212	185,898
Due after five years through ten years	343,847	360,596
Due after ten years	130,583	133,295
	667,942	696,585
Mortgage-backed securities	253,936	257,330
Total	\$ 921,878	\$ 953,915

Gains and losses on the sale of investments, including other-than-temporary impairment charges and other investments' gains or losses, were as follows:

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Fixed maturity gains	\$ 443	\$ 433
Fixed maturity losses	(34)	
Equity security gains	89	571
Equity security losses	(107)	
Other investments, net (losses) gains	1,351	196
 Net realized gains on investments	 \$ 1,742	 \$ 1,200

Pre-tax net realized gains on investments of \$1.7 million for the three months ended March 31, 2012 were primarily generated from net gains associated with equity partnership investments of \$1.4 million and net realized gains associated with the sales of securities of \$0.4 million. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Offsetting these gains were other-than-temporary impairment charges of \$0.1 million on two equity securities. Pre-tax net realized gains on investments of \$1.2 million for the three months ended March 31, 2011 were generated from realized gains associated with the sales or calls of securities of \$1.0 million, which were primarily from common stocks, corporate obligations and municipal bonds and gains associated with equity partnerships of \$0.2 million.

Table of Contents

The following table summarizes the Company's gross unrealized losses on fixed maturities and equity securities and the length of time that individual securities have been in a continuous unrealized loss position:

	Less than Twelve Months				Twelve Months or More			
	Fair Value	Unrealized Losses	Fair Value as % of Cost	Number of Holdings (Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value as % of Cost	Number of Holdings
March 31, 2012:								
Fixed maturities:								
U.S. Government and government agency obligations	\$ 2,040	\$ (13)	99.4%	5	\$	\$		
State and local government obligations	17,151	(209)	98.8%	8	2,708	(342)	88.8%	3
Residential mortgage-backed securities	48,542	(557)	98.9%	21	9,402	(1,915)	83.1%	7
Commercial mortgage-backed securities	7,562	(38)	99.5%	3	1,953	(55)	97.3%	1
Corporate obligations	33,066	(733)	97.8%	62				
Redeemable preferred stocks	464	(12)	97.5%	2	3,217	(163)	95.2%	6
Total fixed maturities	108,825	(1,562)	98.6%	101	17,280	(2,475)	87.5%	17
Equity securities:								
Common stocks	5,438	(317)	94.5%	18				
Perpetual preferred stocks	9	(12)	42.9%	3				
Total equity securities	5,447	(329)	94.3%	21				
Total fixed maturities and equity securities	\$ 114,272	\$ (1,891)	98.4%	122	\$ 17,280	\$ (2,475)	87.5%	17
December 31, 2011:								
Fixed maturities:								
U.S. Government and government agency obligations	\$ 959	\$ (4)	99.6%	2	\$	\$		
Foreign government obligations	1,029	(6)	99.4%	1				
State and local government obligations	16,356	(28)	99.8%	6	3,633	(456)	88.8%	4
Residential mortgage-backed securities	54,588	(1,021)	98.2%	21	12,038	(2,728)	81.5%	8
Commercial mortgage-backed securities	5,040	(17)	99.7%	2	2,461	(67)	97.3%	1
Corporate obligations	48,786	(1,677)	96.7%	95	1,966	(141)	93.3%	2
Redeemable preferred stocks	426	(50)	89.5%	2	2,693	(687)	79.7%	6
Total fixed maturities	127,184	(2,803)	97.8%	129	22,791	(4,079)	84.8%	21
Equity securities:								
Common stocks	13,198	(1,120)	92.2%	39				
Perpetual preferred stocks	600	(24)	96.2%	3				
Total equity securities	13,798	(1,144)	92.3%	42				
Total fixed maturities and equity securities	\$ 140,982	\$ (3,947)	97.3%	171	\$ 22,791	\$ (4,079)	84.8%	21

The gross unrealized losses on the Company's fixed maturities and equity securities portfolios decreased from \$8.0 million at December 31, 2011 to \$4.4 million at March 31, 2012. The improvement in gross unrealized losses was driven by a decrease in market yields resulting from a general tightening of credit spreads from December 31, 2011 reflecting improved market sentiment regarding the global economy during the first quarter. The \$4.4 million in gross unrealized losses at March 31, 2012 was primarily on fixed maturity holdings in residential mortgage-backed securities, and to a lesser extent, corporate obligations, state and local government obligations and common stocks. The gross unrealized losses on common stocks of \$0.3 million were on 18 securities that have been in an unrealized loss position for twelve months or less. The gross unrealized losses on equity securities are considered to be temporary. Investment grade securities (as determined by nationally

Edgar Filing: National Interstate CORP - Form 10-Q

recognized rating agencies) represented 65.1% of all fixed maturity securities with unrealized losses.

At March 31, 2012, gross unrealized losses on residential mortgage-backed securities were \$2.5 million and represented 61.2% of the total gross unrealized losses on fixed maturities. There were 21 securities with gross unrealized losses of \$0.6 million that were in an unrealized loss position for less than 12 months and seven securities with gross unrealized losses of \$1.9 million that were in an unrealized loss position for 12 months or more. Four of these securities previously had both credit and non-credit other-than-temporary impairment charges and were in a gross unrealized loss position of \$1.9 million at March 31, 2012. Based on historical payment data and analysis of expected future cash flows of the underlying collateral, independent credit ratings and other facts and analysis, including management's current intent and ability to hold these securities for a period of time sufficient to allow for anticipated recovery, management believes that, based upon information currently available, the Company will recover its cost basis in all of these securities and no additional charges for other-than-temporary impairments will be required.

Table of Contents

At March 31, 2012, the corporate obligations had 62 holdings that were in an unrealized loss position of \$0.7 million for less than 12 months. Investment grade securities represented 56.8% of all corporate obligations with unrealized losses. The state and local government obligations, with gross unrealized losses of \$0.6 million, had eight holdings that were in an unrealized loss position of \$0.2 million for less than 12 months and three holdings with gross unrealized losses of \$0.4 million that were in an unrealized loss position for more than 12 months. Investment grade securities represented 70.2% of all state and local government obligations with unrealized losses greater than 12 months.

Management concluded that no additional charges for other-than-temporary impairment were required on the fixed maturity holdings in the first quarter of 2012 based on many factors, including the Company's ability and current intent to hold these investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent to which fair value has been below cost, analysis of company-specific financial data and the outlook for industry sectors and credit ratings. The Company believes these unrealized losses are primarily due to temporary market and sector-related factors and does not consider these securities to be other-than-temporarily impaired. If the Company's strategy was to change or these securities were determined to be other-than-temporarily impaired, the Company would recognize a write-down in accordance with its stated policy.

The following table is a progression of the amount related to credit losses on fixed maturity securities for which the non-credit portion of an other-than-temporary impairment has been recognized in other comprehensive income.

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Beginning balance	\$ 2,258	\$ 2,017
Additional credit impairments on:		
Previously impaired securities		
Securities without prior impairments		
Reductions		
Ending balance	\$ 2,258	\$ 2,017

5. Income Taxes

A reconciliation of the provision for income taxes for financial reporting purposes and the provision for income taxes calculated at the statutory rate of 35% is as follows:

	Three Months Ended March 31,	
	2012	2011⁽¹⁾
	(Dollars in thousands)	
Federal income tax expense at statutory rate	\$ 4,816	\$ 4,819
Effect of:		
Tax-exempt investment income	(913)	(634)
Other items, net	111	165
	\$ 4,014	\$ 4,350

⁽¹⁾ 2011 results have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under ASU 2010-26.

Table of Contents

The tax effects of temporary differences that give rise to significant portions of the net deferred tax assets and liabilities in the Consolidated Balance Sheets were as follows:

	March 31, 2012	December 31, 2011 ⁽¹⁾
	(Dollars in thousands)	
Deferred Tax Assets:		
Unearned premiums	\$ 13,736	\$ 13,952
Unpaid losses and loss adjustment expenses	19,070	18,821
Assignments and assessments	1,755	1,632
Realized losses on investments, primarily impairments	5,877	5,873
Accrued compensation	2,318	3,565
Limited partnership investments	980	1,167
Other, net	3,065	3,314
	46,801	48,324
Deferred Tax Liabilities:		
Deferred policy acquisition costs	(8,900)	(8,611)
Unrealized gains on investments	(12,805)	(9,456)
Intangible assets	(2,999)	(3,023)
Other, net	(979)	(993)
	(25,683)	(22,083)
Net deferred income tax assets	\$ 21,118	\$ 26,241

⁽¹⁾ 2011 results have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under ASU 2010-26.

Management has reviewed the recoverability of the deferred tax assets and believes that the amount will be recoverable against future earnings.

6. Shareholders Equity and Stock-Based Compensation

The Company grants options and other stock awards to officers and key employees of the Company under the Long Term Incentive Plan (LTIP). At March 31, 2012, there were options for 655,085 shares outstanding and 749,000 of the Company's common shares reserved for issuance 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.

For the three months ended March 31, 2012 and 2011, the Company recognized stock-based compensation expense of \$0.2 million and \$0.3 million, respectively, with related income tax benefits of approximately \$0.1 million in both periods.

7. Earnings Per Common Share

The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended March 31,	
	2012	2011 ⁽¹⁾
	(In thousands, except per share data)	
Net income	\$ 9,746	\$ 9,418

Edgar Filing: National Interstate CORP - Form 10-Q

Weighted average shares outstanding during period	19,409	19,366
Additional shares issuable under employee common stock option plans using treasury stock method	134	109
Weighted average shares outstanding assuming exercise of stock options	19,543	19,475
Net income per share:		
Basic	\$ 0.50	\$ 0.49
Diluted	\$ 0.50	\$ 0.48

⁽¹⁾ 2011 results have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under ASU 2010-26.

For the three months ended March 31, 2012 and 2011, there were 204,110 and 170,000, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive.

Table of Contents**8. 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 March 31, 2012, Great American owned 52.4% of the outstanding shares of the Company. 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 underwritten pursuant to the reinsurance agreement. NIIA provides administrative services to Great American in connection with Great American's underwriting of these risks. The Company also cedes premium through reinsurance agreements with Great American to reduce exposure in certain of its property and casualty insurance programs.

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

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Assumed premiums written	\$ 683	\$ 1,208
Assumed premiums earned	859	980
Assumed losses and loss adjustment expense incurred	728	1,088
Ceded premiums written	19	333
Ceded premiums earned	68	466
Ceded losses and loss adjustment expense recoveries	395	787
Receivable from Great American as of period end	12	236

During the second quarter of 2011, NIIC began writing its Florida recreational vehicle risks through TCC versus GAIC, thus accounting for the decline in assumed premiums written from GAIC. The decline in risks ceded to GAIC is representative of the fact that GAIC currently only participates as a reinsurer on one of NIIC's reinsurance treaties as compared to three treaties in 2011.

Great American or its parent, American Financial Group, Inc., perform 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 the Company. This could impact the Company's personnel resources, require the Company to hire additional professional staff and generally increase the Company's 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, NIIC-HI and VIC are parties to reinsurance agreements with Validus Reinsurance, Ltd. (Validus), whereby Validus participates on the Company's Hawaii property quota share, Hawaii property catastrophe and workers' compensation excess of loss reinsurance treaties. During the first quarter of 2012, the Company's ceded premiums written and ceding commissions associated with Validus' participation on these treaties were \$0.4 million and \$0.1 million, respectively. These treaties were negotiated at arms length through an independent reinsurance broker as part of the Company's customary reinsurance evaluation and placement process. One of the Company's directors is the president and chief financial officer of Validus Holdings, Ltd., the parent of Validus.

9. Reinsurance

Premiums and reinsurance activity consisted of the following:

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Direct premiums written	\$ 127,961	\$ 131,851
Reinsurance assumed	2,264	2,462
Reinsurance ceded	(23,510)	(24,061)

Edgar Filing: National Interstate CORP - Form 10-Q

Net premiums written	\$ 106,715	\$ 110,252
Direct premiums earned	\$ 128,102	\$ 123,486
Reinsurance assumed	2,263	2,484
Reinsurance ceded	(20,240)	(20,831)
Premiums earned	\$ 110,125	\$ 105,139

Table of Contents

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 March 31, 2012 and 2011 were \$12.4 million and \$13.5 million. 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.

10. 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 the Company's loss and loss adjustment expense (LAE) 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 the Company's compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended.

The Company's subsidiaries also have lawsuits pending in which the plaintiff seeks extra-contractual damages from the Company in addition to damages claimed or in excess of the available limits under an insurance policy. These lawsuits, which are in various stages, generally mirror similar lawsuits filed against other carriers in the industry. Although the Company is vigorously defending these lawsuits, the outcomes of these cases cannot be determined at this time. In accordance with current accounting standards for loss contingencies and based upon information currently known to the Company, reserves are established for litigation when it is probable that a loss associated with a claim or proceeding has been incurred and the amount of the loss or range of loss can be reasonably estimated. As such, the Company has established loss and LAE reserves for lawsuits as to which the Company has determined that a loss is both probable and estimable. In addition to these case reserves, the Company also establishes reserves for claims incurred but not reported to cover unknown exposures and adverse development on known exposures. Based on currently available information, the Company believes that reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on the Company's financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by the Company for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on the Company's financial condition, cash flows and results of operations.

As a direct writer of insurance, the Company receives assessments by state funds to cover losses to policyholders of insolvent or rehabilitated companies and other authorized fees. These mandatory assessments may be partially recovered through a reduction in future premium taxes in some states over several years. At March 31, 2012 and December 31, 2011, the liability for such assessments was \$5.2 million and \$4.8 million, respectively, and will be paid over several years as assessed by the various state funds.

11. Segment Information

The Company operates its business as one segment, property and casualty insurance. The Company manages this segment through a product management structure. The following table shows revenues summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services.

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Revenue:		
Premiums Earned:		
Alternative Risk Transfer	\$ 58,210	\$ 46,108
Transportation	35,137	40,387
Specialty Personal Lines	11,817	13,862
Hawaii and Alaska	3,384	3,362
Other	1,577	1,420
Total premiums earned	110,125	105,139
Net investment income	9,183	6,902
Net realized gains on investments	1,742	1,200

Edgar Filing: National Interstate CORP - Form 10-Q

Other	829	1,116
Total revenues	\$ 121,879	\$ 114,357

Table of Contents

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This document, including information incorporated by reference, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995). All statements, trend analyses and other information contained in this Form 10-Q relative to markets for our products and trends in our operations or financial results, as well as other statements including words such as may, target, anticipate, believe, plan, estimate, expect, intend, project, and other similar expressions, constitute forward-looking statements. We made these statements based on our plans and current analyses of our business and the insurance industry as a whole. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Factors that could contribute to these differences include, among other things:

general economic conditions, weakness of the financial markets and other factors, including prevailing interest rate levels and stock and credit market performance, which may affect or continue to affect (among other things) our ability to sell our products and to collect amounts due to us, our ability to access capital resources and the costs associated with such access to capital and the market value of our investments;

our ability to manage our growth strategy;

customer response to new products and marketing initiatives;

tax law and accounting changes;

increasing competition in the sale of our insurance products and services and the retention of existing customers;

changes in legal environment;

regulatory changes or actions, including those relating to the regulation of the sale, underwriting and pricing of insurance products and services and capital requirements;

levels of natural catastrophes, terrorist events, incidents of war and other major losses;

adequacy of insurance reserves; and

availability of reinsurance and ability of reinsurers to pay their obligations.

The forward-looking statements herein are made only as of the date of this report. We assume no obligation to publicly update any forward-looking statements.

General

We underwrite and sell traditional and alternative risk transfer (ART) property and casualty insurance products primarily to the passenger transportation industry, the trucking industry and to moving and storage transportation companies, general commercial insurance to small

Edgar Filing: National Interstate CORP - Form 10-Q

businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles and commercial vehicles throughout the United States.

Effective July 1, 2010, we and our principal insurance subsidiary, National Interstate Insurance Company (NIIC), completed the acquisition of Vanliner Group, Inc. (Vanliner) from UniGroup, Inc. (UniGroup) whereby NIIC acquired all of the issued and outstanding capital stock of Vanliner and we acquired certain information technology assets. As part of this acquisition, UniGroup agreed to provide us with comprehensive financial guarantees, including a four and a half-year balance sheet guaranty whereby both favorable and unfavorable balance sheet developments inure to UniGroup. Through the acquisition of Vanliner, NIIC acquired Vanliner Insurance Company (VIC), a market leader in providing insurance for the moving and storage industry. Obtaining a presence in this industry was our primary strategic objective associated with the acquisition.

We have five property and casualty insurance subsidiaries: NIIC, VIC, National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI), Triumpe Casualty Company (TCC), Hudson Indemnity, Ltd. (HIL) and five active agency and service subsidiaries. We write our insurance policies on a direct basis through NIIC, VIC, NIIC-HI and TCC. NIIC and VIC are licensed

Table of Contents

in all 50 states and the District of Columbia. NIIC-HI is licensed in Ohio, Hawaii, Michigan and New Jersey. TCC holds licenses for multiple lines of authority, including auto-related lines, in 26 states and the District of Columbia. HIL is domiciled in the Cayman Islands and provides reinsurance for NIIC, VIC, NIIC-HI and TCC, primarily for the ART component. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, program administrators, affiliated agencies and agent internet initiatives. We use our five active agency and service subsidiaries to sell and service our insurance business.

As of March 31, 2012, Great American Insurance Company (Great American) owned 52.4% of our outstanding common shares. Great American is a wholly-owned subsidiary of American Financial Group, Inc.

Results of Operations**Overview**

Through the operations of our subsidiaries, we are engaged in property and casualty insurance operations. We generate underwriting profits by providing what we view as specialized insurance products, services and programs not generally available in the marketplace. We focus on niche insurance markets where we offer insurance products designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry.

We derive our revenues primarily from premiums generated by our insurance policies and income from our investment portfolio. Our expenses consist primarily of losses and loss adjustment expenses (LAE), commissions and other underwriting expenses and other operating and general expenses.

The following table sets forth our March 31, 2012 and 2011 net income from operations and the after-tax impact from the operating results of Vanliner's guaranteed runoff business, which are non-GAAP financial measures, as well as after-tax net realized gains from investments and net income, all of which we believe are useful tools for investors and analysts in analyzing ongoing operating trends.

	2012		2011 ⁽¹⁾	
	Amount	Per Share	Amount	Per Share
	(Dollars in thousands, except per share data)			
Net income from operations	\$ 8,564	\$ 0.44	\$ 9,909	\$ 0.51
After-tax net realized gain from investments	1,132	0.06	780	0.04
After-tax impact from balance sheet guaranty for Vanliner	50	0.00	(1,271)	(0.07)
Net income	\$ 9,746	\$ 0.50	\$ 9,418	\$ 0.48

⁽¹⁾ 2011 results have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under Accounting Standards Update No. 2010-26 (ASU 2010-26).

As discussed above, UniGroup provided us with comprehensive financial guarantees related to the runoff of Vanliner's final balance sheet whereby both favorable and unfavorable balance sheet development inures to the seller. In accordance with purchase accounting requirements we were required to determine the fair value of the future economic benefit of the financial guarantees and acquired loss reserves as of the date of acquisition, despite the fact that certain gains and losses related to the financial guaranty would be reflected in operations as they are incurred in future periods. As a result, the recognition of the revenues and expenses associated with the guaranteed runoff business will not occur in the same period and will result in combined ratios which are inconsistent with the negotiated combined ratio which was to approximate 100% for the Vanliner guaranteed business. As such, the after-tax impact from the runoff business guaranteed by the seller for the three months ended March 31, 2012 and 2011 have been removed from the net after-tax earnings from operations to reflect only those results of the ongoing business.

Our net income from operations for the first quarter of 2012 was \$8.6 million (\$0.44 per share diluted) compared to \$9.9 million (\$0.51 per share diluted) for the same period in 2011. This decrease was driven by the elevated loss and LAE ratio from our ongoing operations, which excludes the impact from the runoff of the guaranteed Vanliner business, of 73.1% for the three months ended March 31, 2012 as compared to 67.0% for the same period in 2011. This 6.1 percentage point increase was driven by higher than average claims severity experienced in two historically

Edgar Filing: National Interstate CORP - Form 10-Q

high-performing products within our Hawaii and Alaska and ART transportation components during the first quarter of 2012, as well as adverse claim development from prior years' loss reserves. Partially offsetting the elevated loss results was the growth in net investment income, which was attributable to the shift into higher-yielding state and local government obligations and mortgage-backed securities that was concentrated in the second half of 2011.

Table of Contents

We recorded after-tax net realized gains from investments of \$1.1 million (\$0.06 per share diluted) for the first quarter of 2012 compared to \$0.8 million (\$0.04 per share diluted) for the same period in 2011. The after-tax net realized gains for the three months ended March 31, 2012 were primarily generated by net gains associated with equity partnership investments, while the after-tax net realized gains for the comparable period in 2011 related primarily to sales of securities.

Gross Premiums Written

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following table sets forth an analysis of gross premiums written by business component during the periods indicated:

	Three Months Ended March 31,		2011	
	2012	Percent	Amount	Percent
	Amount	(Dollars in thousands)		Percent
Alternative Risk Transfer	\$ 76,438	58.7%	\$ 80,861	60.2%
Transportation	35,207	27.0%	34,097	25.4%
Specialty Personal Lines	13,053	10.0%	14,660	10.9%
Hawaii and Alaska	3,880	3.0%	3,678	2.7%
Other	1,647	1.3%	1,017	0.8%
Gross premiums written	\$ 130,225	100.0%	\$ 134,313	100.0%

Gross premiums written includes both direct and assumed premium. During the first quarter of 2012, our gross premiums written decreased \$4.1 million, or 3.0%, compared to the same period in 2011, primarily due to the impact from actions taken in 2011 in two ART programs, as previously reported. These programs, one of which underwent significant underwriting actions while the other was terminated, comprised 6.9% of our gross premiums written during the first quarter of 2011. Gross premiums written in our ART component decreased \$4.4 million, or 5.5%, during the first quarter of 2012 compared to the same period in 2011. Excluding the impact of the two aforementioned programs, the remainder of our ART component increased \$3.7 million, or 5.1%, due to a combination of growth in existing ART programs, both from the addition of new customers and an increase in exposures on renewal business, and near 100% member retention in group ART programs renewing during the period. Our transportation component's gross premiums written increased by \$1.1 million, or 3.3%, in the first quarter of 2012 compared to the same period in 2011, primarily due to growth in our trucking transportation product which benefited from increases in both rates and exposures during the period, as we have begun to see the effects of a gradually improving commercial insurance market. The decrease of \$1.6 million, or 11.0%, in our specialty personal lines component was primarily related to the impact of the ongoing pricing and underwriting actions associated with the commercial vehicle product which have continued into 2012. We also experienced a decrease in our recreational vehicle product due to the continued trend toward recreational vehicle owners going directly to insurance companies for quotes versus using an agent.

Our group ART programs, which focus on specialty or niche businesses, provide various services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention and reinsurance placement, along with providing various types of property and casualty insurance coverage. Insurance coverage is provided primarily to companies with similar risk profiles and to specified classes of business of our agent partners.

As part of our ART programs, we have analyzed, on a quarterly basis, members' loss performance on a policy year basis to determine if there would be a premium assessment to participants or if there would be a return of premium to participants as a result of less-than-expected losses. Assessment premium and return of premium are recorded as adjustments to premiums written (assessments increase premiums written; returns of premium reduce premiums written). For the first quarter of 2012 and 2011, we recorded premium assessments of \$1.5 million and \$1.2 million, respectively.

Table of Contents**Premiums Earned**

Three months ended March 31, 2012 compared to March 31, 2011. The following table shows premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

	Three Months Ended March 31,		Change	
	2012	2011	Amount	Percent
	(Dollars in thousands)			
Premiums earned:				
Alternative Risk Transfer	\$ 58,210	\$ 46,108	\$ 12,102	26.2%
Transportation	35,137	40,387	(5,250)	(13.0%)
Specialty Personal Lines	11,817	13,862	(2,045)	(14.8%)
Hawaii and Alaska	3,384	3,362	22	0.7%
Other	1,577	1,420	157	11.1%
Total premiums earned	\$ 110,125	\$ 105,139	\$ 4,986	4.7%

Our premiums earned increased \$5.0 million, or 4.7%, to \$110.1 million during the three months ended March 31, 2012 compared to \$105.1 million for the same period in 2011. The increase is primarily attributable to our ART component, which grew \$12.1 million, or 26.2%, over 2011 mainly due to the gross premiums written growth from existing and new programs experienced throughout 2011. Partially offsetting this increase were decreases in our transportation and specialty personal lines components of \$5.3 million, or 13.0%, and \$2.0 million, or 14.8%, respectively. The \$5.3 million decline in our transportation component was driven by a \$15.1 million decrease related to the runoff of Vanliner's earned premiums related to the business covered by the balance sheet guaranty, which was partially offset by growth experienced in our moving and storage products throughout 2011. The decrease in our specialty personal lines component was due to the decline in premiums written in our commercial vehicle and recreational vehicle products experienced throughout 2011.

Underwriting and Loss Ratio Analysis

Underwriting profitability, as opposed to overall profitability or net earnings, is measured by the combined ratio. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. A combined ratio under 100% is indicative of an underwriting profit.

Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to accurately estimate losses and LAE at the time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period.

Our underwriting expense ratio includes commissions and other underwriting expenses and other operating and general expenses, offset by other income. Commissions and other underwriting expenses consist principally of brokerage and agent commissions reduced by ceding commissions received from assuming reinsurers, and vary depending upon the amount and types of contracts written and, to a lesser extent, premium taxes.

Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. After several years of modest single digit decreases in rate levels on our renewal business as a whole, beginning in 2011 and continuing into the first quarter of 2012, we saw rate levels begin to stabilize on renewal business, with a number of our products experiencing single digit rate level increases on renewal business.

Table of Contents

The table below presents our net premiums earned and combined ratios for the periods indicated:

	Three Months Ended March 31,	
	2012	2011
	(Dollars in thousands)	
Gross premiums written	\$ 130,225	\$ 134,313
Ceded reinsurance	(23,510)	(24,061)
Net premiums written	106,715	110,252
Change in unearned premiums, net of ceded	3,410	(5,113)
Total premiums earned	\$ 110,125	\$ 105,139
Combined Ratios:		
Loss and LAE ratio ⁽¹⁾	73.1%	71.0%
Underwriting expense ratio ^{(2) (3)}	23.3%	22.8%
Combined ratio	96.4%	93.8%

(1) The ratio of losses and LAE to premiums earned.

(2) The ratio of the sum of commissions and other underwriting expenses, other operating expenses less other income to premiums earned.

(3) 2011 results have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under ASU 2010-26.

Three months ended March 31, 2012 compared to March 31, 2011. Our consolidated loss and LAE ratio for the first quarter of 2012 increased 2.1 percentage points to 73.1% compared to 71.0% in the same period in 2011. The loss and LAE ratio for our ongoing operations, which excludes the impact from the runoff of the guaranteed Vanliner business, was 73.1% for the three months ended March 31, 2012 compared to 67.0% for the same period in 2011. This increase over the prior period is primarily attributable to higher than average claims severity experienced in two historically high-performing products within our Hawaii and Alaska and ART transportation components during the first quarter of 2012, as well as adverse claim development from prior years' loss reserves. For the first quarter of 2012, we had unfavorable development from prior years' loss reserves of \$1.9 million, or 1.8 percentage points, compared to unfavorable development of \$0.2 million, or 0.2 percentage points, in the first quarter of 2011. This unfavorable development was primarily related to settlements above the established case reserves and revisions to our estimated future settlements on an individual case by case basis. The prior years' loss reserve development for both periods is not considered to be unusual or significant to prior years' reserves based on the history of our business and the timing of events in the claims adjustment process.

The consolidated underwriting expense ratio for the first quarter of 2012 increased 0.5 percentage points to 23.3% compared to 22.8% for the same period in 2011. The underwriting expense ratio for our ongoing business remained relatively flat at 23.3% and 23.6% for the three months ended March 31, 2012 and 2011, respectively.

Net Investment Income

Three months ended March 31, 2012 compared to March 31, 2011. Net investment income increased \$2.3 million, or 33.0%, to \$9.2 million in the first quarter of 2012 compared to the same period in 2011, primarily due to a shift into higher-yielding securities, such as state and local government obligations and mortgage-backed securities with a decreased focus on lower yielding U.S. government and government agency obligations which were concentrated in the second half of 2011.

Net Realized Gains (Losses) on Investments

Three months ended March 31, 2012 compared to March 31, 2011. Pre-tax net realized gains on investments were \$1.7 million for the first quarter of 2012 compared to \$1.2 million for the first quarter of 2011. The pre-tax net realized gains for the first quarter of 2012 were primarily generated from net gains associated with equity partnership investments of \$1.4 million and realized gains associated with sales of securities

Edgar Filing: National Interstate CORP - Form 10-Q

totaling \$0.4 million. Offsetting these gains were other-than-temporary impairment charges of \$0.1 million for the quarter ending March 31, 2012. The pre-tax net realized gains for the first quarter of 2011 were generated from net realized gains from the sales of securities of \$1.0 million and gains associated with equity partnership investments of \$0.2 million.

Commissions and Other Underwriting Expenses

Three months ended March 31, 2012 compared to March 31, 2011. During the first quarter of 2012, commissions and other underwriting expenses of \$21.5 million increased \$1.0 million, or 5.1%, from \$20.5 million in the comparable period in 2011, primarily attributable to a slight change in business mix written during the period. Commissions and other underwriting expenses, as a percentage of premiums earned, were relatively flat at 19.6% and 19.5% for the three months ending March 31, 2012 and 2011, respectively. Commissions and other underwriting expenses for the first quarter of 2011 have been retrospectively adjusted for the changes to accounting for deferred policy acquisition costs required under ASU 2010-26.

Table of Contents**Other Operating and General Expenses**

Three months ended March 31, 2012 compared to March 31, 2011. Other operating and general expenses increased \$0.4 million, or 8.6%, to \$4.9 million during the quarter ended March 31, 2012 compared to \$4.5 million for the same period in 2011, primarily due to growth in our employee headcount. Other operating and general expenses, as a percentage of premiums earned, were relatively flat at 4.5% and 4.3% for the first quarters of 2012 and 2011, respectively.

Income Taxes

Three months ended March 31, 2012 compared to March 31, 2011. The effective tax rate of 29.2% for the three month period ended March 31, 2012 decreased 2.4 percentage points, from 31.6%, as compared to the same period in 2011, primarily attributable to an increase in tax-exempt investment income.

Financial Condition**Investments**

At March 31, 2012, our investment portfolio contained \$953.9 million in fixed maturity securities and \$35.5 million in equity securities, all carried at fair value, with unrealized gains and losses reported as a separate component of shareholders' equity and \$30.5 million in other investments, which are limited partnership investments accounted for in accordance with the equity method. At March 31, 2012, we had pre-tax net unrealized gains of \$32.0 million on fixed maturities and \$4.6 million on equity securities. Our investment portfolio allocation is based on diversification among primarily high quality fixed maturity investments and guidelines in our investment policy.

At March 31, 2012, 89.2% of the fixed maturities in our portfolio were rated investment grade (credit rating of AAA to BBB-) by nationally recognized rating agencies. Investment grade securities generally bear lower degrees of risk and corresponding lower yields than those that are unrated or non-investment grade.

Summary information for securities with unrealized gains or losses at March 31, 2012 is shown in the following table. Approximately \$4.4 million of fixed maturities and \$0.6 million of equity securities had no unrealized gains or losses at March 31, 2012.

	Securities with Unrealized Gains	Securities with Unrealized Losses
	(Dollars in thousands)	
Fixed Maturities:		
Fair value of securities	\$ 823,387	\$ 126,105
Amortized cost of securities	787,313	130,142
Gross unrealized gain or (loss)	\$ 36,074	\$ (4,037)
Fair value as a % of amortized cost	104.6%	96.9%
Number of security positions held	721	118
Number individually exceeding \$50,000 gain or (loss)	254	13
Concentration of gains or losses by type or industry:		
U.S. Government and government agencies	\$ 6,191	\$ (13)
Foreign governments	63	
State, municipalities and political subdivisions	13,795	(551)
Residential mortgage-backed securities	5,186	(2,472)
Commercial mortgage-backed securities	773	(93)
Banks, insurance and brokers	3,821	(246)
Industrial and other	6,245	(662)
Percent rated investment grade (a)	92.9%	65.1%
Equity Securities:		
Fair value of securities	\$ 29,470	\$ 5,447
Cost of securities	24,591	5,776
Gross unrealized gain or (loss)	\$ 4,879	\$ (329)
Fair value as a % of cost	119.8%	94.3%

Edgar Filing: National Interstate CORP - Form 10-Q

Number individually exceeding \$50,000 gain or (loss) 22 1

(a) Investment grade of AAA to BBB- by nationally recognized rating agencies.

24

Table of Contents

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at March 31, 2012, based on their fair values. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

	Securities with Unrealized Gains	Securities with Unrealized Losses
Maturity:		
One year or less	1.8%	0.0%
After one year through five years	21.0%	7.7%
After five years through ten years	40.1%	24.4%
After ten years	14.0%	14.4%
	76.9%	46.5%
Mortgage-backed securities	23.1%	53.5%
	100.0%	100.00%

The table below summarizes the unrealized gains and losses on fixed maturities and equity securities by dollar amount.

	At March 31, 2012		
	Aggregate Fair Value	Aggregate Unrealized Gain (Loss) (Dollars in thousands)	Fair Value as % of Cost Basis
Fixed Maturities:			
Securities with unrealized gains:			
Exceeding \$50,000 and for:			
Less than one year (199 issues)	\$ 394,903	\$ 20,617	105.5%
More than one year (55 issues)	93,343	7,671	109.0%
Less than \$50,000 (467 issues)	335,141	7,786	102.4%
	\$ 823,387	\$ 36,074	
Securities with unrealized losses:			
Exceeding \$50,000 and for:			
Less than one year (5 issues)	\$ 16,232	\$ (431)	97.4%
More than one year (8 issues)	10,930	(2,298)	82.6%
Less than \$50,000 (105 issues)	98,943	(1,308)	98.7%
	\$ 126,105	\$ (4,037)	
Equity Securities:			
Securities with unrealized gains:			
Exceeding \$50,000 and for:			
Less than one year (14 issues)	\$ 12,291	\$ 2,332	123.4%
More than one year (8 issues)	7,153	1,725	131.8%
Less than \$50,000 (58 issues)	10,026	822	108.9%
	\$ 29,470	\$ 4,879	
Securities with unrealized losses:			
Exceeding \$50,000 and for:			

Edgar Filing: National Interstate CORP - Form 10-Q

Less than one year (1 issue)	\$ 1,993	\$ (106)	94.9%
More than one year (0 issues)			0.0%
Less than \$50,000 (20 issues)	3,454	(223)	93.9%
	\$ 5,447	\$ (329)	

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include those discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations Other-Than-Temporary Impairment.

Liquidity and Capital Resources

The liquidity requirements of our insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and payments of dividends and taxes to us from insurance subsidiaries. Historically and during the first three months of 2012, cash flows from premiums and investment income have provided sufficient funds to meet these requirements, without requiring significant liquidation of investments. If our cash flows change dramatically from historical patterns, for example as a result of a decrease in premiums, an increase in claims paid or operating expenses, or financing an acquisition, we may be required to sell securities before their maturity and possibly at a loss. Our insurance subsidiaries generally hold a

Table of Contents

significant amount of highly liquid, short-term investments or cash and cash equivalents to meet their liquidity needs. Our historic pattern of using receipts from current premium writings for the payment of liabilities incurred in prior periods provides us with the option to extend the maturities of our investment portfolio beyond the estimated settlement date of our loss reserves. Funds received in excess of cash requirements are generally invested in additional marketable securities.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Our principal sources of liquidity are our existing cash, cash equivalents and short-term investments. Cash and cash equivalents increased \$3.9 million from \$23.7 million at December 31, 2011 to \$27.6 million at March 31, 2012. We generated net cash from operations of \$20.0 million for the three months ended March 31, 2012, compared to \$10.7 million during the comparable period in 2011. This increase of \$9.3 million primarily relates to a lower estimated federal income tax payment made in the first quarter of 2012 as compared to the same period in 2011, as well as various fluctuations within our operating activities. The first quarter 2011 estimated tax payment included \$8.4 million associated with the Vanliner acquisition (included in the line item Increase (decrease) in accounts payable, commissions and other liabilities and assessments and fees payable on our Consolidated Statement of Cash Flows at March 31, 2011), which was offset by cash received of an equal amount included in Collection of amounts refundable on the purchase price of Vanliner in the investing activities section of our Consolidated Statement of Cash Flows for the three months ended March 31, 2011.

Net cash used in investing activities was \$14.1 million and \$10.9 million for the three months ended March 31, 2012 and 2011, respectively. Contributing to the \$3.2 million increase in cash used in investing activities was a \$44.2 million decrease in the proceeds from maturities and redemptions of fixed maturity investments, mostly offset by a \$42.2 million decrease in the purchases of fixed maturity investments. The decreases in investment activity in 2012 was due to a large number of securities obtained as part of the Vanliner acquisition maturing during the first quarter of 2011, and the subsequent reinvestment of the proceeds from those securities. The net purchases of fixed maturities during the first quarter of 2012 were primarily concentrated in mortgage-backed securities and state and local government obligations. Also impacting the change in cash used in investing activities was the receipt of the \$14.3 million refund in the first quarter of 2011 on the purchase price of Vanliner related to making the election under Section 338(h)(10) of the Internal Revenue Code and the finalization of the tangible book value, an \$8.9 million decrease in the purchases of other investments, which are comprised of limited partnership investments, and a \$4.8 million decrease in the purchases of equity securities.

Net cash used in financing activities was \$2.0 million and \$1.8 million for the three months ended March 31, 2012 and 2011, respectively. This \$0.2 million increase in cash used in financing activities was primarily driven by the increase in the quarterly dividends paid on our common shares. Our financing activities also include those related to stock option activity.

We have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends and taxes. Funds to meet these obligations will come primarily from parent company cash, dividends and other payments from our insurance company subsidiaries.

We have a \$50.0 million unsecured Credit Agreement (the Credit Agreement) that terminates in December 2012, which includes a sublimit of \$10.0 million for letters of credit. We have the ability to increase the line of credit to \$75.0 million subject to the Credit Agreement's accordion feature. At March 31, 2012 there was \$22.0 million drawn on this credit facility. Amounts borrowed bear interest at either (1) a rate per annum equal to the greater of the administrative agent's prime rate or 0.5% in excess of the federal funds effective rate or (2) rates ranging from 0.45% to 0.90% over LIBOR based on our A.M. Best insurance group rating, or 0.65% at March 31, 2012. As of March 31, 2012, the interest rate on this debt is equal to the six-month LIBOR (0.50% at March 31, 2012) plus 65 basis points, with interest payments due quarterly.

The Credit Agreement requires us to maintain specified financial covenants measured on a quarterly basis, including consolidated net worth, fixed charge coverage ratio and debt-to-capital ratio. In addition, the Credit Agreement contains certain affirmative and negative covenants, including negative covenants that limit or restrict our ability to, among other things, incur additional indebtedness, effect mergers or consolidations, make investments, enter into asset sales, create liens, enter into transactions with affiliates and other restrictions customarily contained in such agreements. As of March 31, 2012, we were in compliance with all financial covenants.

We expect to procure a new line of credit during 2012 to replace the current Credit Agreement prior to its expiration, although potentially at a higher cost. Due to the favorable terms of the Credit Agreement relative to those currently available in the commercial lending marketplace, we do not anticipate executing a new credit facility until the latter half of 2012.

Table of Contents

We believe that funds generated from operations, including dividends from insurance subsidiaries and parent company cash will provide sufficient resources to meet our liquidity requirements for at least the next 12 months. However, if these funds are insufficient to meet fixed charges in any period, we would be required to generate cash through sale of assets, sale of portfolio securities or similar transactions. If we were required to sell portfolio securities early for liquidity purposes rather than holding them to maturity, we would recognize gains or losses on those securities earlier than anticipated. Our ongoing corporate initiatives include actively evaluating potential acquisitions. At such time that we would execute an agreement to enter into an acquisition, such a transaction, depending upon the structure and size, could have an impact on our liquidity. Since our ability to meet our obligations in the long-term (beyond a 12-month period) is dependent upon factors such as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our long-term operating needs. We are not aware of any trends or uncertainties affecting our liquidity, including any significant future reliance on short-term financing arrangements.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of losses and LAE reserves and the determination of other-than-temporary impairment on investments are the two areas where the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical. For a more detailed discussion of these policies, see Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2011.

Losses and LAE Reserves

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of that loss to us and our final payment of that loss and its related LAE. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. At March 31, 2012 and December 31, 2011, we had \$781.8 million and \$776.6 million, respectively, of gross loss and LAE reserves, representing management s best estimate of the ultimate loss. Management records, on a monthly and quarterly basis, its best estimate of loss reserves. For purposes of computing the recorded reserves, management utilizes various data inputs, including analysis that is derived from a review of prior quarter results performed by actuaries employed by Great American. In addition, on an annual basis, actuaries from Great American review the recorded reserves for NIIC, VIC, NIIC-HI and TCC utilizing current period data and provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by these U.S. insurance subsidiaries. The actuarial analysis of NIIC s, VIC s, NIIC-HI s and TCC s net reserves for the year ending December 31, 2011 reflected point estimates that were within 2% of management s recorded net reserves as of such dates. Using this actuarial data along with its other data inputs, management concluded that the recorded reserves appropriately reflect management s best estimates of the liability as of March 31, 2012 and December 31, 2011.

The quarterly reviews of unpaid loss and LAE reserves by Great American actuaries are prepared using standard actuarial techniques. These may include (but may not be limited to):

the Case Incurred Development Method;

the Paid Development Method;

the Bornhuetter-Ferguson Method; and

the Incremental Paid LAE to Paid Loss Methods.

The period of time from the occurrence of a loss through the settlement of the liability is referred to as the tail. Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to settle particular claims. For short-tail lines, management tends to give more weight to the Case Incurred and Paid Development methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved and more weight may be given to the Bornhuetter-Ferguson method. Liability claims for long-tail lines are more

Edgar Filing: National Interstate CORP - Form 10-Q

susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to a higher degree of variability.

Table of Contents

Supplementary statistical information is reviewed to determine which methods are most appropriate and whether adjustments are needed to particular methods. This information includes:

open and closed claim counts;

average case reserves and average incurred on open claims;

closure rates and statistics related to closed and open claim percentages;

average closed claim severity;

ultimate claim severity;

reported loss ratios;

projected ultimate loss ratios; and

loss payment patterns.

Other-Than-Temporary Impairment

Our investments are exposed to at least one of three primary sources of investment risk: credit, interest rate and market valuation risks. The financial statement risks are those associated with the recognition of impairments and income, as well as the determination of fair values. We evaluate whether impairments have occurred on a case-by-case basis. Management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause and amount of decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations we use in the impairment evaluation process include, but are not limited to:

the length of time and the extent to which the market value has been below amortized cost;

whether the issuer is experiencing significant financial difficulties;

economic stability of an entire industry sector or subsection;

whether the issuer, series of issuers or industry has a catastrophic type of loss;

the extent to which the unrealized loss is credit-driven or a result of changes in market interest rates;

Edgar Filing: National Interstate CORP - Form 10-Q

historical operating, balance sheet and cash flow data;

internally and externally generated financial models and forecasts;

our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value; and

other subjective factors, including concentrations and information obtained from regulators and rating agencies.

Under current other-than-temporary impairment accounting guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then an entity may separate the other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income (loss)). The credit related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are required to be shown in the Consolidated Statements of Income. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge is required to reduce the amortized cost of that security to fair value. Additional disclosures required by this guidance are contained in Note 4 Investments.

Table of Contents

We closely monitor each investment that has a fair value that is below its amortized cost and make a determination each quarter for other-than-temporary impairment for each of those investments. There were no material other-than-temporary impairment charges recorded during the three months ended March 31, 2012 and 2011.

While it is not possible to accurately predict if or when a specific security will become impaired, given the inherent uncertainty in the market, charges for other-than-temporary impairment could be material to net income in subsequent quarters. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity. See Management's Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Investments.

Contractual Obligations/Off-Balance Sheet Arrangements

During the first three months of 2012, our contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2011.

We do not currently have any relationships with unconsolidated entities of financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

As of March 31, 2012, there were no material changes to the information provided in our Annual Report on Form 10-K for the year ended December 31, 2011 under Item 7A Quantitative and Qualitative Disclosures About Market Risk.

ITEM 4. Controls and Procedures

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Our management, with participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e)) as of March 31, 2012. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2012, to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have been no significant changes in our internal controls over financial reporting or in other factors that have occurred during the quarter ended March 31, 2012 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

There are no material changes from the legal proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2011. For more information regarding such legal matters please refer to Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2011, Note 16 to the Consolidated Financial Statements included therein and Note 10 to the Consolidated Financial Statements contained in this quarterly report.

ITEM 1A. Risk Factors

There are no material changes to the risk factors previously reported in our Annual Report on Form 10-K for the year ended December 31, 2011. For more information regarding such risk factors, please refer to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011.

Table of Contents

ITEM 6. Exhibits

3.1	Amended and Restated Articles of Incorporation ⁽¹⁾
3.2	Amended and Restated Code of Regulations ⁽¹⁾
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document ⁽²⁾
101.SCH	XBRL Taxonomy Extension Schema Document ⁽²⁾
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document ⁽²⁾
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document ⁽²⁾
101.LAB	XBRL Taxonomy Extension Label Linkbase Document ⁽²⁾
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document ⁽²⁾

⁽¹⁾ These exhibits are incorporated by reference to our Registration Statement on Form S-1 (Registration No. 333-119270).

⁽²⁾ In accordance with Regulation S-T, the XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall be deemed furnished not filed.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 4, 2012

NATIONAL INTERSTATE CORPORATION

/s/ David W. Michelson

David W. Michelson
President and Chief Executive Officer
(Duly Authorized Officer and Principal Executive Officer)

Date: May 4, 2012

/s/ Julie A. McGraw

Julie A. McGraw
Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)