

National Interstate CORP
Form 10-Q
August 02, 2013
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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 June 30, 2013

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)

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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 July 31, 2013 was 19,717,087.

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National Interstate Corporation

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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)**

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost \$897,577 and \$900,052, respectively)	\$ 921,957	\$ 944,752
Equity securities available-for-sale, at fair value (amortized cost \$45,512 and \$27,210, respectively)	51,743	31,177
Other invested assets	39,198	36,882
Total investments	1,012,898	1,012,811
Cash and cash equivalents	43,223	41,981
Accrued investment income	8,690	8,937
Premiums receivable, net of allowance for doubtful accounts of \$2,710 and \$2,809, respectively	243,992	215,690
Reinsurance recoverable on paid and unpaid losses	167,351	174,345
Prepaid reinsurance premiums	46,063	32,570
Deferred policy acquisition costs	25,708	25,246
Deferred federal income taxes	26,392	19,883
Property and equipment, net	24,328	24,539
Funds held by reinsurer	3,614	3,710
Intangible assets, net	8,214	8,355
Prepaid expenses and other assets	3,419	2,157
Total assets	\$ 1,613,892	\$ 1,570,224
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 801,614	\$ 775,305
Unearned premiums and service fees	287,780	266,126
Long-term debt	12,000	12,000
Amounts withheld or retained for accounts of others	70,714	67,002
Reinsurance balances payable	34,670	19,473
Accounts payable and other liabilities	46,525	59,055
Commissions payable	14,023	11,838
Assessments and fees payable	5,542	5,477
Total liabilities	1,272,868	1,216,276
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 3,693 and 3,759 shares, respectively, in treasury	234	234
Additional paid-in capital	56,106	54,788

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Retained earnings	270,021	272,618
Accumulated other comprehensive income	19,898	31,634
Treasury shares	(5,235)	(5,326)
Total shareholders' equity	341,024	353,948
Total liabilities and shareholders' equity	\$ 1,613,892	\$ 1,570,224

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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenues:				
Premiums earned	\$ 128,866	\$ 110,866	\$ 255,773	\$ 220,991
Net investment income	7,925	8,953	15,888	18,136
Net realized gains on investments (*)	2,534	421	4,080	2,163
Other	849	814	1,682	1,643
Total revenues	140,174	121,054	277,423	242,933
Expenses:				
Losses and loss adjustment expenses	118,957	82,860	215,568	163,413
Commissions and other underwriting expenses	23,432	22,636	46,292	44,170
Other operating and general expenses	5,190	4,569	10,615	9,499
Expense on amounts withheld	1,265	971	2,468	2,011
Interest expense	227	63	302	125
Total expenses	149,071	111,099	275,245	219,218
(Loss) income before income taxes	(8,897)	9,955	2,178	23,715
(Benefit) provision for income taxes	(2,617)	2,690	441	6,704
Net (loss) income	\$ (6,280)	\$ 7,265	\$ 1,737	\$ 17,011
Net (loss) income per share basic	\$ (0.32)	\$ 0.37	\$ 0.09	\$ 0.88
Net (loss) income per share diluted	\$ (0.32)	\$ 0.37	\$ 0.09	\$ 0.87
Weighted average of common shares outstanding basic	19,652	19,415	19,631	19,412
Weighted average of common shares outstanding diluted	19,752	19,535	19,766	19,540
Cash dividends per common share	\$ 0.11	\$ 0.10	\$ 0.22	\$ 0.20

(*) Consists of the following:

Net realized gains before impairment losses	\$ 2,534	\$ 485	\$ 4,097	\$ 2,307
Total losses on securities with impairment charges		(64)	(17)	(144)
Non-credit portion recognized in other comprehensive income				
Net impairment charges recognized in earnings		(64)	(17)	(144)
Net realized gains on investments	\$ 2,534	\$ 421	\$ 4,080	\$ 2,163

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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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net (loss) income	\$ (6,280)	\$ 7,265	\$ 1,737	\$ 17,011
Other comprehensive (loss) income, before tax:				
Net unrealized gains on available-for-sale securities:				
Net unrealized holding (losses) gains on securities arising during the period	(20,265)	2,149	(15,872)	12,050
Reclassification adjustment for net realized gains included in net (loss) income	(1,792)	(2,102)	(2,184)	(2,434)
Total other comprehensive (loss) income, before tax	(22,057)	47	(18,056)	9,616
Deferred income taxes on other comprehensive (loss) income	(7,721)	16	(6,320)	3,365
Other comprehensive (loss) income, net of tax	(14,336)	31	(11,736)	6,251
Total comprehensive (loss) income	\$ (20,616)	\$ 7,296	\$ (9,999)	\$ 23,262

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	Treasury Stock	Total
Balance at January 1, 2013	\$ 234	\$ 54,788	\$ 272,618	\$ 31,634	\$ (5,326)	\$ 353,948
Net income			1,737			1,737
Other comprehensive loss, net of tax				(11,736)		(11,736)
Dividends on common stock			(4,334)			(4,334)
Issuance of 65,483 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		944			91	1,035
Net tax effect from exercise/vesting of stock-based compensation		21				21
Stock compensation expense		353				353
Balance at June 30, 2013	\$ 234	\$ 56,106	\$ 270,021	\$ 19,898	\$ (5,235)	\$ 341,024
Balance at January 1, 2012	\$ 234	\$ 51,295	\$ 285,403	\$ 17,561	\$ (5,594)	\$ 348,899
Net income			17,011			17,011
Other comprehensive income, net of tax				6,251		6,251
Dividends on common stock			(3,896)			(3,896)
Issuance of 17,465 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		(125)			24	(101)
Net tax effect from exercise/vesting of stock-based compensation		80				80
Stock compensation expense		342				342
Balance at June 30, 2012	\$ 234	\$ 51,592	\$ 298,518	\$ 23,812	\$ (5,570)	\$ 368,586

See notes to consolidated financial statements.

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

	Six Months Ended June 30,	
	2013	2012
Operating activities		
Net income	\$ 1,737	\$ 17,011
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	3,561	3,306
Provision for depreciation and amortization	1,613	2,175
Net realized gains on investment securities	(4,080)	(2,163)
Deferred federal income taxes	(190)	712
Stock compensation expense	353	342
Increase in deferred policy acquisition costs, net	(462)	(2,555)
Increase in reserves for losses and loss adjustment expenses	26,309	10,312
Increase in premiums receivable	(28,302)	(35,556)
Increase in unearned premiums and service fees	21,654	27,689
(Increase) decrease in interest receivable and other assets	(919)	847
Increase in prepaid reinsurance premiums	(13,493)	(6,202)
(Decrease) increase in accounts payable, commissions and other liabilities and assessments and fees payable	(10,280)	7,055
Increase in amounts withheld or retained for accounts of others	3,712	2,156
Decrease in reinsurance recoverable	6,994	7,325
Increase in reinsurance balances payable	15,197	4,934
Other	(60)	(48)
Net cash provided by operating activities	23,344	37,340
Investing activities		
Purchases of fixed maturities	(113,862)	(113,253)
Purchases of equity securities	(22,062)	(1,720)
Proceeds from sale of fixed maturities	18,940	24,737
Proceeds from sale of equity securities	4,280	10,231
Proceeds from maturities and redemptions of investments	96,200	72,323
Change in other investments, net	(1,120)	(6,700)
Capital expenditures	(1,200)	(2,350)
Net cash used in investing activities	(18,824)	(16,732)
Financing activities		
Net tax effect from exercise/vesting of stock-based compensation	21	80
Issuance of common shares from treasury upon exercise of stock options or stock award grants	1,035	(101)
Cash dividends paid on common shares	(4,334)	(3,896)
Net cash used in financing activities	(3,278)	(3,917)
Net increase in cash and cash equivalents	1,242	16,691
Cash and cash equivalents at beginning of period	41,981	23,674
Cash and cash equivalents at end of period	\$ 43,223	\$ 40,365

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See notes to consolidated financial statements.

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NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) 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., National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI), Triumphe Casualty Company (TCC), National Interstate Insurance Agency, Inc. (NIIA), Hudson Management Group, Ltd., Vanliner Group, Inc., 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, 2012. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature. Operating results for the three and six month periods ended June 30, 2013 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2013.

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.

2. Recent Accounting Pronouncements

Effective January 1, 2013, the Company adopted Accounting Standards Update No. 2012-02, *Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment* (ASU 2012-02). ASU 2012-02 provides additional guidance in performing impairment tests for indefinite-lived intangible assets by simplifying how an entity tests those assets for impairment. The update allows an entity to make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The adoption did not have a material impact on the Company's results of operations or financial position.

Effective January 1, 2013, the Company prospectively adopted Accounting Standards Update No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income* (ASU 2013-02). ASU 2013-02 requires an entity to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income (AOCI) by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. As the updated guidance only required 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.

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.

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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, who report to the Chief Investment Officer, as well as investment professionals affiliated with American Financial Group, Inc. ("AFG"), our ultimate parent company, compare the valuation received to independent third party pricing sources and consider 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 securities, fixed maturity investments and perpetual preferred stocks that are not actively traded. Included in Level 2 are \$76.0 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, 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. The Company's internal and affiliated investment professionals review 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 June 30, 2013:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. Government and government agency obligations	\$ 1,506	\$ 91,638	\$	\$ 93,144
Foreign government obligations		3,586		3,586
State and local government obligations		352,072	844	352,916
Residential mortgage-backed securities		198,341		198,341
Commercial mortgage-backed securities		39,578		39,578
Corporate obligations		192,385	8,617	201,002
Other debt obligations		28,915		28,915
Redeemable preferred stocks	3,994		481	4,475
Total fixed maturities	5,500	906,515	9,942	921,957
Equity securities:				
Common stocks	37,444	1,800		39,244
Perpetual preferred stocks	4,184	7,352	963	12,499
Total equity securities	41,628	9,152	963	51,743

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Total fixed maturities and equity securities	47,128	915,667	10,905	973,700
Cash and cash equivalents	43,223			43,223
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$ 90,351	\$ 915,667	\$ 10,905	\$ 1,016,923

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

	Level 1	Level 2 (Dollars in thousands)	Level 3	Total
Fixed maturities:				
U.S. Government and government agency obligations	\$ 2,056	\$ 110,041	\$	\$ 112,097
Foreign government obligations		5,660		5,660
State and local government obligations		360,989	837	361,826
Residential mortgage-backed securities		194,695		194,695
Commercial mortgage-backed securities		47,604		47,604
Corporate obligations		199,553	7,658	207,211
Other debt obligations		11,428		11,428
Redeemable preferred stocks	3,748		483	4,231
Total fixed maturities	5,804	929,970	8,978	944,752
Equity securities:				
Common stocks	24,219	755		24,974
Perpetual preferred stocks	2,936	3,267		6,203
Total equity securities	27,155	4,022		31,177
Total fixed maturities and equity securities	32,959	933,992	8,978	975,929
Cash and cash equivalents	41,981			41,981
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$ 74,940	\$ 933,992	\$ 8,978	\$ 1,017,910

The tables above exclude investments in limited partnerships, which are reported as other invested assets and accounted for under the equity method, of \$39.2 million and \$36.9 million (included in other invested assets) at June 30, 2013 and December 31, 2012, respectively. Equity method investments are not reported at fair value.

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the three and six months ended June 30, 2013 there was one redeemable preferred stock totaling \$1.0 million and four perpetual preferred stocks totaling \$0.3 million that transferred from Level 2 to Level 1 due to changes in trading activity. During the three and six months ended June 30, 2012 there were four perpetual preferred stocks totaling \$45 thousand that transferred from Level 1 and Level 2, and for the six months ending June 30, 2012 there was a \$0.2 million redeemable preferred stock that transferred from Level 2 to Level 1 due to changes in 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 and six months ended June 30, 2013.

	Three Months Ended June 30, 2013			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
	(Dollars in thousands)			
Beginning balance at April 1, 2013	\$ 844	\$ 8,707	\$ 484	\$ 963
Total gains or (losses):				
Included in earnings				
Included in other comprehensive income		(47)	(3)	
Purchases and issuances				
Sales, settlements and redemptions		(43)		
Transfers in and/or (out) of Level 3				

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Ending balance at June 30, 2013	\$ 844	\$ 8,617	\$ 481	\$ 963
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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	\$	\$	\$	\$
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	Six Months Ended June 30, 2013			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
	(Dollars in thousands)			
Beginning balance at January 1, 2013	\$ 837	\$ 7,658	\$ 483	\$
Total gains or (losses):				
Included in earnings				
Included in other comprehensive income	7	51	(2)	(6)
Purchases and issuances		1,000		969
Sales, settlements and redemptions		(92)		
Transfers in and/or (out) of Level 3				
Ending balance at June 30, 2013	\$ 844	\$ 8,617	\$ 481	\$ 963
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 and six months ended June 30, 2012.

	Three Months Ended June 30, 2012			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
	(Dollars in thousands)			
Beginning balance at April 1, 2012	\$ 1,665	\$ 7,121	\$ 470	\$ 396
Total gains or (losses):				
Included in earnings				
Included in other comprehensive income	(37)	200	8	
Purchases and issuances				
Sales, settlements and redemptions		(79)		
Transfers in and/or (out) of Level 3				
Ending balance at June 30, 2012	\$ 1,628	\$ 7,242	\$ 478	\$ 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	\$	\$	\$	\$

	Six Months Ended June 30, 2012			
	State and Local Government Obligations	Corporate Obligations	Redeemable Preferred Stock	Perpetual Preferred Stock
	(Dollars in thousands)			
Beginning balance at January 1, 2012	\$ 1,572	\$ 7,256	\$ 472	\$ 396
Total gains or (losses):				
Included in earnings				

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Included in other comprehensive income	56	113	6	
Purchases and issuances				
Sales, settlements and redemptions		(127)		
Transfers in and/or (out) of Level 3				
Ending balance at June 30, 2012	\$ 1,628	\$ 7,242	\$ 478	\$ 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	\$	\$	\$	\$
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At June 30, 2013, the Company had ten securities with a fair value of \$10.9 million that are included in Level 3, which represented 1.1% of its total investments reported at fair value. 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. 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 approximately 3.2% of the Company's shareholders' equity at June 30, 2013, any change in unobservable inputs would not have a material impact on the Company's financial position.

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Under 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)				
June 30, 2013:				
Fixed Maturities:				
U.S. Government and government agency obligations	\$ 89,400	\$ 3,899	\$ (155)	\$ 93,144
Foreign government obligations	3,550	36		3,586
State and local government obligations	345,481	9,409	(1,974)	352,916
Residential mortgage-backed securities	192,610	8,219	(2,488)	198,341
Commercial mortgage-backed securities	38,158	1,420		39,578
Corporate obligations	194,851	7,694	(1,543)	201,002
Other debt obligations	29,137	26	(248)	28,915
Redeemable preferred stocks	4,390	108	(23)	4,475
Total fixed maturities	897,577	30,811	(6,431)	921,957
Equity securities:				
Common stocks	33,343	6,612	(711)	39,244
Perpetual preferred stocks	12,169	629	(299)	12,499
Total equity securities	45,512	7,241	(1,010)	51,743
Total fixed maturities and equity securities	\$ 943,089	\$ 38,052	\$ (7,441)	\$ 973,700
December 31, 2012:				
Fixed Maturities:				
U.S. Government and government agency obligations	\$ 104,958	\$ 7,141	\$ (2)	\$ 112,097
Foreign government obligations	5,587	73		5,660
State and local government obligations	344,660	17,339	(173)	361,826
Residential mortgage-backed securities	188,498	7,835	(1,638)	194,695
Commercial mortgage-backed securities	45,632	1,974	(2)	47,604
Corporate obligations	195,261	12,134	(184)	207,211
Other debt obligations	11,321	107		11,428
Redeemable preferred stocks	4,135	113	(17)	4,231
Total fixed maturities	900,052	46,716	(2,016)	944,752
Equity securities:				
Common stocks	21,376	3,669	(71)	24,974
Perpetual preferred stocks	5,834	369		6,203
Total equity securities	27,210	4,038	(71)	31,177

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Total fixed maturities and equity securities	\$ 927,262	\$ 50,754	\$ (2,087)	\$ 975,929
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The table above excludes investments in limited partnerships, which are reported as other invested assets and accounted for under the equity method, of \$39.2 million and \$36.9 million (included in other invested assets) at June 30, 2013 and December 31, 2012, respectively. Equity method investments are not reported at fair value.

State and local government obligations represented approximately 38.3% of the Company's fixed maturity portfolio at June 30, 2013, with approximately \$280.8 million, or 79.6%, of the Company's state and local government obligations held in special revenue obligations, and the remaining amount held in general obligations. The Company's state and local government obligations portfolio is high quality, as 99.5% of such securities were rated investment grade (as determined by nationally recognized agencies) at June 30, 2013. The Company had no state and local government obligations for any state, municipality or political subdivision that comprised 10% or more of the total amortized cost or fair value of such obligations at June 30, 2013.

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The amortized cost and fair value of fixed maturities at June 30, 2013, by contractual maturity, are shown below. Other debt obligations, which are primarily comprised of asset-backed securities other than those related to mortgages, are categorized based on their average maturity. 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 3.6 years in the Company's investment portfolio.

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	\$ 20,536	\$ 20,763
Due after one year through five years	265,959	277,408
Due after five years through ten years	274,255	279,513
Due after ten years	106,059	106,354
	666,809	684,038
Mortgage-backed securities	230,768	237,919
Total	\$ 897,577	\$ 921,957

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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Fixed maturity gains	\$ 1,357	\$ 1,508	\$ 1,699	\$ 1,951
Fixed maturity losses	(5)	(49)	(5)	(83)
Equity security gains	795	859	1,210	948
Equity security losses	(15)	(607)	(69)	(714)
Other investments, net (losses) gains	402	(1,290)	1,245	61
Net realized gains on investments	\$ 2,534	\$ 421	\$ 4,080	\$ 2,163

Pre-tax net realized gains on investments of \$2.5 million and \$4.1 million for the three and six months ended June 30, 2013 were primarily generated from net realized gains associated with the sales or redemptions of securities of \$2.1 million and \$2.9 million, respectively. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Equity partnership investments generated net gains of \$0.4 million and \$1.2 million for the three and six months ended June 30, 2013, respectively.

Pre-tax net realized gains on investments of \$0.4 million and \$2.2 million for the three and six months ended June 30, 2012 were primarily generated from net realized gains associated with the sales or redemptions of securities of \$1.8 million and \$2.2 million, respectively. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Equity partnership investments generated net losses of \$1.3 million and net gains of \$0.1 million for the three and six months ended June 30, 2012, respectively.

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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
June 30, 2013:								
Fixed maturities:								
U.S. Government and government agency obligations	\$ 11,931	\$ (155)	98.7%	12	\$	\$	0.0%	
Foreign government obligations			0.0%				0.0%	
State and local government obligations	86,116	(1,818)	97.9%	57	844	(156)	84.4%	1
Residential mortgage-backed securities	62,401	(1,347)	97.9%	45	6,562	(1,141)	85.2%	6
Commercial mortgage-backed securities	938		100.0%	1			0.0%	
Corporate obligations	47,315	(1,543)	96.8%	53			0.0%	
Other debt obligations	19,377	(248)	98.7%	17			0.0%	
Redeemable preferred stocks	1,620	(5)	99.7%	2	481	(18)	96.4%	1
Total fixed maturities	229,698	(5,116)	97.8%	187	7,887	(1,315)	85.7%	8
Equity securities:								
Common stocks	7,386	(711)	91.2%	21			0.0%	
Perpetual preferred stocks	9,297	(299)	96.9%	14			0.0%	
Total equity securities	16,683	(1,010)	94.3%	35			0.0%	
Total fixed maturities and equity securities	\$ 246,381	\$ (6,126)	97.6%	222	\$ 7,887	\$ (1,315)	85.7%	8
December 31, 2012:								
Fixed maturities:								
U.S. Government and government agency obligations	\$ 6,195	\$ (2)	100.0%	3	\$	\$	0.0%	
Foreign government obligations			0.0%				0.0%	
State and local government obligations	1,048	(10)	99.1%	1	837	(163)	83.7%	1
Residential mortgage-backed securities	19,541	(135)	99.3%	9	12,194	(1,503)	89.0%	7
Commercial mortgage-backed securities	2,000	(2)	99.9%	1			0.0%	
Corporate obligations	12,001	(184)	98.5%	19			0.0%	
Other debt obligations			0.0%				0.0%	
Redeemable preferred stocks			0.0%		483	(17)	96.6%	1
Total fixed maturities	40,785	(333)	99.2%	33	13,514	(1,683)	88.9%	9
Equity securities:								
Common stocks	1,110	(71)	94.0%	9			0.0%	
Perpetual preferred stocks			0.0%				0.0%	
Total equity securities	1,110	(71)	94.0%	9			0.0%	
Total fixed maturities and equity securities	\$ 41,895	\$ (404)	99.0%	42	\$ 13,514	\$ (1,683)	88.9%	9

The gross unrealized losses on the Company's fixed maturities and equity securities portfolios increased from \$2.1 million at December 31, 2012 to \$7.4 million at June 30, 2013. The increase in gross unrealized losses was driven primarily by an increase in market yields resulting from rising interest rates. The \$7.4 million in gross unrealized losses at June 30, 2013 was primarily on fixed maturity holdings in residential mortgage-backed securities, state and local government obligations and corporate obligations. The gross unrealized losses on equity securities

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were \$1.0 million and have been in an unrealized loss position for less than twelve months and are considered to be temporary. Investment grade securities represented 87.5% of all fixed maturity securities with unrealized losses.

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At June 30, 2013, gross unrealized losses on residential mortgage-backed securities were \$2.5 million and represented 38.7% of the total gross unrealized losses on fixed maturities. There were 45 securities with gross unrealized losses of \$1.4 million that were in an unrealized loss position for less than 12 months and six securities with gross unrealized losses of \$1.1 million that were in an unrealized loss position for 12 months or more. Four of the securities in an unrealized loss position for 12 months or more previously had both credit and non-credit other-than-temporary impairment charges and were in a gross unrealized loss position of \$1.1 million at June 30, 2013. 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.

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At June 30, 2013, the state and local government obligations, with gross unrealized losses of \$2.0 million, consisted of 57 securities with gross unrealized losses of \$1.8 million that were in an unrealized loss position for less than 12 months and one security with gross unrealized losses of \$0.2 million that was in an unrealized loss position for 12 months or more. All of these state and local government obligations are investment grade securities. The corporate obligations, with gross unrealized losses of \$1.5 million, consisted of 53 securities with gross unrealized losses of \$1.5 million that were in an unrealized loss position for less than 12 months. Investment grade securities represented 66.8% of fixed maturity securities with unrealized losses in corporate obligations.

Management concluded that no additional charges for other-than-temporary impairment were required on the fixed maturity holdings in the first six months of 2013 based on several 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Beginning balance	\$ 2,282	\$ 2,258	\$ 2,282	\$ 2,258
Additional credit impairments on:				
Previously impaired securities				
Securities without prior impairments				
Reductions				
Ending balance	\$ 2,282	\$ 2,258	\$ 2,282	\$ 2,258

5. Income Taxes

The Company's provision for income taxes in interim periods is computed by applying its estimated full-year effective tax rate against pre-tax income for the period. The effective tax rate was 29.4% and 20.2% for the three and six months ended June 30, 2013, respectively, and 27.0% and 28.3% for the three and six months ended June 30, 2012, respectively. The 8.1 percentage point decrease in the Company's effective tax rate for the six months ended June 30, 2013 as compared to the same period in 2012 was primarily due to the significant decline in pre-tax income experienced during the first half of 2013 as compared to the first half of 2012.

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:

	June 30, 2013	December 31, 2012
	(Dollars in thousands)	
Deferred Tax Assets:		
Unearned premiums	\$ 16,931	\$ 16,341
Unpaid losses and loss adjustment expenses	20,850	19,630
Assessments and fees payable	1,817	1,801
Realized losses on investments, primarily impairments	5,633	5,376
Accrued compensation	2,018	3,216
Limited partnership investments	539	827
Other, net	2,059	2,406
	49,847	49,597

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Deferred Tax Liabilities:

Deferred policy acquisition costs	(8,998)	(8,836)
Unrealized gains on investments	(10,714)	(17,034)
Intangible assets	(2,875)	(2,924)
Other, net	(868)	(920)
Total deferred tax liabilities	(23,455)	(29,714)
Net deferred income tax assets	\$ 26,392	\$ 19,883

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

Table of Contents**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 June 30, 2013, there were options for 438,550 shares outstanding and 1,001,313 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 June 30, 2013, the Company recognized stock-based compensation expense of \$0.2 million with related income tax benefits of approximately \$40 thousand, as compared to the stock-based compensation expense of \$0.1 million with related income tax benefits of approximately \$30 thousand for the same period in 2012. For the six months ended June 30, 2013 and 2012, the Company recognized stock-based compensation expense of \$0.4 million and \$0.3 million, respectively, with related income tax benefits of approximately \$0.1 million recognized 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(In thousands, except per share data)		(In thousands, except per share data)	
Net (loss) income	\$ (6,280)	\$ 7,265	\$ 1,737	\$ 17,011
Weighted average shares outstanding during period	19,652	19,415	19,631	19,412
Additional shares issuable under employee common stock option plans using treasury stock method	100	120	135	128
Weighted average shares outstanding assuming exercise of stock options	19,752	19,535	19,766	19,540
Net (loss) income per share:				
Basic	\$ (0.32)	\$ 0.37	\$ 0.09	\$ 0.88
Diluted	\$ (0.32)	\$ 0.37	\$ 0.09	\$ 0.87

For the three months ended June 30, 2013 and 2012, there were 100,000 and 214,105, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive. For the six months ended June 30, 2013 and 2012, there were 77,515 and 214,105, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive.

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 June 30, 2013, Great American owned 51.7% 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.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Assumed premiums written	\$ 481	\$ 690	\$ 1,099	\$ 1,373
Assumed premiums earned	561	709	1,145	1,568
Assumed losses and loss adjustment expense incurred	1,010	484	1,497	1,212
Ceded premiums written	11	27	26	46
Ceded premiums earned	12	30	30	98
Ceded losses and loss adjustment expense recoveries	300	222	398	617
Payable to Great American as of period end	107	42	107	42

Effective October 1, 2012, the Company entered into an agreement with American Money Management Corporation (AMMC), a wholly-owned subsidiary of AFG, whereby AMMC manages a portion of the Company's investment portfolio at an annual cost of 15 basis points of the fair value of the assets under management. AMMC's management of this portion of the Company's portfolio commenced during the fourth quarter of 2012, with fees accrued for such services approximating \$0.2 million and \$0.5 million, respectively, for the three and six months ended June 30, 2013.

Great American or its parent, AFG, 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 six months of 2013, the Company's ceded premiums written and ceding commissions associated with Validus participation on these treaties were \$0.5 million and \$0.1 million, respectively. These treaties were negotiated at arm's length through an independent reinsurance broker in the ordinary course of business as part of the Company's customary reinsurance evaluation and placement process. The Company's Chairman of the Board is also on the Board of Directors of Validus Holdings, Ltd., the parent of Validus.

The Company is not substantially dependent on any individual reinsurance agreements, including the agreements with Great American and Validus. The Company does not depend on these specific reinsurers to a material extent, as other reinsurers could be obtained for those treaties or the business could be retained.

9. Reinsurance

Premiums and reinsurance activity consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Direct premiums written	\$ 165,944	\$ 158,095	\$ 315,408	\$ 286,056
Reinsurance assumed	3,072	2,035	5,476	4,299
Reinsurance ceded	(29,798)	(24,375)	(56,909)	(47,885)
Net premiums written	\$ 139,218	\$ 135,755	\$ 263,975	\$ 242,470
Direct premiums earned	\$ 148,416	\$ 130,207	\$ 294,086	\$ 258,309
Reinsurance assumed	2,773	2,100	5,102	4,363
Reinsurance ceded	(22,323)	(21,441)	(43,415)	(41,681)

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Premiums earned	\$ 128,866	\$ 110,866	\$ 255,773	\$ 220,991
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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 June 30, 2013 and 2012 were \$17.7 million and \$11.8 million, respectively, and were \$27.4 million and \$24.1 million for the six months ended June 30, 2013 and 2012, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company, or otherwise obtains sufficient collateral, and regularly evaluates the financial condition of its reinsurers.

Table of Contents**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 both June 30, 2013 and December 31, 2012, the liability for such assessments was \$5.5 million 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Revenue:				
Premiums Earned:				
Alternative Risk Transfer	\$ 68,857	\$ 57,946	\$ 140,165	\$ 116,156
Transportation	42,403	36,079	81,035	71,216
Specialty Personal Lines	11,457	11,786	22,788	23,603
Hawaii and Alaska	3,787	3,511	7,348	6,895
Other	2,362	1,544	4,437	3,121
Total premiums earned	128,866	110,866	255,773	220,991
Net investment income	7,925	8,953	15,888	18,136
Net realized gains on investments	2,534	421	4,080	2,163
Other	849	814	1,682	1,643
Total revenues	\$ 140,174	\$ 121,054	\$ 277,423	\$ 242,933

12. Accumulated Other Comprehensive Income

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Comprehensive income is defined as all changes in Shareholders' Equity except those arising from transactions with shareholders. Comprehensive income includes net earnings and other comprehensive income, which consists entirely of changes in net unrealized gains or losses on the Company's investment portfolio, which is classified as available for sale. The following tables show the progression of the components of AOCI during the three and six months ended June 30, 2013.

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	Three Months Ended June 30, 2013 (Dollars in thousands)
Balance at April 1, 2013	\$ 34,234
Net unrealized losses on available-for-sale securities:	
Net unrealized holding losses on securities arising during the period, net of tax	(13,171)
Reclassification adjustment for net realized gains included in net income, net of tax	(1,165)
Other comprehensive loss, net of tax	(14,336)
Ending balance at June 30, 2013	\$ 19,898

	Six Months Ended June 30, 2013 (Dollars in thousands)
Balance at January 1, 2013	\$ 31,634
Net unrealized losses on available-for-sale securities:	
Net unrealized holding losses on securities arising during the period, net of tax	(10,316)
Reclassification adjustment for net realized gains included in net income, net of tax	(1,420)
Other comprehensive loss, net of tax	(11,736)
Ending balance at June 30, 2013	\$ 19,898

The following table presents amounts related to unrealized gains and losses on available-for-sale securities which were reclassified out of AOCI during the three and six months ended June 30, 2013, categorized by the respective affected line items in the Consolidated Statement of Income:

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
	(Dollars in thousands)	
Increase to net realized gains on investments	\$ 1,792	\$ 2,184
Increase to income before income taxes	1,792	2,184
Increase to provision for income taxes	627	764
Increase to net income	\$ 1,165	\$ 1,420

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

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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;

performance of securities markets;

our ability to attract and retain independent agents and brokers;

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;

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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 moving and storage transportation companies, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles and commercial vehicles throughout the United States.

We have five property and casualty insurance subsidiaries: National Interstate Insurance Company (NIIC), Vanliner Insurance Company (VIC or Vanliner), National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI), Triumphe Casualty Company (TCC) and 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 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 32 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 June 30, 2013, Great American Insurance Company (Great American) owned 51.7% 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.

Our net (loss) income, determined in accordance with U.S. generally accepted accounting principles (GAAP), includes after-tax net realized gains from investments that may not be indicative of our ongoing operations. The following table reconciles net (loss) income to net (loss) income from operations, a non-GAAP financial measure that we believe is a useful tool for investors and analysts in analyzing ongoing operating trends.

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	Three Months Ended June 30,			
	2013		2012	
	Amount	Per Share	Amount	Per Share
	(Dollars in thousands, except per share data)			
Net (loss) income from operations	\$ (7,927)	\$ (0.40)	\$ 6,991	\$ 0.36
After-tax net realized gains from investments	1,647	0.08	274	0.01
Net (loss) income	\$ (6,280)	\$ (0.32)	\$ 7,265	\$ 0.37

	Six Months Ended June 30,			
	2013		2012	
	Amount	Per Share	Amount	Per Share
	(Dollars in thousands, except per share data)			
Net (loss) income from operations	\$ (915)	\$ (0.05)	\$ 15,605	\$ 0.79
After-tax net realized gains from investments	2,652	0.14	1,406	0.08
Net income	\$ 1,737	\$ 0.09	\$ 17,011	\$ 0.87

We recorded a net loss for the three months ended June 30, 2013 of \$6.3 million (\$0.32 per share diluted) and net income for the first half of 2013 of \$1.7 million (\$0.09 per share diluted), compared to net income of \$7.3 million (\$0.37 per share diluted) and \$17.0 million (\$0.87 per share diluted) for the three and six months ended June 30, 2012. These decreases were driven by the elevated loss and LAE ratios for the three and six months ended June 30, 2013 of 92.3% and 84.3%, respectively, as compared to 74.7% and 73.9% for the same periods in 2012. The loss ratio increases for the second quarter and first six months of 2013 were driven by uncharacteristically high claims severity and unfavorable development from prior years' loss reserves. Three claims occurring in the second quarter, two in our traditional passenger transportation business and one in our moving and storage business, represented a significant portion of the severe claims activity in accident year 2013. All three of these claims were related to long-term insureds with historically favorable loss histories. Included in the unfavorable development from prior years' loss reserves was \$6.0 million related to reserve strengthening in our accident year 2011 commercial auto liability line. Also contributing to the decline in net income for the three and six months ended June 30, 2013 compared to the same periods in 2012 was a decrease in net investment income, as yields available in the financial markets on fixed maturity securities have generally declined in recent years, placing downward pressure on our investment portfolio yield. Net investment income was also impacted by our average invested asset balances being slightly lower in the first six months of 2013 as compared to the same period in 2012 due to our one-time special dividend payment in December 2012.

We recorded after-tax net realized gains from investments of \$1.6 million (\$0.08 per share diluted) and \$2.7 million (\$0.14 per share diluted) for the second quarter and first six months of 2013, respectively, compared to \$0.3 million (\$0.01 per share diluted) and \$1.4 million (\$0.08 per share diluted) for the comparative periods in 2012. Our after-tax net realized gains for the three and six months ended June 30, 2013 were primarily generated by net gains associate with sales of securities. The after tax net gains for the second quarter of 2012 were generated by sales of securities partially offset by net losses associated with equity partnership investments, while the after-tax net realized gains for the first half of 2012 were driven by sales of securities.

Our net loss from operations for the three and six months ended June 30, 2013 was \$7.9 million (\$0.40 per share diluted) and \$0.9 million (\$0.05 per share diluted), respectively, compared to net income of \$7.0 million (\$0.36 per share diluted) and \$15.6 million (\$0.79 per share diluted) for the same periods in 2012. The primary drivers for the period-over-period fluctuations are the same as those discussed above for the change in net income for the respective periods.

Gross Premiums Written

2013 compared to 2012. 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 June 30,			
	2013		2012	
	Amount	Percent	Amount	Percent

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(Dollars in thousands)

Alternative Risk Transfer	\$ 84,920	50.2%	\$ 92,006	57.5%
Transportation	62,395	36.9%	47,731	29.8%
Specialty Personal Lines	13,857	8.2%	14,149	8.8%
Hawaii and Alaska	5,029	3.0%	4,709	2.9%
Other	2,815	1.7%	1,535	1.0%
Gross premiums written	\$ 169,016	100.0%	\$ 160,130	100.0%

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	Six Months Ended June 30,			
	2013		2012	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Alternative Risk Transfer	\$ 170,488	53.2%	\$ 168,444	57.9%
Transportation	109,165	34.0%	82,938	28.6%
Specialty Personal Lines	27,399	8.5%	27,202	9.4%
Hawaii and Alaska	8,919	2.8%	8,589	3.0%
Other	4,913	1.5%	3,182	1.1%
Gross premiums written	\$ 320,884	100.0%	\$ 290,355	100.0%

Three months ended June 30, 2013 compared to June 30, 2012. Gross premiums written includes both direct and assumed premium. During the second quarter of 2013, our gross premiums written increased \$8.9 million, or 5.5%, compared to the same period in 2012, primarily attributable to the growth experienced in our transportation component. Gross premiums written in our transportation component increased \$14.7 million, or 30.7%, during the second quarter of 2013 compared to the same period in 2012 primarily due to a combination of the continued growth of our trucking product extension introduced in 2012 and premiums generated by the waste operations and energy distribution insurance products which were rolled out in the first quarter of 2013. Vanliner's moving and storage products also contributed to the transportation component's growth during the second quarter of 2013 as compared to the same period in 2012 due to a combination of rate increases, growth in the exposure base among its existing customers and the addition of new customers. Our ART component's gross premiums written decreased \$7.1 million, or 7.7%, for the three months ended June 30, 2013 as compared to the same period in 2012, primarily due to non-renewing or pricing away the accounts of two customers within our large account ART product, as well as the impact of ending the business relationship with the agent for one of the products within the program business portion of our ART component, as previously reported. These two large account ART customers and the program business ART product comprised 11.9% of our gross premiums written during the second quarter of 2012. Partially offsetting these decreases within the ART component was the addition of a new customer to our large account ART product, rate increases and growth in exposures on renewal business. Additionally, we continued to experience high levels of member retention in group ART programs renewing during the period. The Other component, which is comprised of assigned risk policies that we receive from involuntary state insurance plans typically based on written premiums in that state and over which we have no control, increased \$1.3 million, or 83.4%, compared to the same period in 2012.

Six months ended June 30, 2013 compared to June 30, 2012. During the first six months of 2013, our gross premiums written increased \$30.5 million, or 10.5%, compared to the same period in 2012, primarily due to the growth experienced in our transportation component. Gross premiums written in our transportation component grew by \$26.2 million, or 31.6%, driven by our trucking product extension, the new waste operations and energy distribution products and Vanliner's moving and storage products, as discussed above for the three month period. Also contributing to the transportation component's growth were rate increases on all transportation component products and high renewal retention in our traditional passenger transportation business. Gross premiums written in our ART component increased \$2.0 million, or 1.2%, for the six months ended June 30, 2013 compared to the same period in 2012. The ART component increase was primarily due to the addition of two new customers to our large account ART product and growth within our group ART programs resulting from the same factors as discussed above for the three month period. This growth was largely offset by no longer writing the accounts of the two large account ART customers and ending the business relationship with an agent within the program business portion of our ART component, as discussed above for the three month period. These two large account ART customers and the program business ART product comprised 8.6% of our gross premiums written during the first six months of 2012.

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 second quarter of 2013 and 2012, we recorded a \$1.7 million premium assessment and a \$1.0 million return of premium, respectively. For the first six months of 2013 and 2012, we recorded premium assessments of \$4.9 million and \$0.5 million, respectively.

Table of Contents**Premiums Earned**

Three months ended June 30, 2013 compared to June 30, 2012. 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 June 30,		Change	
	2013	2012	Amount	Percent
	(Dollars in thousands)			
Premiums earned:				
Alternative Risk Transfer	\$ 68,857	\$ 57,946	\$ 10,911	18.8%
Transportation	42,403	36,079	6,324	17.5%
Specialty Personal Lines	11,457	11,786	(329)	(2.8%)
Hawaii and Alaska	3,787	3,511	276	7.9%
Other	2,362	1,544	818	53.0%
Total premiums earned	\$ 128,866	\$ 110,866	\$ 18,000	16.2%

Our premiums earned increased \$18.0 million, or 16.2%, to \$128.9 million during the three months ended June 30, 2013 compared to \$110.9 million for the same period in 2012. The increase is primarily attributable to our ART component, which grew \$10.9 million, or 18.8%, over 2012 mainly due to the gross premiums written growth from new and existing programs experienced throughout 2012. Our transportation component increased \$6.3 million, or 17.5%, during the second quarter of 2013 compared to the same period in 2012 mainly due to the gross premiums written growth in our traditional trucking business in 2012 and the growth among Vanliner's moving and storage products throughout 2012 and the first six months of 2013. The increase in the transportation component's premiums earned was also impacted by the addition of new products, rate increases and high renewal retention in our traditional transportation business during the first six months of 2013, as previously discussed.

Six months ended June 30, 2013 compared to June 30, 2012. 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:

	Six Months Ended June 30,		Change	
	2013	2012	Amount	Percent
	(Dollars in thousands)			
Premiums earned:				
Alternative Risk Transfer	\$ 140,165	\$ 116,156	\$ 24,009	20.7%
Transportation	81,035	71,216	9,819	13.8%
Specialty Personal Lines	22,788	23,603	(815)	(3.5%)
Hawaii and Alaska	7,348	6,895	453	6.6%
Other	4,437	3,121	1,316	42.2%
Total premiums earned	\$ 255,773	\$ 220,991	\$ 34,782	15.7%

Our premiums earned increased \$34.8 million, or 15.7%, to \$255.8 million during the six months ended June 30, 2013 compared to \$221.0 million for the same period in 2012. The increase is primarily attributable to our ART component, which grew \$24.0 million, or 20.7%, over 2012 mainly due to the same factors discussed above for the three month period. Our transportation component increased \$9.8 million, or 13.8%, over 2012 primarily due to the same factors as discussed above for the three month period.

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.

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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.

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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, since 2011 we have seen rate levels gradually stabilize on renewal business, with a number of our products experiencing single digit rate level increases on renewal business. This positive trend has continued into the first six months of 2013, with many of our products taking rate increases of over 5% and, in some instances, exceeding 10%.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands)		(Dollars in thousands)	
Gross premiums written	\$ 169,016	\$ 160,130	\$ 320,884	\$ 290,355
Ceded reinsurance	(29,798)	(24,375)	(56,909)	(47,885)
Net premiums written	139,218	135,755	263,975	242,470
Change in unearned premiums, net of ceded	(10,352)	(24,889)	(8,202)	(21,479)
Total premiums earned	\$ 128,866	\$ 110,866	\$ 255,773	\$ 220,991
Combined Ratios:				
Loss and LAE ratio ⁽¹⁾	92.3%	74.7%	84.3%	73.9%
Underwriting expense ratio ⁽²⁾	21.6%	23.8%	21.6%	23.6%
Combined ratio	113.9%	98.5%	105.9%	97.5%

(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. *Three months ended June 30, 2013 compared to June 30, 2012.* Our loss and LAE ratio for the second quarter of 2013 increased 17.6 percentage points to 92.3% compared to 74.7% in the same period in 2012. This increase over the prior period is primarily attributable to a combination of uncharacteristically high claims severity and unfavorable development in prior years' loss reserves. Three claims, two in our traditional passenger transportation business and one in our moving and storage business, which represented a significant portion of the severe claim activity in accident year 2013, were related to long-term insureds with historically favorable loss histories. For the second quarter of 2013, we had unfavorable development from prior years' loss reserves of \$8.4 million, or 6.5 percentage points, of which \$6.0 million was related to reserve strengthening in our accident year 2011 commercial auto liability line. This compares to favorable development of \$0.2 million, or 0.2 percentage points, in the second quarter of 2012. The accident year 2011 reserve strengthening is predominately related to products now in runoff within the program portion of our ART component, as well as our commercial vehicle product, which is part of our specialty personal lines component. We have experienced higher than initially anticipated frequency and severity levels in accident year 2011, and though in 2011 adjustments to our pricing and reserving practices were made and underwriting actions were implemented to stem such adverse results and improve the claim frequency, our severity experience has not improved as rapidly as anticipated. As such it was deemed necessary by management to bring loss reserves into an adequate position relative to our most recent actuarial ultimate loss projections. The remaining unfavorable development primarily related to settlements above the established case reserves and revisions to our estimated future settlements on an individual case by case basis.

In addition to the aforementioned renewal rate increases that we have continued to realize, we have also, during the first six months of 2013, responded to the deterioration in our underwriting margins by taking additional rate increases in certain of our loss layers and by non-renewing or pricing away approximately \$34.9 million of renewal business. Such accounts were across all components of our business. We will continue to respond with rate increases, non-renewals or other corrective actions, as necessary.

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The underwriting expense ratio for the second quarter of 2013 decreased 2.2 percentage points to 21.6% compared to 23.8% for the same period in 2012, which was primarily attributable to leveraging our fixed operating costs while increasing our premium base in the second quarter of 2013 compared to the same period in the prior year. Specifically, operating costs associated with our insurance operations, such as product management, underwriting, sales and marketing costs, have remained flat during the second quarter of 2013 as compared to the second quarter of 2012.

Six months ended June 30, 2013 compared to June 30, 2012. Our loss and LAE ratio for the six months ended June 30, 2013 increased 10.4 percentage points to 84.3% compared to 73.9% in the same period in 2012. This increase over the prior period is

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primarily due to the high claims severity concentrated in our traditional passenger transportation and moving and storage products and unfavorable development from prior years' loss reserves, as discussed above for the three month period. For the six months ended June 30, 2013, we had unfavorable development from prior years' loss reserves of \$10.8 million, or 4.2 percentage points, compared to unfavorable development of \$1.7 million, or 0.8 percentage points, for the first six months of 2012.

The consolidated underwriting expense ratio for the six months ended June 30, 2013 decreased 2.0 percentage points to 21.6% compared to 23.6% for the same period in 2012, primarily due to leveraging our fixed operating costs while increasing our premium based, as discussed above for the three month period.

Net Investment Income

2013 compared to 2012. For the three and six month periods ended June 30, 2013, net investment income was \$7.9 million and \$15.9 million, respectively, compared to \$9.0 million and \$18.1 million for the same periods in 2012. In recent years, yields available in the financial markets on fixed maturity securities have remained low, placing downward pressure on our net investment income. While we have normally had higher average invested assets period over period that helped offset the declining interest rate environment, average invested asset balances were slightly lower in 2013 as compared to the same periods in 2012 due to our one-time special \$2.00 per share dividend payment in December 2012.

Net Realized Gains on Investments

2013 compared to 2012. Pre-tax net realized gains on investments were \$2.5 million for the second quarter of 2013 compared to \$0.4 million for the second quarter of 2012. For the six months ended June 30, 2013 and 2012, pre-tax net realized gains were \$4.1 million and \$2.2 million, respectively. The pre-tax net realized gains for both the second quarter and first six months of 2013 were primarily generated from net realized gains associated with sales of securities totaling \$2.1 million and \$2.9 million, respectively. Equity partnership investments produced net gains of \$0.4 million and \$1.2 million for the second quarter and first half of 2013, respectively. The pre-tax net realized gains for both the second quarter and first six months of 2012 were primarily generated from net realized gains associated with sales or redemptions of securities totaling \$1.8 million and \$2.2 million, respectively. Equity partnership investments produced net losses of \$1.3 million and net gains of \$0.1 million for the second quarter and first half of 2012, respectively.

Commissions and Other Underwriting Expenses

2013 compared to 2012. During the second quarter of 2013, commissions and other underwriting expenses of \$23.4 million increased \$0.8 million, or 3.5%, from \$22.6 million in the comparable period in 2012. For the six months ended June 30, 2013 and 2012, commissions and other underwriting expenses were \$46.3 million and \$44.2 million, respectively, increasing \$2.1 million, or 4.8%. Commissions and other underwriting expenses, as a percentage of premiums earned, were 18.2% and 18.1% for the three months and six months ended June 30, 2013, respectively, compared to 20.4% and 20.0% for the same periods in 2012. Both the quarter and year-to-date decreases as a percentage of premiums earned are primarily attributable to increasing our premium base while maintaining relatively flat fixed operating costs associated with our insurance operations.

Other Operating and General Expenses

2013 compared to 2012. Other operating and general expenses increased \$0.6 million, or 13.6%, to \$5.2 million during the quarter ended June 30, 2013 compared to \$4.6 million for the same period in 2012. For the six months ended June 30, 2013 and 2012, other operating and general expenses were \$10.6 million and \$9.5 million, respectively, increasing \$1.1 million, or 11.7%. Both the quarter and year-to-date increases are primarily attributable to growth in our employee headcount and other expenses necessary to support the growth in our business. As a percentage of premiums earned, such expenses were relatively flat at 4.0% and 4.2% for the three months and six months ended June 30, 2013, respectively, compared to 4.1% and 4.3% for the same periods in 2012.

Income Taxes

2013 compared to 2012. We have recorded our income tax provision for the six months ended June 30, 2013 to reflect our full-year estimated effective tax rate of 20.2%, which represents an 8.1 percentage point decrease from the 28.3% effective tax rate reported for the first six months of 2012, driven by the significant decline in pre-tax income experienced during the first half of 2013 as compared to the first half of 2012. As a result of adjusting our year-to-date provision for income taxes, our effective tax rate for the second quarter of 2013 increased 2.4 percentage points to 29.4%, as compared to 27.0% for the same period in 2012.

Table of Contents**Financial Condition****Investments**

At June 30, 2013, our investment portfolio contained \$922.0 million in fixed maturity securities and \$51.7 million in equity securities, all carried at fair value, with unrealized gains and losses reported as a separate component of shareholders' equity, and \$39.2 million in other investments, which are limited partnership investments accounted for in accordance with the equity method. At June 30, 2013, we had pre-tax net unrealized gains of \$24.4 million on fixed maturities and \$6.2 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 June 30, 2013, 89.1% 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.

State and local government obligations represented approximately 38.3% of our fixed maturity portfolio at June 30, 2013, with approximately \$280.8 million, or 79.6%, of our state and local government obligations held in special revenue obligations, and the remaining amount held in general obligations. Our state and local government obligations portfolio is high quality, as 99.5% of such securities were rated investment grade at June 30, 2013. We had no state and local government obligations for any state, municipality or political subdivision that comprised 10% or more of the total amortized cost or fair value of such obligations at June 30, 2013.

Summary information for securities with unrealized gains or losses at June 30, 2013 is shown in the following table. Approximately \$7.0 million of fixed maturities and \$1.0 million of equity securities had no unrealized gains or losses at June 30, 2013.

	Securities with Unrealized Gains	Securities with Unrealized Losses
	(Dollars in thousands)	
Fixed Maturities:		
Fair value of securities	\$ 677,418	\$ 237,585
Amortized cost of securities	646,607	244,016
Gross unrealized gain or (loss)	\$ 30,811	\$ (6,431)
Fair value as a % of amortized cost	104.8%	97.4%
Number of security positions held	575	195
Number individually exceeding \$50,000 gain or (loss)	208	39
Concentration of gains or losses by type or industry:		
U.S. Government and government agencies	\$ 3,899	\$ (155)
Foreign governments	36	
State, municipalities and political subdivisions	9,409	(1,974)
Residential mortgage-backed securities	8,219	(2,488)
Commercial mortgage-backed securities	1,420	
Other debt obligations	26	(248)
Financial institutions, insurance and real estate	2,484	(338)
Industrial and other	5,318	(1,228)
Percent rated investment grade (a)	89.7%	87.5%
Equity Securities:		
Fair value of securities	\$ 34,060	\$ 16,683
Cost of securities	26,819	17,693
Gross unrealized gain or (loss)	\$ 7,241	\$ (1,010)
Fair value as a % of cost	127.0%	94.3%
Number individually exceeding \$50,000 gain or (loss)	39	9

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

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The table below sets forth the scheduled maturities of available for sale fixed maturity securities at June 30, 2013, based on their fair values. Other debt obligations, which are primarily comprised of asset-backed securities other than those related to mortgages, are categorized based on their average maturity. 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	2.2%	0.8%
After one year through five years	36.5%	12.7%
After five years through ten years	29.5%	32.8%
After ten years	7.0%	24.2%
	75.2%	70.5%
Mortgage-backed securities	24.8%	29.5%
	100.0%	100.0%

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

	At June 30, 2013		Fair Value as % of Cost Basis
	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	
	(Dollars in thousands)		
Fixed Maturities:			
Securities with unrealized gains:			
Exceeding \$50,000 and for:			
Less than one year (38 issues)	\$ 78,914	\$ 4,673	106.3%
More than one year (170 issues)	324,612	20,130	106.6%
\$50,000 or less (367 issues)	273,892	6,008	102.2%
	\$ 677,418	\$ 30,811	
Securities with unrealized losses:			
Exceeding \$50,000 and for:			
Less than one year (34 issues)	\$ 61,249	\$ (2,691)	95.8%
More than one year (5 issues)	4,542	(1,246)	78.5%
\$50,000 or less (156 issues)	171,794	(2,494)	98.6%
	\$ 237,585	\$ (6,431)	
Equity Securities:			
Securities with unrealized gains:			
Exceeding \$50,000 and for:			
Less than one year (31 issues)	\$ 15,387	\$ 3,624	130.8%
More than one year (8 issues)	7,217	2,695	159.6%
\$50,000 or less (48 issues)	11,456	922	108.8%
	\$ 34,060	\$ 7,241	

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Securities with unrealized losses:			
Exceeding \$50,000 and for:			
Less than one year (9 issue)	\$ 6,774	\$ (741)	90.1%
More than one year (0 issues)			0.0%
\$50,000 or less (26 issues)	9,909	(269)	97.4%
	\$ 16,683	\$ (1,010)	

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.

Table of Contents**Premiums and Reinsurance**

Premiums receivable increased \$28.3 million, or 13.1%, and unearned premiums increased \$21.7 million, or 8.1%, from December 31, 2012 to June 30, 2013. Prepaid reinsurance premiums increased \$13.5 million, or 41.4%, and reinsurance balances payable increased \$15.2 million, or 78.0%, from December 31, 2012 to June 30, 2013. Under most of our group ART programs, all members of the group share a common renewal date. These common renewal dates are scheduled throughout the year. However, we have several large ART programs that renew during the first six months of a given fiscal year resulting in a large increase in premiums receivable, unearned premiums, prepaid reinsurance premiums and reinsurance balances payable. These balances gradually decline throughout the remainder of the year.

Liquidity and Capital Resources

Our cash flows from operating, investing and financing activities as detailed in our Consolidated Statement of Cash Flows are shown below (in thousands):

	Six Months Ended June 30,	
	2013	2012
Net cash provided by operating activities	\$ 23,344	\$ 37,340
Net cash used in investing activities	(18,824)	(16,732)
Net cash used in financing activities	(3,278)	(3,917)
Net increase in cash and cash equivalents	\$ 1,242	\$ 16,691

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 six months of 2013, 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 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 \$1.2 million from \$42.0 million at December 31, 2012 to \$43.2 million at June 30, 2013. We generated net cash from operations of \$23.3 million for the six months ended June 30, 2013, compared to \$37.3 million during the comparable period in 2012. This decrease of \$14.0 million is primarily attributable to a \$17.3 million payment made in June 2013 associated with the settlement of the Vanliner balance sheet guaranty through December 31, 2012, whereas the payment in the prior year was made in the third quarter of 2012.

Net cash used in investing activities was \$18.8 million and \$16.7 million for the six months ended June 30, 2013 and 2012, respectively. Contributing to the \$2.1 million increase in cash used in investing activities was a \$20.3 million increase in the purchases of equity securities, offset by a \$23.9 million increase in the proceeds from maturities and redemptions of fixed maturity investments. The increase in the purchases of equity securities during the first six months of 2013 was primarily attributable to reinvesting the proceeds from matured and redeemed fixed maturity securities. These purchases of equity securities were mainly concentrated in dividend yielding common and preferred stocks. The increase in maturities and redemptions of fixed maturity investments in the first six months of 2013 was due to an increase in scheduled maturities as compared to the same period in 2012. Also contributing to the change in cash used in investing activities were decreases of \$6.0 million and \$5.8 million in the proceeds

from the sales of equity securities and fixed maturities, respectively, and a \$5.6 million decrease in the purchases of other investments, which are comprised of limited partnership investments.

Net cash used in financing activities was \$3.3 million and \$3.9 million for the six months ended June 30, 2013 and 2012, respectively. Our financing activities include those related to stock option activity and dividends paid on our common shares.

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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.

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In 2012, we replaced our \$50.0 million credit agreement with a \$100.0 million unsecured credit agreement (the *Credit Agreement*) that terminates in November 2017, which includes a sublimit of \$10.0 million for letters of credit. We have the ability to increase the line of credit to \$125.0 million subject to the *Credit Agreement*'s accordion feature. Amounts borrowed bear interest at either (1) a LIBOR rate plus an applicable margin ranging from 0.75% to 1.00% based on our A.M. Best insurance group rating, or (2) a rate per annum equal to the greater of (a) the administrative agent's prime rate, (b) 0.50% in excess of the federal funds effective rate, or (c) 1.00% in excess of the one-month LIBOR rate. Based on our A.M. Best insurance group rating of *A-* at June 30, 2013, we would pay interest at a LIBOR rate plus 0.875%. At June 30, 2013, we had \$12.0 million outstanding under the *Credit Agreement*, with the interest rate on this debt equal to the six-month LIBOR (0.4649% at June 30, 2013) plus 87.5 basis points, with interest payments due throughout the year at each interest rate repricing date.

The *Credit Agreement* requires us to maintain specified financial covenants measured on a quarterly basis, including minimum consolidated net worth and a maximum debt to capital ratio. In addition, the *Credit Agreement* contains certain affirmative and negative covenants customary for facilities of this type, including negative covenants that limit or restrict our ability to, among other things, pay dividends, 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 June 30, 2013, we were in compliance with all covenants.

We believe that funds generated from operations, including dividends from insurance subsidiaries, parent company cash and funds available under our *Credit Agreement*, 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. If we were forced to borrow additional funds in order to meet liquidity needs, we would incur additional interest expense, which could have a negative impact on our earnings. 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. 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, 2012.

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 June 30, 2013 and December 31, 2012, we had \$801.6 million and \$775.3 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 our recorded reserves for our U.S. insurance subsidiaries 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. This actuarial analysis of our U.S. insurance subsidiaries' combined net reserves for the year ending December 31, 2012 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 June 30, 2013 and December 31, 2012.

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;

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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 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.

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:

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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;

historical operating, balance sheet and cash flow data;

internally and externally generated financial models and forecasts;

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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.

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 charges recorded during the three and six months ended June 30, 2013 and 2012. 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 six months of 2013, our contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2012.

We do not 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 June 30, 2013, there were no material changes to the information provided in our Annual Report on Form 10-K for the year ended December 31, 2012 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 June 30, 2013. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2013, 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 June 30, 2013 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

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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, 2012. 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, 2012, Note 16 Commitments and Contingencies to the Consolidated Financial Statements included therein and Note 10 Commitments and Contingencies 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, 2012. 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, 2012.

ITEM 6. Exhibits

- 3.1 Amended and Restated Articles of Incorporation ⁽¹⁾
- 3.2 Amended and Restated Code of Regulations ⁽¹⁾
- *10.1 Long Term Incentive Plan, as amended ⁽²⁾
- 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 The following financial information from National Interstate Corporation's Form 10-Q for the quarter ended June 30, 2013 formatted in XBRL (Extensible Business Reporting Language):
 - (i) Consolidated Balance Sheet
 - (ii) Consolidated Statement of Income
 - (iii) Consolidated Statement of Comprehensive Income
 - (iv) Consolidated Statement of Shareholders' Equity
 - (v) Consolidated Statement of Cash Flows

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(vi) Notes to Consolidated Financial Statements

- * Indicates a management contract or compensatory plan or arrangement.
- (1) These exhibits are incorporated by reference to our Registration Statement on Form S-1 (Registration No. 333-119270).
- (2) This exhibit is incorporated by reference to our Form 8-K filed May 8, 2013.

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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.

NATIONAL INTERSTATE CORPORATION

Date: August 2, 2013

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

Date: August 2, 2013

/s/ Julie A. McGraw
Julie A. McGraw
Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)