

State Auto Financial CORP
Form 10-Q
November 04, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2015

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 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Ohio | 31-1324304 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|--|------------|
| 518 East Broad Street, Columbus, Ohio | 43215-3976 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (614) 464-5000

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 ý 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ý No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer ý Non-accelerated filer ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No ý

On October 30, 2015, the Registrant had 41,332,382 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

PART I – FINANCIAL STATEMENTS

Item 1. Condensed Consolidated Balance Sheets

| (\$ and shares in millions, except per share amounts) | September 30, 2015 (unaudited) | December 31, 2014 |
|---|--------------------------------------|----------------------|
| Assets | | |
| Fixed maturities, available-for-sale, at fair value (amortized cost \$1,938.9 and \$1,831.3, respectively) | \$ 1,979.6 | \$ 1,891.9 |
| Equity securities, available-for-sale, at fair value (cost \$266.1 and \$235.5, respectively) | 298.0 | 310.4 |
| Other invested assets, available-for-sale, at fair value (cost \$56.6 and \$50.5, respectively) | 82.8 | 80.3 |
| Other invested assets | 5.3 | 5.3 |
| Notes receivable from affiliate | 70.0 | 70.0 |
| Total investments | 2,435.7 | 2,357.9 |
| Cash and cash equivalents | 50.9 | 86.3 |
| Accrued investment income and other assets | 38.7 | 33.8 |
| Deferred policy acquisition costs (affiliated net assumed \$51.8 and \$46.8, respectively) | 134.0 | 126.5 |
| Reinsurance recoverable on losses and loss expenses payable | 7.7 | 9.6 |
| Prepaid reinsurance premiums | 6.8 | 6.1 |
| Due from affiliate | 21.9 | 40.1 |
| Current federal income taxes | 0.3 | 1.1 |
| Net deferred federal income taxes | 104.0 | 97.4 |
| Property and equipment, at cost | 7.7 | 8.1 |
| Total assets | \$ 2,807.7 | \$ 2,766.9 |
| Liabilities and Stockholders' Equity | | |
| Losses and loss expenses payable (affiliated net assumed \$506.5 and \$494.3, respectively) | \$ 1,021.5 | \$ 983.2 |
| Unearned premiums (affiliated net assumed \$220.4 and \$201.7, respectively) | 637.5 | 612.4 |
| Notes payable (affiliates \$15.5 and \$15.5, respectively) | 100.8 | 100.8 |
| Postretirement and pension benefits (affiliated net ceded \$58.4 and \$63.2, respectively) | 108.6 | 117.3 |
| Other liabilities (affiliated net ceded \$6.8 and \$5.1, respectively) | 64.0 | 80.3 |
| Total liabilities | 1,932.4 | 1,894.0 |
| Stockholders' equity: | | |
| Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued | — | — |
| Class B Preferred stock, without par value. Authorized 2.5 shares; none issued | — | — |
| Common stock, without par value. Authorized 100.0 shares; 47.9 and 47.7 shares issued, respectively, at stated value of \$2.50 per share | 119.9 | 119.3 |
| Treasury stock, 6.8 and 6.8 shares, respectively, at cost | (116.3) | (116.0) |
| Additional paid-in capital | 149.8 | 143.2 |
| Accumulated other comprehensive income (affiliated net ceded \$61.0 and \$65.1, respectively) | 31.4 | 71.7 |
| Retained earnings | 690.5 | 654.7 |

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| | | |
|--|-----------|-----------|
| Total stockholders' equity | 875.3 | 872.9 |
| Total liabilities and stockholders' equity | \$2,807.7 | \$2,766.9 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

| (\$ in millions, except per share amounts) (unaudited) | Three months ended September 30 | |
|---|------------------------------------|----------|
| | 2015 | 2014 |
| Earned premiums (affiliated net assumed \$112.2 and \$55.0, respectively) | \$ 319.7 | \$ 270.2 |
| Net investment income (affiliated \$1.3 and \$1.3, respectively) | 18.7 | 18.9 |
| Net realized gains on investments: | | |
| Total other-than-temporary impairment losses | (3.5 |) (1.1 |
| Portion of loss recognized in other comprehensive income | — | — |
| Other net realized investment gains | 14.3 | 2.7 |
| Total net realized gains on investments | 10.8 | 1.6 |
| Other income from affiliates | 0.5 | 0.6 |
| Total revenues | 349.7 | 291.3 |
| Losses and loss expenses (affiliated net assumed \$67.4 and \$53.6, respectively) | 207.5 | 184.4 |
| Acquisition and operating expenses (affiliated net assumed \$52.8 and \$36.3, respectively) | 109.4 | 91.4 |
| Interest expense (affiliated \$0.1 and \$0.2, respectively) | 1.3 | 1.4 |
| Other expenses | 1.6 | 1.0 |
| Total expenses | 319.8 | 278.2 |
| Income before federal income taxes | 29.9 | 13.1 |
| Federal income tax expense: | | |
| Current | 2.7 | 1.2 |
| Deferred | 6.5 | — |
| Total federal income tax expense | 9.2 | 1.2 |
| Net income | \$ 20.7 | \$ 11.9 |
| Earnings per common share: | | |
| Basic | \$ 0.50 | \$ 0.29 |
| Diluted | \$ 0.50 | \$ 0.28 |
| Dividends paid per common share | \$ 0.10 | \$ 0.10 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

| (\$ in millions, except per share amounts) (unaudited) | Nine months ended September 30 | |
|---|-----------------------------------|----------|
| | 2015 | 2014 |
| Earned premiums (affiliated net assumed \$320.5 and \$153.6, respectively) | \$ 946.5 | \$ 801.0 |
| Net investment income (affiliate \$3.7 and \$3.7, respectively) | 53.9 | 57.0 |
| Net realized gains on investments: | | |
| Total other-than-temporary impairment losses | (4.8 |) (2.3 |
| Portion of loss recognized in other comprehensive income | — | — |
| Other net realized investment gains | 24.8 | 19.9 |
| Total net realized gains on investments | 20.0 | 17.6 |
| Other income from affiliates | 1.6 | 1.4 |
| Total revenues | 1,022.0 | 877.0 |
| Losses and loss expenses (affiliated net assumed \$200.9 and \$131.6, respectively) | 627.1 | 546.6 |
| Acquisition and operating expenses (affiliated net assumed \$188.9 and \$117.5, respectively) | 318.7 | 277.2 |
| Interest expense (affiliates \$0.5 and \$0.5, respectively) | 4.0 | 4.0 |
| Other expenses | 5.7 | 5.3 |
| Total expenses | 955.5 | 833.1 |
| Income before federal income taxes | 66.5 | 43.9 |
| Federal income tax expense: | | |
| Current | 3.3 | 1.9 |
| Deferred | 15.1 | — |
| Total federal income tax expense | 18.4 | 1.9 |
| Net income | \$ 48.1 | \$ 42.0 |
| Earnings per common share: | | |
| Basic | \$ 1.17 | \$ 1.03 |
| Diluted | \$ 1.16 | \$ 1.02 |
| Dividends paid per common share | \$ 0.30 | \$ 0.30 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Consolidated Statements of Comprehensive Income

| (\$ in millions, except per share amounts) (unaudited) | Three months ended September 30 | | |
|--|------------------------------------|---------|----------|
| | 2015 | 2014 | |
| Net income | \$ 20.7 | \$ 11.9 | |
| Other comprehensive (loss) income, net of tax: | | | |
| Net unrealized holding (losses) gains on investments: | | | |
| Unrealized holding (losses) gains | (24.5 |) | (16.3) |
| Reclassification adjustments for gains realized in net income | (10.8 |) | (1.6) |
| Income tax benefit (expense) | 12.4 | | (0.6) |
| Total net unrealized holding losses on investments | (22.9 |) | (18.5) |
| Net unrecognized benefit plan obligations: | | | |
| Reclassification adjustments for amortization to statements of income: | | | |
| Negative prior service cost | (1.3 |) | (1.3) |
| Net actuarial loss | 2.8 | | 1.6 |
| Income tax expense | (0.6 |) | — |
| Total net unrecognized benefit plan obligations | 0.9 | | 0.3 |
| Other comprehensive loss | (22.0 |) | (18.2) |
| Comprehensive loss | \$(1.3 |) | \$(6.3) |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Consolidated Statements of Comprehensive Income

| (\$ in millions, except per share amounts) (unaudited) | Nine months ended September 30 | |
|--|-----------------------------------|---------|
| | 2015 | 2014 |
| Net income | \$48.1 | \$42.0 |
| Other comprehensive (loss) income, net of tax: | | |
| Net unrealized holding (losses) gains on investments: | | |
| Unrealized holding (losses) gains | (46.1 |) 41.6 |
| Reclassification adjustments for gains realized in net income | (20.4 |) (17.6 |
| Income tax benefit (expense) | 23.3 | (8.3 |
| Total net unrealized holding (losses) gains on investments | (43.2 |) 15.7 |
| Net unrecognized benefit plan obligations: | | |
| Net actuarial loss arising during period | — | (1.6 |
| Reclassification adjustments for amortization to statements of income: | | |
| Negative prior service cost | (4.1 |) (4.1 |
| Net actuarial loss | 8.6 | 5.4 |
| Income tax expense | (1.6 |) — |
| Total net unrecognized benefit plan obligations | 2.9 | (0.3 |
| Other comprehensive (loss) income | (40.3 |) 15.4 |
| Comprehensive income | \$7.8 | \$57.4 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Cash Flows

| (\$ in millions) (unaudited) | Nine months ended September 30 | |
|--|-----------------------------------|---------|
| | 2015 | 2014 |
| Cash flows from operating activities: | | |
| Net income | \$48.1 | \$42.0 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization, net | 10.8 | 6.6 |
| Share-based compensation | 5.1 | 2.7 |
| Net realized gains on investments | (20.0) | (17.6) |
| Changes in operating assets and liabilities: | | |
| Deferred policy acquisition costs | (7.5) | (12.6) |
| Accrued investment income and other assets | (4.5) | 0.7 |
| Postretirement and pension benefits | (5.8) | (8.0) |
| Other liabilities and due to/from affiliates, net | (63.5) | (11.1) |
| Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums | 1.2 | (1.3) |
| Losses and loss expenses payable | 38.3 | 1.4 |
| Unearned premiums | 25.1 | 37.8 |
| Excess tax benefits on share-based awards | 0.1 | — |
| Federal income taxes | 17.6 | 1.0 |
| Cash provided from December 31, 2014 unearned premium transfer related to the homeowners quota share arrangement | 63.5 | — |
| Net cash provided by operating activities | 108.5 | 41.6 |
| Cash flows from investing activities: | | |
| Purchases of fixed maturities available-for-sale | (459.8) | (325.8) |
| Purchases of equity securities available-for-sale | (131.8) | (95.7) |
| Purchases of other invested assets | (6.5) | (1.5) |
| Maturities, calls and pay downs of fixed maturities available-for-sale | 203.4 | 180.8 |
| Sales of fixed maturities available-for-sale | 142.7 | 135.4 |
| Sales of equity securities available-for-sale | 117.4 | 76.6 |
| Sales of other invested assets available-for-sale | 0.5 | 0.5 |
| Net additions of property and equipment | (0.1) | — |
| Net cash used in investing activities | (134.2) | (29.7) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 2.9 | 2.4 |
| Payments to acquire treasury stock | (0.3) | (0.1) |
| Payment of dividends | (12.3) | (12.3) |
| Net cash used in financing activities | (9.7) | (10.0) |
| Net decrease in cash and cash equivalents | (35.4) | 1.9 |
| Cash and cash equivalents at beginning of period | 86.3 | 80.3 |
| Cash and cash equivalents at end of period | \$50.9 | \$82.2 |
| Supplemental disclosures: | | |
| Interest paid (affiliates \$0.5 and \$0.5, respectively) | \$3.9 | \$3.9 |
| Federal income taxes paid | \$2.4 | \$1.0 |

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries (“State Auto Financial” or the “Company”) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month period ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The balance sheet at December 31, 2014 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2014 (the “2014 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2014 Form 10-K.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

2. Investments

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at September 30, 2015 and December 31, 2014:

(\$ millions)

| September 30, 2015 | Cost or amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | Fair value |
|--|------------------------------|---|--|-------------|
| Fixed maturities: | | | | |
| U.S. treasury securities and obligations of U.S. government agencies | \$235.0 | \$7.8 | \$(1.7) |) \$241.1 |
| Obligations of states and political subdivisions | 840.6 | 20.8 | (4.3) |) 857.1 |
| Corporate securities | 409.0 | 8.4 | (5.7) |) 411.7 |
| U.S. government agencies mortgage-backed securities | 454.3 | 16.9 | (1.5) |) 469.7 |
| Total fixed maturities | 1,938.9 | 53.9 | (13.2) |) 1,979.6 |
| Equity securities: | | | | |
| Large-cap securities | 213.0 | 27.0 | (9.1) |) 230.9 |
| Small-cap securities | 53.1 | 14.3 | (0.3) |) 67.1 |
| Total equity securities | 266.1 | 41.3 | (9.4) |) 298.0 |
| Other invested assets | 56.6 | 26.2 | — |) 82.8 |
| Total available-for-sale securities | \$2,261.6 | \$121.4 | \$(22.6) |) \$2,360.4 |

(\$ millions)

| December 31, 2014 | Cost or amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | Fair value |
|--|------------------------------|---|--|-------------|
| Fixed maturities: | | | | |
| U.S. treasury securities and obligations of U.S. government agencies | \$296.7 | \$14.1 | \$(1.5) |) \$309.3 |
| Obligations of states and political subdivisions | 742.5 | 27.4 | (0.4) |) 769.5 |
| Corporate securities | 333.4 | 10.2 | (3.0) |) 340.6 |
| U.S. government agencies mortgage-backed securities | 458.7 | 15.6 | (1.8) |) 472.5 |
| Total fixed maturities | 1,831.3 | 67.3 | (6.7) |) 1,891.9 |
| Equity securities: | | | | |
| Large-cap securities | 185.5 | 57.3 | (0.6) |) 242.2 |
| Small-cap securities | 50.0 | 18.2 | — |) 68.2 |
| Total equity securities | 235.5 | 75.5 | (0.6) |) 310.4 |
| Other invested assets | 50.5 | 29.8 | — |) 80.3 |
| Total available-for-sale securities | \$2,117.3 | \$172.6 | \$(7.3) |) \$2,282.6 |

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at September 30, 2015 and December 31, 2014:

(\$ millions, except # of positions)

| | Less than 12 months | | | 12 months or more | | | Total | | |
|--|---------------------|-------------------|---------------------|-------------------|-------------------|---------------------|------------|-------------------|---------------------|
| | Fair value | Unrealized losses | Number of positions | Fair value | Unrealized losses | Number of positions | Fair value | Unrealized losses | Number of positions |
| September 30, 2015 | | | | | | | | | |
| Fixed maturities: | | | | | | | | | |
| U.S. treasury securities and obligations | | | | | | | | | |