

National Interstate CORP  
Form 10-Q  
November 09, 2010

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2010**

**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)

**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

Smaller Reporting  
Company

(Do not check if a 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 November 4, 2010 was 19,445,062.



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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)

|   | <b>September<br/>30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|---|---|------------------------------|
| <b>ASSETS</b>   |   |                              |
| Investments:  |   |                              |
| Fixed maturities available-for-sale, at fair value (amortized cost \$876,914 and \$565,753, respectively) | \$ 898,176  | \$ 566,901                   |
| Equity securities available-for-sale, at fair value (amortized cost and \$26,203, respectively) \$26,305  | 28,612  | 28,673                       |
| Short-term investments, at cost which approximates fair value   | 267   | 811                          |
| <br>  |   |                              |
| Total investments   | 927,055   | 596,385                      |
| Cash and cash equivalents   | 35,084  | 18,589                       |
| Accrued investment income   | 8,208   | 4,926                        |
| Premiums receivable, net of allowance for doubtful accounts of \$1,253 and \$963, respectively            | 185,766   | 98,679                       |
| Reinsurance recoverable on paid and unpaid losses   | 209,438   | 149,949                      |
| Prepaid reinsurance premiums  | 39,691  | 25,163                       |
| Deferred policy acquisition costs   | 23,331  | 17,833                       |
| Deferred federal income taxes   | 20,807  | 18,178                       |
| Property and equipment, net   | 25,038  | 21,747                       |
| Funds held by reinsurer   | 4,008   | 3,441                        |
| Intangible assets, net  | 9,049   |                              |
| Amounts refundable on estimated purchase price of Vanliner  | 5,894   |                              |
| Prepaid expenses and other assets   | 4,489   | 863                          |
| <br>  |   |                              |
| Total assets  | \$ 1,497,858                                      | \$ 955,753                   |
| <br><b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |   |                              |
| Liabilities:  |   |                              |
| Unpaid losses and loss adjustment expenses  | \$ 786,794  | \$ 417,260                   |
| Unearned premiums and service fees  | 247,292   | 149,509                      |
| Long-term debt  | 18,500  | 15,000                       |
| Amounts withheld or retained for accounts of others   | 58,248  | 51,359                       |
| Reinsurance balances payable  | 25,941  | 10,540                       |
| Accounts payable and other liabilities  | 38,776  | 29,371                       |
| Commissions payable   | 9,639   | 8,164                        |
| Assessments and fees payable  | 4,739   | 3,233                        |

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|   |              |            |
|---|--------------|------------|
| Total liabilities   | 1,189,929    | 684,436    |
| 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 3,994 and 4,048 shares, respectively, in treasury | 234          | 234        |
| Additional paid-in capital  | 50,358       | 49,264     |
| Retained earnings   | 247,670      | 225,195    |
| Accumulated other comprehensive income  | 15,320       | 2,353      |
| Treasury shares   | (5,653)      | (5,729)    |
| Total shareholders' equity  | 307,929      | 271,317    |
| Total liabilities and shareholders' equity  | \$ 1,497,858 | \$ 955,753 |

See notes to consolidated financial statements.

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**National Interstate Corporation and Subsidiaries**  
**Consolidated Statements of Income**  
**(Unaudited)**

**(In thousands, except per share data)**

|   | <b>Three Months Ended</b> |                 | <b>Nine Months Ended</b> |                  |
|---|---------------------------|-----------------|--------------------------|------------------|
|   | <b>September 30,</b>      |                 | <b>September 30,</b>     |                  |
|   | <b>2010</b>               | <b>2009</b>     | <b>2010</b>              | <b>2009</b>      |
| <b>Revenues:</b>                                      |                           |                 |                          |                  |
| Premiums earned                                       | \$ 111,866                | \$ 70,825       | \$ 251,280               | \$ 209,927       |
| Net investment income                                 | 6,440                     | 4,501           | 16,411                   | 14,430           |
| Net realized gains on investments (*)                 | 983                       | 760             | 3,534                    | 1,831            |
| Gain on bargain purchase                              | 635                       |                 | 635                      |                  |
| Other   | 1,030                     | 879             | 2,824                    | 2,627            |
| <b>Total revenues</b>                                 | <b>120,954</b>            | <b>76,965</b>   | <b>274,684</b>           | <b>228,815</b>   |
| <b>Expenses:</b>                                      |                           |                 |                          |                  |
| Losses and loss adjustment expenses                   | 85,204                    | 48,286          | 174,340                  | 127,052          |
| Commissions and other underwriting expenses           | 18,433                    | 15,189          | 48,004                   | 43,565           |
| Other operating and general expenses                  | 3,799                     | 3,085           | 11,421                   | 9,580            |
| Expense on amounts withheld                           | 840                       | 811             | 2,575                    | 2,578            |
| Interest expense                                      | 131                       | 71              | 235                      | 403              |
| <b>Total expenses</b>                                 | <b>108,407</b>            | <b>67,442</b>   | <b>236,575</b>           | <b>183,178</b>   |
| <b>Income before income taxes</b>                     | <b>12,547</b>             | <b>9,523</b>    | <b>38,109</b>            | <b>45,637</b>    |
| Provision for income taxes                            | 3,603                     | 1,367           | 10,961                   | 12,726           |
| <b>Net income</b>                                     | <b>\$ 8,944</b>           | <b>\$ 8,156</b> | <b>\$ 27,148</b>         | <b>\$ 32,911</b> |
| <br>  |                           |                 |                          |                  |
| Net income per share basic                            | \$ 0.46                   | \$ 0.42         | \$ 1.40                  | \$ 1.71          |
| Net income per share diluted                          | \$ 0.46                   | \$ 0.42         | \$ 1.40                  | \$ 1.70          |
| <br>  |                           |                 |                          |                  |
| Weighted average of common shares outstanding basic   | 19,344                    | 19,301          | 19,338                   | 19,301           |
| Weighted average of common shares outstanding diluted | 19,457                    | 19,384          | 19,431                   | 19,360           |
| <br>  |                           |                 |                          |                  |
| Cash dividends per common share                       | \$ 0.08                   | \$ 0.07         | \$ 0.24                  | \$ 0.21          |

(\*) Consists of the following:

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Net realized gains before impairment losses        | \$ 1,180 | \$ 2,035 | \$ 3,832 | \$ 4,339 |
| Total losses on securities with impairment charges | (197)    | (1,275)  | (197)    | (5,522)  |
| Non-credit portion in other comprehensive income   |          |          | (101)    | 3,014    |
| Net impairment charges recognized in earnings      | (197)    | (1,275)  | (298)    | (2,508)  |
| Net realized gains on investments                  | \$ 983   | \$ 760   | \$ 3,534 | \$ 1,831 |

See notes to consolidated financial statements.

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**National Interstate Corporation and Subsidiaries**  
**Consolidated Statements of Shareholders Equity**  
**(Unaudited)**  
**(Dollars in thousands)**

|   | <b>Common</b> | <b>Additional<br/>Paid-In</b> | <b>Retained</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> | <b>Treasury</b> | <b>Total</b> |
|---|---------------|-------------------------------|-----------------|--|-----------------|--------------|
|   | <b>Stock</b>  | <b>Capital</b>                | <b>Earnings</b> |  | <b>Stock</b>    |              |
| Balance at January 1, 2010  | \$ 234        | \$ 49,264                     | \$ 225,195      | \$ 2,353   | \$ (5,729)      | \$ 271,317   |
| Net income  |               |                               | 27,148          |  |                 | 27,148       |
| Unrealized appreciation of investment securities, net of tax of \$7.0 million   |               |                               |                 | 12,967   |                 | 12,967       |
| Comprehensive income  |               |                               |                 |  |                 | 40,115       |
| Dividends on common stock   |               |                               | (4,673)         |  |                 | (4,673)      |
| Issuance of 54,457 treasury shares upon exercise of options, stock award grants and restricted stock issued, net of forfeitures |               | 414                           |                 |  | 76              | 490          |
| Tax benefit realized from exercise of stock options   |               | 31                            |                 |  |                 | 31           |
| Stock compensation expense  |               | 649                           |                 |  |                 | 649          |
| Balance at September 30, 2010   | \$ 234        | \$ 50,358                     | \$ 247,670      | \$ 15,320  | \$ (5,653)      | \$ 307,929   |
| Balance at January 1, 2009  | \$ 234        | \$ 48,004                     | \$ 184,187      | \$ (10,613)  | \$ (5,738)      | \$ 216,074   |
| Net income  |               |                               | 32,911          |  |                 | 32,911       |
| Unrealized appreciation of investment securities, net of tax of \$7.5 million   |               |                               |                 | 14,060   |                 | 14,060       |
| Comprehensive income  |               |                               |                 |  |                 | 46,971       |
| Dividends on common stock   |               |                               | (4,081)         |  |                 | (4,081)      |
| Issuance of 6,089 treasury shares from restricted stock issued, net of forfeitures  |               | (56)                          |                 |  | 8               | (48)         |
| Stock compensation expense  |               | 994                           |                 |  |                 | 994          |
| Balance at September 30, 2009   | \$ 234        | \$ 48,942                     | \$ 213,017      | \$ 3,447   | \$ (5,730)      | \$ 259,910   |

See notes to consolidated financial statements.

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

|   | <b>Nine Months Ended September</b> |              |
|---|------------------------------------|--------------|
|   | <b>30,</b>                         |              |
|   | <b>2010</b>                        | <b>2009</b>  |
| <b>Operating activities</b>   |                                    |              |
| Net income  | \$ 27,148                          | \$ 32,911    |
| Adjustments to reconcile net income to net cash provided by operating activities:                           |                                    |              |
| Net amortization of bond premiums and discounts   | 3,649                              | 1,940        |
| Provision for depreciation and amortization   | 1,883                              | 1,350        |
| Net realized gains on investment securities   | (3,534)                            | (1,831)      |
| Gain on bargain purchase  | (635)                              |              |
| Deferred federal income taxes   | (1,542)                            | (1,871)      |
| Stock compensation expense  | 649                                | 994          |
| Increase in deferred policy acquisition costs, net  | (5,498)                            | (879)        |
| Increase in reserves for losses and loss adjustment expenses  | 11,936                             | 17,785       |
| Increase in premiums receivable   | (20,708)                           | (22,664)     |
| Increase in unearned premiums and service fees  | 24,667                             | 14,397       |
| Decrease (increase) in interest receivable and other assets   | 9,592                              | (856)        |
| Increase in prepaid reinsurance premiums  | (7,530)                            | (4,326)      |
| Increase (decrease) in accounts payable, commissions and other liabilities and assessments and fees payable | 107                                | (3,880)      |
| Increase in amounts withheld or retained for accounts of others   | 1,355                              | 4,656        |
| Decrease (increase) in reinsurance recoverable  | 11,599                             | (948)        |
| Increase in reinsurance balances payable  | 7,462                              | 5,610        |
| Other   | (109)                              | (45)         |
| <br>Net cash provided by operating activities   | <br>60,491                         | <br>42,343   |
| <br><b>Investing activities</b>   |                                    |              |
| Purchases of fixed maturities   | (412,680)                          | (271,708)    |
| Purchases of equity securities  |                                    | (4,756)      |
| Proceeds from sale of fixed maturities  | 89,750                             | 39,467       |
| Proceeds from sale of equity securities   | 654                                | 12,135       |
| Proceeds from maturities and redemptions of investments   | 314,477                            | 216,345      |
| Acquisition of subsidiary, net of cash and cash equivalents acquired  | (33,438)                           |              |
| Capital expenditures  | (2,107)                            | (2,592)      |
| <br>Net cash used in investing activities   | <br>(43,344)                       | <br>(11,109) |
| <br><b>Financing activities</b>   |                                    |              |
| Decrease in securities lending collateral   |                                    | 49,314       |
| Decrease in securities lending obligation   |                                    | (95,828)     |

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|  |           |           |
|--|-----------|-----------|
| Additional long-term borrowings  | 30,000    |           |
| Reductions of long-term debt   | (26,500)  |           |
| Tax benefit realized from exercise of stock options  | 31        |           |
| Issuance of common shares from treasury upon exercise of stock options or stock award grants | 490       | (48)      |
| Cash dividends paid on common shares   | (4,673)   | (4,081)   |
| Net cash used in financing activities  | (652)     | (50,643)  |
| Net increase (decrease) in cash and cash equivalents   | 16,495    | (19,409)  |
| Cash and cash equivalents at beginning of period   | 18,589    | 77,159    |
| Cash and cash equivalents at end of period   | \$ 35,084 | \$ 57,750 |

See notes to consolidated financial statements.

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**NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

Effective July 1, 2010, the Company and its principal insurance subsidiary, National Interstate Insurance Company (NIIC), completed the acquisition of Vanliner Group, Inc. (Vanliner) from UniGroup, Inc. (UniGroup). The Company has accounted for the acquisition under the acquisition method of accounting in accordance with Accounting Standard Codification (ASC) 805, *Business Combinations* and the purchase price has been preliminarily allocated to the assets acquired and liabilities assumed based on their estimated fair value at the acquisition date. See Note 2 Acquisition of Vanliner Group, Inc. for additional discussion regarding the acquisition and the related financial disclosures. The Consolidated Financial Statements as of and for the three and nine months ended September 30, 2010 and the Notes to Consolidated Financial Statements reflect the consolidated results of the Company and Vanliner commencing on July 1, 2010.

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

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature. Operating results for the three and nine month period ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

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. Acquisition of Vanliner Group, Inc.**

Effective July 1, 2010, NIIC and the Company completed the acquisition of Vanliner from UniGroup. Pursuant to the Purchase Agreement (the Agreement), NIIC acquired all of the issued and outstanding capital stock of Vanliner and the Company acquired certain named information technology assets. Through the acquisition of Vanliner, NIIC acquired VIC, a market leader in providing insurance for the moving and storage industry. VIC wrote approximately \$104 million of gross moving and storage premiums in 2009, representing approximately 58% of its total business. Obtaining a presence in this industry was the Company's primary strategic objective associated with the acquisition. The initial purchase price of \$128.1 million, paid in cash from available funds, represented Vanliner's estimated tangible book value at closing of \$125.1 million, as well as \$3.0 million of certain named information technology assets. This estimated purchase price was to be adjusted based on Vanliner's closing balance sheet delivered to NIIC on August 27, 2010, which resulted in a \$4.6 million decrease in tangible book value. The Agreement provided NIIC with an additional 60 day review period following the delivery of Vanliner's closing balance sheet. As a result of certain items identified during the review period, NIIC provided a notice of disagreement to UniGroup on October 26, 2010 regarding certain amounts in the closing balance sheet, the net effect of which reduced tangible book value by an additional \$1.3 million to \$119.2 million. Additional purchase price adjustments may result from the resolution of the notice of disagreement and/or from certain financial guarantees, including a four and a half-year balance sheet guarantee whereby both favorable and unfavorable developments related to the closing balance sheet inure to

UniGroup. As of the date of this filing, the financial guarantees, which will be re-measured at each subsequent reporting date, have not resulted in a purchase price adjustment or have NIIC and UniGroup resolved the items identified in the notice of

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disagreement. It is anticipated that the final closing balance sheet and related initial purchase price will be determined by the parties in the fourth quarter of 2010 pursuant to the Agreement.

The acquisition is being accounted for in accordance with ASC 805, *Business Combinations*. Purchase accounting, as defined by ASC 805, requires that the assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The purchase price allocation is dependent upon the finalization of fair values and the resolution of NIIC's disagreement with UniGroup related to certain items in the closing balance sheet and is therefore subject to change. Accordingly, the purchase price has been preliminarily allocated based on an estimate of the fair value of assets acquired, liabilities assumed and additional consideration expected to be paid. The estimated fair values disclosed herein were determined based on management's best estimates and ongoing analyses at the time of this filing. Significant judgment is required to arrive at these estimates of fair value and changes to assumptions used could lead to materially different results. The fair value measurement period will continue into the fourth quarter of 2010 as the finalization of certain valuation analyses could result in changes to management's assumptions related to the purchase price allocation and estimated bargain purchase.

The estimated purchase consideration consists of cash and additional future consideration as follows (in thousands):

**Purchase consideration:**

|  |                |
|--|----------------|
| Cash paid  | \$ 128,059     |
| Additional future consideration  | 2,936          |
| Refund based on closing balance sheet delivered by UniGroup              | (4,579)        |
| Refund from closing balance sheet adjustments noted during 60 day review | (1,315)        |
| <br>Total purchase consideration   | <br>\$ 125,101 |

The additional future consideration is based on a calculation where the inputs were agreed upon during negotiations and relate to future interest earnings on investments held related to unearned premium on policies in force on the date of acquisition. There is not expected to be significant variability in this schedule of payments and these payments are not contingent on the results of Vanliner during the period in which these payments will be made.

The following table presents the preliminary fair value allocation of the assets acquired and liabilities assumed relating to the acquisition of Vanliner under the fair value hierarchy level as of July 1, 2010:

|   | Level 1    | Level 2<br>(Dollars in thousands) | Level 3     | Total       |
|---|------------|-----------------------------------|-------------|-------------|
| <b>Assets:</b>  |            |                                   |             |             |
| Investments   | \$         | \$ 303,033                        | \$          | \$ 303,033  |
| Cash and cash equivalents                                   | 94,621     |                                   |             | 94,621      |
| Accrued investment income                                   |            | 3,589                             |             | 3,589       |
| Premiums receivable, net of allowance for doubtful accounts |            |                                   | 66,183      | 66,183      |
| Reinsurance recoverable on paid and unpaid losses           |            |                                   | 71,088      | 71,088      |
| Prepaid reinsurance premiums                                |            |                                   | 6,998       | 6,998       |
| Deferred federal income taxes                               |            |                                   | 8,069       | 8,069       |
| Property and equipment                                      |            |                                   | 2,950       | 2,950       |
| Intangible assets   |            |                                   | 9,061       | 9,061       |
| Other assets  |            |                                   | 14,106      | 14,106      |
| <br>Total assets  | <br>94,621 | <br>306,622                       | <br>178,455 | <br>579,698 |
| <b>Liabilities:</b>   |            |                                   |             |             |
| Unpaid loss and loss adjustment expenses                    |            |                                   | 357,598     | 357,598     |
| Unearned premiums   |            |                                   | 73,116      | 73,116      |

|                          |         |         |
|--------------------------|---------|---------|
| Payable to reinsurers    | 7,939   | 7,939   |
| Other liabilities        | 15,309  | 15,309  |
| Total liabilities        | 453,962 | 453,962 |
| Net assets acquired      |         | 125,736 |
| Adjusted purchase price  |         | 125,101 |
| Gain on bargain purchase |         | \$ 635  |

The estimated gain on bargain purchase of \$0.6 million shown in the table above has been recognized as a separate component of revenues in the Company's Consolidated Statements of Income for the three and nine months ended September 30, 2010. Because the purchase price of the acquisition was based on Vanliner's tangible book value at June 30, 2010 and as certain financial guarantees were included in the agreement, the Company anticipated no goodwill would be recognized after recording the fair value of Vanliner's assets acquired and liabilities assumed. Accordingly, the estimated fair value of net assets acquired was in excess of the total purchase consideration, due to the Company having to recognize intangible assets under purchase accounting, resulting in the estimated gain on bargain purchase. The Company has taken certain actions and incurred certain costs associated with the transaction, totaling approximately \$0.1 million and \$1.0 million, respectively, which are reflected in Other operating

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and general expenses in the Company's Consolidated Statements of Income for the three and nine months ended September 30, 2010.

**Significant Factors Affecting Acquisition Date Fair Values*****Intangibles***

The preliminary fair value of intangible assets represents acquired insurance licenses estimated to be \$7.7 million and an acquired relationship asset estimated to be \$1.4 million, relating to renewal rights, trade names, customer relationships and a distribution network related to UniGroup's affiliated moving and storage agents that use Vanliner for their commercial insurance needs. The preliminary fair value of the licenses was based upon a market approach methodology using limited available data, which we are continuing to analyze, and the fair value of the relationship asset was estimated based upon an income approach methodology utilizing certain cash flow projections, subject to further confirmation. The intangible asset relating to insurance licenses has an indefinite life and the intangible asset relating to the acquired relationship asset has an estimated life of five years. The Company recorded amortization expense of \$0.1 million for both the three and nine months ended September 30, 2010 relating to the relationship asset. Critical inputs into the valuation models of the relationship and other intangible assets included estimations of expected premium, operating margins, capital requirements and historical returns on equity of peer insurance companies.

***Loss and Loss Adjustment Expense (LAE) Reserves Acquired***

The preliminary valuation of loss and loss adjustment expense reserves acquired was determined using preliminary actuarial cash flow models and payment assumptions rather than an observable market price since a liquid market for such underwriting liabilities does not exist. The valuation model used an estimate of future cash flows related to expected liabilities for losses and LAE that a market participant would expect to incur as of the date of the acquisition. These future cash flows were adjusted for the time value of money at a risk free rate and a risk margin to compensate an acquiror for bearing the risk associated with the liabilities that exist outside of the financial guarantees from UniGroup. The preliminary fair value adjustment for loss and LAE of \$1.2 million will be amortized over the expected loss and LAE payout pattern and reflected as a component of loss and LAE. The Company amortized \$0.1 million for both the three and nine months ended September 30, 2010.

***Non-financial Assets and Liabilities***

Receivables, other assets and liabilities were valued at fair value which preliminarily approximated carrying value.

**Vanliner's Contribution to the Company's Revenues and Income**

The following selected financial information summarizes the results of Vanliner from July 1, 2010 that have been included within the Company's Consolidated Statements of Income (in thousands):

|            |           |
|------------|-----------|
| Revenues   | \$ 37,688 |
| Net income | \$ 1,622  |

**Proforma Results of Operations**

The following unaudited pro forma financial information has been provided to present a summary of the combined results of the Company's operations with Vanliner's as if the acquisition has occurred on January 1, 2009. The unaudited pro forma financial information is for informational purposes only and is not necessarily indicative of what the results would have been had the acquisition been completed at the date indicated above. Future changes to the current book of business which have not been contemplated in this unaudited pro forma financial information, such as, but not limited to, the decision to discontinue an insurance product offering, the impact from underwriting decisions, or a change in risk selection or retention rates, could result in a material favorable or unfavorable impact on the Company's future results of operations and financial position. Additionally, the estimated gain on bargain purchase has not been included in the unaudited pro forma financial information due to its non-recurring nature.

| Three Months Ended                            |      | Nine Months Ended September |      |
|---|------|-----------------------------|------|
| September 30,                                 |      | 30,                         |      |
| 2010  | 2009 | 2010                        | 2009 |
| (Dollars in thousands, except per share data) |      |                             |      |



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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Pro forma revenues                     | \$ 119,030 | \$ 119,279 | \$ 354,716 | \$ 350,914 |
| Pro forma net income                   | 8,774      | 13,118     | 33,853     | 50,627     |
| Pro forma net income per share basic   | 0.45       | 0.68       | 1.75       | 2.62       |
| Pro forma net income per share diluted | 0.45       | 0.68       | 1.74       | 2.62       |

**3. Recent Accounting Pronouncements**

In October 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2010-26, *Financial Services Insurance* ( ASU 2010-26 ). ASU 2010-26 amends ASC 944, *Financial Services Insurance*. ASU 2010-26, limiting the capitalization of costs incurred in the acquisition of new and renewal contracts to incremental direct costs of contract

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acquisition and certain costs related directly to certain acquisition activities performed by the insurer of the contract. ASU 2010-26 is effective for interim and annual reporting periods beginning after December 15, 2011. The Company will adopt ASU 2010-26 on January 1, 2012 and is still in the process of evaluating the impact such adoption will have on financial condition, results of operations and liquidity.

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update No. 2010-06, *Improving Disclosures about Fair Value Measurements* ( ASU 2010-06 ). ASU 2010-06 amends ASC 820, *Fair Value Measurements and Disclosures*. ASU 2010-06 requires expanded disclosures around significant transfers between levels of the fair value hierarchy and valuation techniques and inputs used in fair value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009. The Company adopted the expanded disclosures required by ASU 2010-06 beginning in 2010.

**4. 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. Fair values for the Company's investment portfolio are reviewed by company personnel using data from nationally recognized pricing services as well as non-binding broker quotes on a limited basis.

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 values obtained from brokers and independent financial institutions are reviewed by company personnel who are familiar with the securities being priced and the markets in which they trade to ensure that the fair value determination is representative of an exit price, as defined by accounting standards.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability. Level 1 consists of publicly traded equity securities whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government and government agency securities, fixed maturity investments, perpetual preferred stock and certain publicly traded common stocks and other equity securities that are not actively traded. Included in Level 2 are \$5.5 million of securities, which are valued based upon a non-binding broker quote and validated with other observable market data by management. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes, for which the Company believes reflects fair value, but are unable to verify inputs to the valuation methodology. The Company obtained one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. Management reviews these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.



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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 fall as of September 30, 2010:

|   | Level 1   | Level 2<br>(Dollars in thousands) | Level 3   | Total      |
|---|-----------|-----------------------------------|-----------|------------|
| <b>Fixed maturities:</b>                          |           |                                   |           |            |
| U.S. Government and government agency obligations | \$        | \$ 224,015                        | \$        | \$ 224,015 |
| Foreign government obligations                    |           | 4,706                             |           | 4,706      |
| State and local government obligations            |           | 254,024                           | 4,006     | 258,030    |
| Residential mortgage-backed securities            |           | 172,928                           | 2,667     | 175,595    |
| Commercial mortgage-backed securities             |           | 3,508                             |           | 3,508      |
| Corporate obligations                             |           | 214,643                           | 5,202     | 219,845    |
| Redeemable preferred stocks                       | 9,752     | 297                               | 2,428     | 12,477     |
| Total fixed maturities                            | 9,752     | 874,121                           | 14,303    | 898,176    |
| <b>Equity securities:</b>                         |           |                                   |           |            |
| Perpetual preferred stock                         | 865       | 128                               | 396       | 1,389      |
| Common stock                                      | 14,020    | 13,203                            |           | 27,223     |
| Total equity securities                           | 14,885    | 13,331                            | 396       | 28,612     |
| Short-term investments                            |           | 267                               |           | 267        |
| Total investments                                 | 24,637    | 887,719                           | 14,699    | 927,055    |
| Cash and cash equivalents                         | 35,084    |                                   |           | 35,084     |
| Total investments and cash and cash equivalents   | \$ 59,721 | \$ 887,719                        | \$ 14,699 | \$ 962,139 |

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of December 31, 2009:

|   | Level 1 | Level 2<br>(Dollars in thousands) | Level 3 | Total      |
|---|---------|-----------------------------------|---------|------------|
| <b>Fixed maturities:</b>                          |         |                                   |         |            |
| U.S. Government and government agency obligations | \$      | \$ 212,538                        | \$      | \$ 212,538 |
| State and local government obligations            |         | 148,594                           | 6,369   | 154,963    |
| Residential mortgage-backed securities            |         | 114,329                           | 2,384   | 116,713    |
| Commercial mortgage-backed securities             |         | 3,935                             |         | 3,935      |
| Corporate obligations                             |         | 61,582                            | 5,842   | 67,424     |
| Redeemable preferred stocks                       | 8,297   | 678                               | 2,353   | 11,328     |
| Total fixed maturities                            | 8,297   | 541,656                           | 16,948  | 566,901    |
| <b>Equity securities:</b>                         |         |                                   |         |            |
| Perpetual preferred stock                         | 857     | 167                               | 396     | 1,420      |
| Common stock                                      | 14,270  | 12,983                            |         | 27,253     |
| Total equity securities                           | 15,127  | 13,150                            | 396     | 28,673     |
| Short-term investments                            |         | 811                               |         | 811        |
| Total investments                                 | 23,424  | 555,617                           | 17,344  | 596,385    |

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|   |           |            |           |            |
|---|-----------|------------|-----------|------------|
| Cash and cash equivalents                       | 18,589    |            |           | 18,589     |
| Total investments and cash and cash equivalents | \$ 42,013 | \$ 555,617 | \$ 17,344 | \$ 614,974 |

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The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. There were no significant transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2010. The following tables present reconciliations 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 nine months ended September 30, 2010:

|  | <b>Three Months Ended September 30, 2010</b> |                               |  |                                   |                                  |
|--|--|-------------------------------|--|-----------------------------------|----------------------------------|
|  | <b>State and Local</b>                       |                               | <b>Residential</b>                                       |                                   | <b>Perpetual Preferred Stock</b> |
|  | <b>Corporate Obligations</b>                 | <b>Government Obligations</b> | <b>Mortgage-Backed Securities (Dollars in thousands)</b> | <b>Redeemable Preferred Stock</b> |                                  |
| Beginning balance at July 1, 2010  | \$ 5,561                                     | \$ 3,964                      | \$ 2,067   | \$ 2,407                          |                                  |
| Total gains or (losses):   |  |                               |  |                                   |                                  |
| Included in earnings   | (187)  |                               |  |                                   |                                  |
| Included in other comprehensive income   | (109)  | 42                            | 812  | 21                                |                                  |
| Purchases, issuances, sales and settlements:   |  |                               |  |                                   |                                  |
| Sales (a)  | (63)   |                               | (212)  |                                   |                                  |
| Transfers in and/or (out) of Level 3   |  |                               |  |                                   |                                  |
| Ending balance at September 30, 2010   | \$ 5,202                                     | \$ 4,006                      | \$ 2,667   | \$ 2,428                          | \$ 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 | \$ (187)                                     | \$                            | \$   | \$                                | \$                               |

(a) These amounts are attributable to principal pay downs during the three months ended September 30, 2010.

|  | <b>Nine Months Ended September 30, 2010</b> |                               |                                   |                                   |                                  |
|--|---|-------------------------------|-----------------------------------|-----------------------------------|----------------------------------|
|  | <b>State and Local</b>                      |                               | <b>Residential</b>                |                                   | <b>Perpetual Preferred Stock</b> |
|  | <b>Corporate Obligations</b>                | <b>Government Obligations</b> | <b>Mortgage-Backed Securities</b> | <b>Redeemable Preferred Stock</b> |                                  |

**(Dollars in  
thousands)**

|   |          |    |         |    |       |    |       |    |     |
|---|----------|----|---------|----|-------|----|-------|----|-----|
| Beginning balance at January 1,<br>2010   | \$ 5,842 | \$ | 6,369   | \$ | 2,384 | \$ | 2,353 | \$ | 396 |
| Total gains or (losses):  |          |    |         |    |       |    |       |    |     |
| Included in earnings  | (187)    |    |         |    |       |    |       |    |     |
| Included in other<br>comprehensive income   | (97)     |    | 637     |    | 1,013 |    | 75    |    |     |
| Purchases, issuances, sales and<br>settlements:   |          |    |         |    |       |    |       |    |     |
| Sales (a)   | (356)    |    | (3,000) |    | (730) |    |       |    |     |
| Transfers in and/or (out) of<br>Level 3   |          |    |         |    |       |    |       |    |     |
| Ending balance at<br>September 30, 2010   | \$ 5,202 | \$ | 4,006   | \$ | 2,667 | \$ | 2,428 | \$ | 396 |
| The amount of total gains or<br>(losses) for the period included<br>in earnings and attributable to<br>the change in unrealized gains<br>or (losses) relating to assets still<br>held at the reporting date | \$ (187) | \$ |         | \$ |       | \$ |       | \$ |     |

(a) These amounts are attributable to either principal pay downs or calls during the nine months ended September 30, 2010.

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The following tables present reconciliations of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs during the three and nine months ended September 30, 2009:

|  | <b>Three Months Ended September 30, 2009</b> |                                   |  |   |    |     |
|--|--|-----------------------------------|--|---|----|-----|
|  | <b>State and<br/>Local</b>                   |                                   | <b>Residential</b>   |   |    |     |
|  | <b>Corporate<br/>Obligations</b>             | <b>Government<br/>Obligations</b> | <b>Mortgage-backed<br/>securities<br/>(Dollars in thousands)</b> | <b>Redeemable<br/>Preferred<br/>Stock</b> |    |     |
| Beginning balance at July 1, 2009  | \$ 5,825                                     | \$ 6,338                          | \$ 2,705   | \$ 2,299                                  | \$ | 396 |
| Total gains or (losses):   |  |                                   |  |   |    |     |
| Included in earnings   | 65   |                                   |  |   |    |     |
| Included in other comprehensive income   | 65   | 35                                | 16   | 47  |    |     |
| Purchases, issuances, sales and settlements (a)  | (77)   |                                   | (227)  |   |    |     |
| Transfers in and/or (out) of Level 3   |  |                                   |  |   |    |     |
| Ending balance at September 30, 2009   | \$ 5,878                                     | \$ 6,373                          | \$ 2,494   | \$ 2,346                                  | \$ | 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 | \$ 65  | \$                                | \$   | \$  | \$ | \$  |

(a) These amounts are attributable to either purchases of securities, principal pay downs, conversions or maturities during the three months ended September 30, 2009.

|                                      | <b>Nine Months Ended September 30, 2009</b> |                                   |  |   |          |          |
|--------------------------------------|---|-----------------------------------|--|---|----------|----------|
|                                      | <b>State and<br/>Local</b>                  |                                   | <b>Residential</b>   |   |          |          |
|                                      | <b>Corporate<br/>Obligations</b>            | <b>Government<br/>Obligations</b> | <b>Mortgage-backed<br/>securities<br/>(Dollars in thousands)</b> | <b>Redeemable<br/>Preferred<br/>Stock</b> |          |          |
| Beginning balance at January 1, 2009 | \$ 4,295                                    | \$ 6,118                          | \$   | \$ 2,406                                  | \$ 3,265 | \$ 5,046 |
| Total gains or (losses):             |   |                                   |  |   |          |          |
| Included in earnings                 | 65  |                                   | (497)  |   | (170)    | (421)    |



|   |          |          |          |          |         |         |
|---|----------|----------|----------|----------|---------|---------|
| Included in other comprehensive income          | (45)     | 255      | 716      | (60)     | 1,551   | 546     |
| Purchases, issuances, sales and settlements (a) | (577)    |          | (269)    |          | (4,250) | (487)   |
| Transfers in and/or (out) of Level 3 (b)        | 2,140    |          | 2,544    |          |         | (4,684) |
| Ending balance at September 30, 2009            | \$ 5,878 | \$ 6,373 | \$ 2,494 | \$ 2,346 | \$ 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 | \$ 65 | \$ | (497) | \$ | (170) | (421) |
|--|-------|----|-------|----|-------|-------|

(a) These amounts are attributable to either purchases of securities, principal pay downs, conversions or maturities during the nine months ended September 30, 2009.

(b) Transfers in and/or (out) of Level 3 relate to the termination of the securities lending program and moving longer-term assets into the investment portfolio during the nine months ended September 30, 2009.

#### 5. Investments

Under current other-than-temporary impairment accounting guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then an entity may separate the other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive

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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 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:

|   | <b>Cost or<br/>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains<br/>(Dollars in thousands)</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|---------------------------------------|--|--|-----------------------|
| <b>September 30, 2010:</b>                        |                                       |  |  |                       |
| <b>Fixed Maturities:</b>                          |                                       |  |  |                       |
| U.S. Government and government agency obligations | \$ 219,715                            | \$ 4,352   | \$ (52)                                | \$ 224,015            |
| Foreign government obligations                    | 4,726                                 |  | (20)                                   | 4,706                 |
| State and local government obligations            | 248,549                               | 10,347   | (866)                                  | 258,030               |
| Residential mortgage-backed securities            | 174,343                               | 4,217  | (2,965)                                | 175,595               |
| Commercial mortgage-backed securities             | 3,720                                 |  | (212)                                  | 3,508                 |
| Corporate obligations                             | 213,434                               | 7,189  | (778)                                  | 219,845               |
| Redeemable preferred stock                        | 12,427                                | 237  | (187)                                  | 12,477                |
| <b>Total fixed maturities</b>                     | <b>876,914</b>                        | <b>26,342</b>  | <b>(5,080)</b>                         | <b>898,176</b>        |
| <b>Equity securities:</b>                         |                                       |  |  |                       |
| Perpetual preferred stocks                        | 1,309                                 | 80   |  | 1,389                 |
| Common stocks                                     | 24,996                                | 2,227  |  | 27,223                |
| <b>Total equity securities</b>                    | <b>26,305</b>                         | <b>2,307</b>   |  | <b>28,612</b>         |
| Short-term investments                            | 267                                   |  |  | 267                   |
| <b>Total investments</b>                          | <b>\$ 903,486</b>                     | <b>\$ 28,649</b>   | <b>\$ (5,080)</b>                      | <b>\$ 927,055</b>     |
| <b>December 31, 2009:</b>                         |                                       |  |  |                       |
| <b>Fixed Maturities:</b>                          |                                       |  |  |                       |
| U.S. Government and government agency obligations | \$ 211,151                            | \$ 1,736   | \$ (349)                               | \$ 212,538            |
| State and local government obligations            | 151,139                               | 5,436  | (1,612)                                | 154,963               |
| Residential mortgage-backed securities            | 118,967                               | 2,224  | (4,478)                                | 116,713               |
| Commercial mortgage-backed securities             | 4,482                                 |  | (547)                                  | 3,935                 |
| Corporate obligations                             | 67,588                                | 1,465  | (1,629)                                | 67,424                |
| Redeemable preferred stock                        | 12,426                                | 89   | (1,187)                                | 11,328                |
| <b>Total fixed maturities</b>                     | <b>565,753</b>                        | <b>10,950</b>  | <b>(9,802)</b>                         | <b>566,901</b>        |
| <b>Equity securities:</b>                         |                                       |  |  |                       |
| Perpetual preferred stocks                        | 1,320                                 | 109  | (9)                                    | 1,420                 |
| Common stocks                                     | 24,883                                | 2,370  |  | 27,253                |

|                         |            |           |            |            |
|-------------------------|------------|-----------|------------|------------|
| Total equity securities | 26,203     | 2,479     | (9)        | 28,673     |
| Short-term investments  | 811        |           |            | 811        |
| Total investments       | \$ 592,767 | \$ 13,429 | \$ (9,811) | \$ 596,385 |

The amortized cost and fair value of fixed maturities at September 30, 2010, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 2.8 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:

|  | <b>Amortized</b>              |                   |
|--|-------------------------------|-------------------|
|  | <b>Cost</b>                   | <b>Fair Value</b> |
|  | <b>(Dollars in thousands)</b> |                   |
| Due in one year or less                | \$ 25,058                     | \$ 25,348         |
| Due after one year through five years  | 322,604                       | 329,150           |
| Due after five years through ten years | 258,131                       | 269,973           |
| Due after ten years                    | 93,058                        | 94,602            |
|  | 698,851                       | 719,073           |
| Mortgage-backed securities             | 178,063                       | 179,103           |
| Total                                  | \$ 876,914                    | \$ 898,176        |

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Gains and losses on the sale of investments, including other-than-temporary impairments charges, were as follows:

|  | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b>      |             |
|--|-------------------------------|-------------|-------------------------------|-------------|
|  | <b>September 30,</b>          |             | <b>September 30,</b>          |             |
|  | <b>2010</b>                   | <b>2009</b> | <b>2010</b>                   | <b>2009</b> |
|  | <b>(Dollars in thousands)</b> |             | <b>(Dollars in thousands)</b> |             |
| Fixed maturity gains                     | \$ 1,020                      | \$ 266      | \$ 3,428                      | \$ 1,828    |
| Fixed maturity losses                    | (255)                         | (1,392)     | (357)                         | (2,424)     |
| Equity security gains                    | 403                           | 1,886       | 947                           | 4,766       |
| Equity security losses                   | (185)                         |             | (484)                         | (1,916)     |
| Securities lending fixed maturity losses |                               |             |                               | (423)       |
| Net realized gains on investments        | \$ 983                        | \$ 760      | \$ 3,534                      | \$ 1,831    |

Pre-tax net realized gains were \$1.0 million and \$3.5 million for the three and nine months ended September 30, 2010, respectively. The net realized gains for both the three and nine months ended September 30, 2010 were primarily generated from gains associated with the sales of securities of \$1.0 million and \$3.4 million, respectively, and gains associated with an equity partnership investment of \$0.4 million and \$0.9 million, respectively. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of the securities over book value and include gains from sales to generate funds for the Vanliner acquisition. Offsetting these gains were losses associated with an equity partnership of \$0.2 million and \$0.5 million and other-than-temporary impairment charges of \$0.2 million and \$0.3 million for the three and nine months ended September 30, 2010, respectively. The other-than-temporary impairment charges for both the three and nine months ended September 30, 2010, are primarily due to a \$0.2 million charge on one corporate bond that had a decrease in market value below book value and, due to the uncertainty of ultimate recovery, the entire impairment was recorded as a credit loss. Included in the remaining other-than-temporary impairment charge for the nine months ended September 30, 2010 is a \$0.1 million charge that was recorded on a mortgage-backed security, for which a previous impairment charge had been recorded. The other-than-temporary impairment charge on this security was separated into: a credit loss of \$0.1 million, which is recognized in earnings, and a reduction in the non-credit loss of \$0.1 million, which was previously included in other comprehensive income. The credit loss of \$0.1 million was the result of management's analysis that the Company may not receive the full principal amounts due to potential defaults on the mortgage loans underlying the mortgage-backed security and that the recovery of expected principal will take longer than previously expected.

Pre-tax net realized gains were \$0.8 million and \$1.8 million for the three and nine months ended September 30, 2009, respectively. The net realized gains for both the three and nine months ended September 30, 2009 were primarily generated from gains on an equity partnership of \$1.0 million and \$3.6 million, respectively, realized gains from the sales of equity securities of \$0.9 million for the three and nine months ended September 30, 2009 and realized gains from the sales or calls of fixed maturity securities of \$0.3 and \$1.8 million, respectively, for the three and nine months ended September 30, 2009. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of the securities over book value and the Company sold these securities to realize these gains. These gains were offset by other-than-temporary impairment charges of \$1.3 million and \$2.5 million for the three and nine months ended September 30, 2009, respectively, and equity security losses of \$1.3 million primarily related to a conversion of a perpetual preferred stock to common stock on a financial institution holding and losses on an equity partnership of \$0.5 million for the nine months ended September 30, 2009. The other-than-temporary impairment charge of \$1.3 million during the three months and nine months ended September 30, 2009 related to one corporate note in the financial services sector that experienced credit issues and, due to the possibility that this security may have been sold subsequent to September 30, 2009, the entire impairment charge loss was recognized in earnings. Included in the remaining other-than-temporary impairment charge for the nine months ended September 30, 2009 were several securities totaling \$0.7 million, including one fixed maturity investment previously held within the

securities lending collateral portfolio, which experienced credit issues that, in the Company's estimation, made full recovery of the cost of these investments unlikely and credit only impairments of \$0.5 million on two mortgage-backed securities which were written down to the present value of the expected cash flows. A non-credit charge of \$3.0 million relating to these two mortgage-backed securities was included in other comprehensive income for the nine months ended September 30, 2009.

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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 |
| <b>September 30, 2010:</b>                        |                         |                   |                         |   |                       |                   |                         |                    |
| Fixed maturities:                                 |                         |                   |                         |   |                       |                   |                         |                    |
| U.S. Government and government agency obligations |                         |                   |                         |   |                       |                   |                         |                    |
|   | \$ 52,172               | \$ (52)           | 99.9%                   | 17  | \$                    | \$                |                         |                    |
| Foreign government obligations                    |                         |                   |                         |   |                       |                   |                         |                    |
|   | 4,706                   | (20)              | 99.6%                   | 3   |                       |                   |                         |                    |
| State and local government obligations            |                         |                   |                         |   |                       |                   |                         |                    |
|   | 6,248                   | (38)              | 99.4%                   | 6   | 3,672                 | (828)             | 81.6%                   | 3                  |
| Residential mortgage-backed securities            |                         |                   |                         |   |                       |                   |                         |                    |
|   | 37,743                  | (203)             | 99.5%                   | 10  | 7,245                 | (2,762)           | 72.4%                   | 6                  |
| Commercial mortgage-backed securities             |                         |                   |                         |   |                       |                   |                         |                    |
|   |                         |                   |                         |   | 3,507                 | (212)             | 94.3%                   | 1                  |
| Corporate obligations                             |                         |                   |                         |   |                       |                   |                         |                    |
|   | 7,132                   | (90)              | 98.8%                   | 16  | 6,311                 | (688)             | 90.2%                   | 5                  |
| Redeemable preferred stocks                       |                         |                   |                         |   |                       |                   |                         |                    |
|   |                         |                   |                         |   | 6,217                 | (187)             | 97.1%                   | 10                 |
| Total fixed maturities                            |                         |                   |                         |   |                       |                   |                         |                    |
|   | 108,001                 | (403)             | 99.6%                   | 52  | 26,952                | (4,677)           | 85.2%                   | 25                 |
| Equity securities:                                |                         |                   |                         |   |                       |                   |                         |                    |
| Perpetual preferred stocks                        |                         |                   |                         |   |                       |                   |                         |                    |
| Common stocks                                     |                         |                   |                         |   |                       |                   |                         |                    |
| Total equity securities                           |                         |                   |                         |   |                       |                   |                         |                    |
| Total fixed maturities and equity securities      |                         |                   |                         |   |                       |                   |                         |                    |
|   | \$ 108,001              | \$ (403)          | 99.6%                   | 52  | \$ 26,952             | \$ (4,677)        | 85.2%                   | 25                 |

**December 31,  
2009:**

## Fixed maturities:

|   |                   |                   |              |            |                  |                   |              |           |
|---|-------------------|-------------------|--------------|------------|------------------|-------------------|--------------|-----------|
| U.S. Government<br>and government<br>agency obligations     | \$ 84,971         | \$ (349)          | 99.6%        | 46         | \$               | \$                |              |           |
| State and local<br>government<br>obligations                | 14,279            | (122)             | 99.2%        | 13         | 6,725            | (1,490)           | 81.9%        | 6         |
| Residential<br>mortgage-backed<br>securities                | 35,434            | (210)             | 99.4%        | 20         | 8,426            | (4,268)           | 66.4%        | 7         |
| Commercial<br>mortgage-backed<br>securities                 |                   |                   |              |            | 3,934            | (547)             | 87.8%        | 2         |
| Corporate<br>obligations                                    | 23,189            | (459)             | 98.1%        | 45         | 12,150           | (1,170)           | 91.2%        | 9         |
| Redeemable<br>preferred stocks                              |                   |                   |              |            | 8,742            | (1,187)           | 88.0%        | 20        |
| <b>Total fixed<br/>maturities</b>                           | <b>157,873</b>    | <b>(1,140)</b>    | <b>99.3%</b> | <b>124</b> | <b>39,977</b>    | <b>(8,662)</b>    | <b>82.2%</b> | <b>44</b> |
| Equity securities:  |                   |                   |              |            |                  |                   |              |           |
| Perpetual preferred<br>stocks                               |                   |                   |              |            | 94               | (9)               | 91.3%        | 1         |
| <b>Total equity<br/>securities</b>                          |                   |                   |              |            | <b>94</b>        | <b>(9)</b>        | <b>91.3%</b> | <b>1</b>  |
| <b>Total fixed<br/>maturities and<br/>equity securities</b> | <b>\$ 157,873</b> | <b>\$ (1,140)</b> | <b>99.3%</b> | <b>124</b> | <b>\$ 40,071</b> | <b>\$ (8,671)</b> | <b>82.2%</b> | <b>45</b> |

The gross unrealized losses on the Company's fixed maturities and equity securities portfolios decreased from \$9.8 million at December 31, 2009 to \$5.1 million at September 30, 2010. The improvement in gross unrealized losses was driven by a decrease in market yields and a general tightening of credit spreads from December 31, 2009. The \$5.1 million in gross unrealized losses at September 30, 2010 was primarily on fixed maturity holdings in residential mortgage-backed securities, state and local government obligations and corporate obligations. There were no gross unrealized losses on perpetual preferred stocks and common stocks. Investment grade securities (as determined by nationally recognized rating agencies) represented 90.4% of all fixed maturity securities with unrealized losses. At September 30, 2010, gross unrealized losses on residential mortgage-backed securities were \$3.0 million and represented 58.4% of the total gross unrealized losses on fixed maturities. There were six securities with gross unrealized losses of \$2.8 million that were in an unrealized loss position for 12 months or more. Three of these securities previously had both credit and non-credit other-than-temporary impairment charges and were in a gross unrealized loss position of \$1.7 million at September 30, 2010. 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 currently believes that the Company will recover its cost basis in all these securities and no additional charges for other-than-temporary impairments will be required.

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At September 30, 2010, the state and local government obligations, with gross unrealized losses of \$0.9 million, had three holdings that were in an unrealized loss position of \$0.8 million for more than 12 months. Investment grade securities represented 79.3% of all state and local government obligations with unrealized losses greater than 12 months. The corporate obligations had gross unrealized losses totaling \$0.8 million at September 30, 2010. The gross unrealized losses on corporate obligations consisted of 16

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holdings that were in an unrealized loss position of \$0.1 million for less than 12 months and five holdings with gross unrealized losses of \$0.7 million that were in an unrealized loss position for more than 12 months. Investment grade securities represented 85.2% of all corporate obligations with unrealized losses greater than 12 months.

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

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

|                                      | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--------------------------------------|-------------------------------------|--------|------------------------------------|--------|
|                                      | 2010                                | 2009   | 2010                               | 2009   |
|                                      | (Dollars in thousands)              |        | (Dollars in thousands)             |        |
| Beginning balance                    | \$ 1,974                            | \$ 534 | \$ 1,910                           | \$     |
| Additional credit impairments on:    |                                     |        |                                    |        |
| Previously impaired securities       |                                     |        | 101                                |        |
| Securities without prior impairments |                                     |        |                                    | 534    |
| Reductions                           |                                     |        | (37)                               |        |
| Ending balance                       | \$ 1,974                            | \$ 534 | \$ 1,974                           | \$ 534 |

**6. Long-term Debt**

At September 30, 2010 and December 31, 2009, long-term debt outstanding was \$18.5 million and \$15.0 million, respectively.

The Company has a \$50 million unsecured Credit Agreement (the "Credit Agreement") that terminates in December 2012, which includes a sublimit of \$10 million for letters of credit. The Company has the ability to increase the line of credit to \$75 million subject to the Credit Agreement's accordion feature. Amounts borrowed bear interest at either (1) a rate per annum equal to the greater of the administrative agent's prime rate or 0.5% in excess of the federal funds effective rate or (2) rates ranging from 0.45% to 0.90% over LIBOR based on the Company's A.M. Best insurance group rating, or 0.65% at September 30, 2010. Commitment fees on the average daily unused portion of the Credit Agreement also vary with the Company's A.M. Best insurance group rating and range from 0.090% to 0.175%, or 0.125% at September 30, 2010.

On June 24, 2010, the Company drew \$30 million from this credit facility to help fund the purchase of Vanliner. During the third quarter of 2010, the Company used available cash to pay down this credit facility by \$26.5 million. As of September 30, 2010, the interest rate under this Credit Agreement is equal to the six-month LIBOR (0.75% at September 30, 2010) plus 65 basis points, with interest payments due quarterly.

The Credit Agreement requires the Company to maintain specified financial covenants measured on a quarterly basis, including consolidated net worth, fixed charge coverage ratio and debt to capital ratio. In addition, the Credit Agreement contains certain affirmative and negative covenants, including negative covenants that limit or restrict the Company's ability to, among other things, incur additional indebtedness, effect mergers or consolidations, make investments, enter into asset sales, create liens, enter into transactions with affiliates and other restrictions customarily contained in such agreements. As of September 30, 2010, the Company was in compliance with all financial covenants.



**Table of Contents****7. Income Taxes**

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

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2010</b>                                 | <b>2009</b> | <b>2010</b>                                | <b>2009</b> |
|   | <b>(Dollars in thousands)</b>               |             | <b>(Dollars in thousands)</b>              |             |
| Federal income tax expense at statutory rate        | \$ 4,392                                    | \$ 3,333    | \$ 13,338                                  | \$ 15,973   |
| Effect of:  |   |             |  |             |
| Tax-exempt investment income                        | (559)                                       | (420)       | (1,310)                                    | (1,287)     |
| Change in valuation allowance on net capital losses |   | (1,792)     | (810)                                      | (2,397)     |
| Gain on bargain purchase                            | (222)                                       |             | (222)                                      |             |
| Other items, net                                    | (8)   | 246         | (35)                                       | 437         |
|   | \$ 3,603                                    | \$ 1,367    | \$ 10,961                                  | \$ 12,726   |

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:

|   | <b>September<br/>30, 2010</b> | <b>December 31,<br/>2009</b> |
|---|-------------------------------|------------------------------|
|   | <b>(Dollars in thousands)</b> |                              |
| <b>Deferred Tax Assets:</b>                           |                               |                              |
| Unearned premiums                                     | \$ 14,541                     | \$ 8,750                     |
| Unpaid losses and loss adjustment expenses            | 18,486                        | 8,742                        |
| Assignments and assessments                           | 1,310                         | 817                          |
| Realized losses on investments, primarily impairments | 2,035                         | 6,436                        |
| Accrued compensation                                  | 2,271                         | 2,218                        |
| Other, net  | 2,154                         | 1,398                        |
|   | 40,797                        | 28,361                       |
| Valuation allowance                                   |                               | (810)                        |
|   | 40,797                        | 27,551                       |
| <b>Deferred Tax Liabilities:</b>                      |                               |                              |
| Deferred policy acquisition costs                     | (8,166)                       | (6,241)                      |
| Unrealized gains on investments                       | (8,249)                       | (1,266)                      |
| Other, net  | (3,575)                       | (1,866)                      |
| Total deferred tax liabilities                        | (19,990)                      | (9,373)                      |
| Net deferred income tax assets                        | \$ 20,807                     | \$ 18,178                    |

Management has reviewed the recoverability of the deferred tax assets and believes that the amount will be recoverable against future earnings. The gross deferred tax assets were reduced by a valuation allowance related to net realized losses on investments of \$0.8 million for December 31, 2009, primarily related to impairment charges. There was no such valuation allowance related to net realized losses on investments subsequent to March 31, 2010.

### **8. 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 September 30, 2010, there were 773,682 of the Company s common shares reserved for issuance under the LTIP and options for 601,550 shares were outstanding. In March 2010, the Company granted a restricted share award and a stock bonus award under the LTIP. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Compensation Committee of the Board of Directors may accelerate vesting and exercisability of options. For the three months ended September 30, 2010, the Company recognized stock-based compensation expense, inclusive of options forfeited during the quarter, of \$0.2 million with related income tax benefits of approximately \$44 thousand, as compared to stock-based compensation expense of \$0.3 million and related income tax benefits of approximately \$0.1 million for the same period in 2009. For the nine months ended September 30, 2010 and 2009, the Company recognized stock-based compensation expense, inclusive of options forfeited, of \$0.6 million and \$1.0 million, respectively. Related income tax benefits of approximately \$0.2 million were recognized for both the nine months ended September 30, 2010 and 2009. In the first nine months of 2010, the Company also recognized compensation expense related to a stock bonus award of approximately \$0.1 million.

**Table of Contents****9. Earnings Per Common Share**

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

|   | Three Months Ended<br>September 30,              |          | Nine Months Ended<br>September 30,               |           |
|---|--|----------|--|-----------|
|   | 2010<br>(In thousands, except per<br>share data) | 2009     | 2010<br>(In thousands, except per<br>share data) | 2009      |
| Net income  | \$ 8,944   | \$ 8,156 | \$ 27,148  | \$ 32,911 |
| Weighted average shares outstanding<br>during period  | 19,344   | 19,301   | 19,338   | 19,301    |
| Additional shares issuable under employee<br>common stock option plans using treasury<br>stock method | 113  | 83       | 93   | 59        |
| Weighted average shares outstanding<br>assuming exercise of stock options                             | 19,457   | 19,384   | 19,431   | 19,360    |
| Net income per share:   |  |          |  |           |
| Basic   | \$ 0.46  | \$ 0.42  | \$ 1.40  | \$ 1.71   |
| Diluted   | \$ 0.46  | \$ 0.42  | \$ 1.40  | \$ 1.70   |

For the three months ended September 30, 2010 and 2009, there were 279,906 and 498,050, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive. For the nine months ended September 30, 2010 and 2009, there were 398,550 and 498,050, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive.

**10. Transactions with Related Parties**

The Company's principal insurance subsidiary, NIIC, is involved in both the cession and assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA, a wholly-owned subsidiary of the Company, is a party to an underwriting management agreement with Great American Insurance Company (Great American). As of September 30, 2010, Great American owned 52.5% of the outstanding shares of the Company. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American's net premiums written for public transportation and recreational vehicle risks underwritten pursuant to the reinsurance agreement. NIIA provides administrative services to Great American in connection with Great American's underwriting of these risks. The Company also cedes premium through reinsurance agreements with Great American to reduce exposure in certain of its property and casualty insurance programs.

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

|  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|--------|------------------------------------|----------|
|  | 2010<br>(Dollars in thousands)      | 2009   | 2010<br>(Dollars in thousands)     | 2009     |
| Assumed premiums written                               | \$ 855                              | \$ 588 | \$ 3,141                           | \$ 2,624 |
| Assumed premiums earned                                | 902                                 | 835    | 2,473                              | 3,042    |
| Assumed losses and loss adjustment expense<br>incurred | 702                                 | 931    | 1,351                              | 3,215    |

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|   |     |     |       |       |
|---|-----|-----|-------|-------|
| Ceded premiums written                              | 484 | 610 | 1,866 | 2,789 |
| Ceded premiums earned                               | 577 | 827 | 1,881 | 2,422 |
| Ceded losses and loss adjustment expense recoveries | 558 | 783 | 2,260 | 2,454 |
| Payable to Great American as of period end          | 325 | 531 | 325   | 531   |

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

**Table of Contents****11. Reinsurance**

Premiums and reinsurance activity consisted of the following:

|                         | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|-------------------------|-------------------------------------|-----------|------------------------------------|------------|
|                         | 2010                                | 2009      | 2010                               | 2009       |
|                         | (Dollars in thousands)              |           | (Dollars in thousands)             |            |
| Direct premiums written | \$ 114,329                          | \$ 67,423 | \$ 326,695                         | \$ 274,044 |
| Reinsurance assumed     | 2,200                               | 2,145     | 6,364                              | 5,702      |
| Reinsurance ceded       | (16,005)                            | (10,584)  | (65,154)                           | (59,875)   |
| Net premiums written    | \$ 100,524                          | \$ 58,984 | \$ 267,905                         | \$ 219,871 |
| Direct premiums earned  | \$ 132,590                          | \$ 87,158 | \$ 303,411                         | \$ 259,372 |
| Reinsurance assumed     | 2,063                               | 2,191     | 5,481                              | 6,103      |
| Reinsurance ceded       | (22,787)                            | (18,524)  | (57,612)                           | (55,548)   |
| Total premiums earned   | \$ 111,866                          | \$ 70,825 | \$ 251,280                         | \$ 209,927 |

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property and casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the three months ended September 30, 2010 and 2009 were \$11.4 million and \$11.3 million, respectively, and were \$36.5 million and \$37.5 million for the nine months ended September 30, 2010 and 2009, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company and regularly evaluates the financial condition of its reinsurers.

**12. 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 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. The Company has established loss and loss adjustment expense 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 September 30, 2010 and December 31, 2009, the liability for such assessments was \$4.7 million and \$3.2 million, respectively, and will be paid over several years as assessed by the various state funds.



**Table of Contents****13. 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. Vanliner's premiums earned are included in the table below as part of the Company's transportation component for the three and nine months ended September 30, 2010.

|                                   | Three Months Ended     |           | Nine Months Ended      |            |
|-----------------------------------|------------------------|-----------|------------------------|------------|
|                                   | September 30,          |           | September 30,          |            |
|                                   | 2010                   | 2009      | 2010                   | 2009       |
|                                   | (Dollars in thousands) |           | (Dollars in thousands) |            |
| <b>Revenue:</b>                   |                        |           |                        |            |
| Premiums Earned:                  |                        |           |                        |            |
| Alternative Risk Transfer         | \$ 40,833              | \$ 36,695 | \$ 113,206             | \$ 105,680 |
| Transportation                    | 51,518                 | 14,300    | 80,701                 | 46,074     |
| Specialty Personal Lines          | 14,504                 | 14,262    | 43,188                 | 42,127     |
| Hawaii and Alaska                 | 3,550                  | 3,837     | 10,230                 | 11,671     |
| Other                             | 1,461                  | 1,731     | 3,955                  | 4,375      |
| Total premiums earned             | 111,866                | 70,825    | 251,280                | 209,927    |
| Net investment income             | 6,440                  | 4,501     | 16,411                 | 14,430     |
| Net realized gains on investments | 983                    | 760       | 3,534                  | 1,831      |
| Gain on bargain purchase          | 635                    |           | 635                    |            |
| Other                             | 1,030                  | 879       | 2,824                  | 2,627      |
| Total revenues                    | \$ 120,954             | \$ 76,965 | \$ 274,684             | \$ 228,815 |

**14. Comprehensive Income**

Comprehensive income includes the Company's net income plus the changes in the unrealized gains or losses (net of income taxes) on the Company's available-for-sale securities. There was total comprehensive income for the three months ended September 30, 2010 and 2009 of \$17.5 million and \$17.4 million, respectively. Total comprehensive income for the nine months ended September 30, 2010 and 2009 was \$40.1 million and \$47.0 million, respectively.

**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, intend, project, and other similar expressions, constitute forward-looking statements. We made these statements based on our plans and current analyses of our business and the insurance industry as a whole. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Factors that could contribute to these differences include, among other things:

- general economic conditions, weakness of the financial markets and other factors, including prevailing interest rate levels and stock and credit market performance, which may affect or continue to affect (among other things) our ability to sell our products and to collect amounts due to us, our ability to access capital resources and the costs associated with such access to capital and the market value of our investments;
- our ability to manage our growth strategy, including the ongoing integration of Vanliner Group, Inc. (Vanliner);
- customer response to new products and marketing initiatives;

tax law changes;  
increasing competition in the sale of our insurance products and services and the retention of existing customers;  
changes in legal environment;

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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 property and casualty insurance products primarily to the passenger transportation industry and the trucking industry, 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. Effective July 1, 2010, with the acquisition of Vanliner Insurance Company ( VIC ), we also now underwrite and sell insurance products for moving and storage transportation companies.

With the acquisition of Vanliner, we have five active property and casualty insurance subsidiaries: National Interstate Insurance Company ( NIIC ), VIC, National Interstate Insurance Company of Hawaii, Inc. ( NIIC-HI ), Triumpher Casualty Company ( TCC ), Hudson Indemnity, Ltd. ( HIL ) and six 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, a Pennsylvania domiciled company, holds licenses for multiple lines of authority, including auto-related lines, in 25 states and the District of Columbia. HIL is domiciled in the Cayman Islands and provides reinsurance for NIIC, NIIC-HI and TCC primarily for the alternative risk transfer product. We anticipate that HIL will also provide reinsurance for VIC during the fourth quarter of 2010. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, program administrators, affiliated agencies and agent internet initiatives. We use our six active agency and service subsidiaries to sell and service our insurance business.

Effective July 1, 2010, we and our principal insurance subsidiary, NIIC, completed the acquisition of Vanliner from UniGroup, Inc. ( UniGroup ) whereby NIIC acquired all of the issued and outstanding capital stock of Vanliner and we acquired certain information technology assets. The initial purchase price of \$128.1 million, paid in cash from available funds, represented Vanliner's estimated tangible book value at closing of \$125.1 million, as well as \$3.0 million for the information technology assets. This estimated purchase price was to be adjusted based on Vanliner's closing balance sheet delivered to us on August 27, 2010, which resulted in a \$4.6 million decrease in tangible book value. The purchase agreement provided us with an additional 60 day review period following the delivery of Vanliner's closing balance sheet. As a result of certain items identified during the review period, we provided a notice of disagreement to UniGroup on October 26, 2010 regarding certain amounts included in the closing balance sheet, the net effect of which further reduced tangible book value by an additional \$1.3 million to \$119.2 million. Additional purchase price adjustments may result from the resolution of the notice of disagreement and/or from certain financial guarantees, including a four and a half-year balance sheet guarantee whereby both favorable and unfavorable balance sheet developments inure to UniGroup. As of the date of this filing, we have not resolved the items identified in the notice of disagreement provided to UniGroup. It is anticipated that the final closing balance sheet and related initial purchase price will be determined by the parties in the fourth quarter of 2010 pursuant to the purchase agreement.

Through the acquisition of Vanliner, NIIC acquired VIC, a market leader in providing insurance for the moving and storage industry. This industry was our primary strategic objective associated with the acquisition. VIC wrote approximately \$104 million of gross moving and storage premiums in 2009, representing approximately 58% of its total business.

Three months of earnings of Vanliner are included in our Consolidated Financial Statements for the three and nine months ended September 30, 2010.

As of September 30, 2010, Great American Insurance Company ( Great American ) owned 52.5% of our outstanding common shares. Great American is a wholly-owned subsidiary of American Financial Group, Inc.

**Table of Contents****Results of Operations****Overview**

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

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

The following table sets forth our September 30, 2010 and 2009 net income from operations, change in valuation allowance related to net capital losses and after-tax net realized gains from investments, all of which are non-GAAP financial measures that we believe are useful tools for investors and analysts in analyzing ongoing operating trends, as well as the estimated gain on bargain purchase of Vanliner and net income.

|   | Three Months Ended September 30,<br>2010             |           | 2009 (a) |           |
|---|--|-----------|----------|-----------|
|   | Amount   | Per Share | Amount   | Per Share |
|   | <b>(Dollars in thousands, except per share data)</b> |           |          |           |
| Net income from operations                                  | \$ 7,670   | \$ 0.40   | \$ 5,869 | \$ 0.30   |
| Change in valuation allowance related to net capital losses |  |           | 1,792    | 0.09      |
| After-tax net realized gains from investments               | 639  | 0.03      | 495      | 0.03      |
| Gain on bargain purchase of Vanliner                        | 635  | 0.03      |          |           |
| Net income  | \$ 8,944   | \$ 0.46   | \$ 8,156 | \$ 0.42   |

(a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition. Consequently, 2009 data does not include Vanliner's financial results.

|   | Nine Months Ended September 30,<br>2010              |           | 2009 (a)  |           |
|---|--|-----------|-----------|-----------|
|   | Amount   | Per Share | Amount    | Per Share |
|   | <b>(Dollars in thousands, except per share data)</b> |           |           |           |
| Net income from operations                                  | \$ 23,406  | \$ 1.21   | \$ 29,324 | \$ 1.51   |
| Change in valuation allowance related to net capital losses | 810  | 0.04      | 2,397     | 0.13      |
| After-tax net realized gains from investments               | 2,297  | 0.12      | 1,190     | 0.06      |
| Gain on bargain purchase of Vanliner                        | 635  | 0.03      |           |           |
| Net income  | \$ 27,148  | \$ 1.40   | \$ 32,911 | \$ 1.70   |

(a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition. Consequently, 2009 data does not include Vanliner's financial results.

Our net income from operations for the three and nine months ended September 30, 2010 was \$7.7 million (\$0.40 per share diluted) and \$23.4 million (\$1.21 per share diluted), respectively, compared to \$5.9 million (\$0.30 per share diluted) and \$29.3 million (\$1.51 per share diluted) for the same periods in 2009. Included in these results for both the third quarter and first nine months of 2010 is net income from operations of \$1.6 million related to Vanliner, primarily attributable to net investment income, as Vanliner's underwriting results were breakeven. Our consolidated loss and LAE ratios for the third quarter and first nine months of 2010 were 76.2% and 69.4%, respectively, as compared to 68.2% and 60.5% for the comparable periods in 2009. The standalone loss and LAE ratios for our legacy operation, which are exclusive of Vanliner, were 70.3% and 66.2% for the three and nine months ended September 30, 2010. While our legacy operations' 2010 loss and LAE ratios are running at profitable levels, they are several percentage points higher than our historical ratios and management's expectations. In particular, we have noted an increase in claim severity among certain of our trucking products in both our alternative risk transfer and transportation components, as well as increased claim frequency within our specialty personal lines component. We have already initiated underwriting and pricing actions in our specialty personal lines component and are currently in the process of examining the results of our trucking products in order to respond with the appropriate actions to bring their performance back in line with our expectations. Our consolidated underwriting expense ratios of 18.9% and 22.5% for the third quarter and first nine months of 2010, respectively, were both several points better than our historical run rate due to the impact of Vanliner. Excluding Vanliner, our legacy operations' underwriting expense ratios for the quarter and nine months ended September 30, 2010 were 22.5% and 24.4%, respectively, which are in line with management's expectations. Vanliner's favorable impact on our consolidated underwriting expense ratio and unfavorable impact on our consolidated loss and LAE ratio were primarily attributable to adjustments from the initial fair value recording of Vanliner's opening balance sheet, which we anticipate will be less significant



|                           | <b>Nine Months Ended September 30,</b> |                | <b>2009 (a)</b> |                |
|---------------------------|--|----------------|-----------------|----------------|
|                           | <b>2010</b>                            | <b>Percent</b> | <b>Amount</b>   | <b>Percent</b> |
|                           | <b>(Dollars in thousands)</b>          |                |                 |                |
| Alternative Risk Transfer | \$ 179,753                             | 54.0%          | \$ 161,188      | 57.6%          |
| Transportation            | 85,378                                 | 25.6%          | 51,147          | 18.3%          |
| Specialty Personal Lines  | 49,467                                 | 14.9%          | 48,210          | 17.2%          |
| Hawaii and Alaska         | 14,435                                 | 4.3%           | 14,958          | 5.4%           |
| Other                     | 4,026                                  | 1.2%           | 4,243           | 1.5%           |
| Gross premiums written    | \$ 333,059                             | 100.0%         | \$ 279,746      | 100.0%         |

(a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition. Consequently, 2009 data does not include Vanliner's financial results.

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Gross premiums written includes both direct and assumed premium. During the third quarter of 2010, our gross premiums written increased \$47.0 million, or 67.5%, compared to the same period in 2009. Included in this increase was \$27.9 million of gross premiums written related to Vanliner, which are included in the transportation component. Excluding Vanliner's gross premiums written, the increase in gross premiums written is primarily attributable to our alternative risk transfer (ART) component, which increased by \$17.8 million, or 63.8%. The growth in this component is primarily due to a change in common renewal date for one of our existing ART programs. After renewing for \$11.1 million in the first quarter of 2009, one of our largest ART customers requested that their common renewal date be changed from the first quarter to the third quarter of each year to align with the beginning of their fiscal year. As a result of accommodating this change, we recorded an additional \$8.2 million in gross premiums written in the third quarter of 2010 as compared to the same period in 2009. Also contributing to the increase were the additions of new customers to our large account ART product and group ART products.

During the first nine months of 2010, our gross premiums written increased \$53.3 million, or 19.1%, compared to the same period in 2009. This increase is primarily due to our transportation component, which increased \$34.2 million, or 66.9%, and is primarily the result of our acquisition of Vanliner, which writes a significant portion of its business in the first and third quarters of each year and contributed \$27.9 million to our year-over-year growth. Excluding the Vanliner related premiums, the transportation component increased \$6.3 million, or 12.3%, which is primarily attributable to our continued focus on marketing efforts, including the appointment of additional production sources. These actions have led to increased business submissions and therefore premium growth. We have placed additional emphasis on seeking out and quoting the very best truck and passenger transportation accounts, all the while continuing to emphasize and maintain our disciplined underwriting approach. Also contributing to the increase in gross premiums written is our alternative risk transfer component, which increased \$18.6 million, or 11.5%, primarily due to the addition of three new customers to our large account ART product and growth in existing programs, totaling approximately \$27.9 million. This growth was partially offset by management's decision to reduce lines of coverage written in one of our other ART programs beginning in the second quarter of 2009. Our specialty personal lines component increased \$1.3 million, or 2.6%, during the first nine months of 2010 compared to the same period in 2009, primarily due to the continued growth in our commercial vehicle product, as we introduced the product into nine additional states, bringing the total number of states to twelve. Growth in the commercial vehicle product began to slow during the second quarter of 2010 reflecting the underwriting and pricing actions that were initiated during the fourth quarter of 2009. This growth was partially offset by a decrease in our recreational vehicle product, which has seen an increase in competitor activity as decreased discretionary spending has created a decline in the demand for recreational vehicles.

The 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 third quarter of 2010 and 2009, we recorded a \$0.3 million premium assessment and a \$1.7 million return of premium, respectively. For the first nine months of 2010 and 2009, we recorded a \$5 thousand premium assessment and a \$3.2 million return of premium, respectively.

**Premiums Earned**

*Three months ended September 30, 2010 compared to September 30, 2009.* 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:

**Change**



|                           | <b>Three Months Ended</b>     |                 |               | <b>Percent</b> |
|---------------------------|-------------------------------|-----------------|---------------|----------------|
|                           | <b>September 30,</b>          |                 |               |                |
|                           | <b>2010</b>                   | <b>2009 (a)</b> | <b>Amount</b> |                |
|                           | <b>(Dollars in thousands)</b> |                 |               |                |
| Premiums earned:          |                               |                 |               |                |
| Alternative Risk Transfer | \$ 40,833                     | \$ 36,695       | \$ 4,138      | 11.3%          |
| Transportation            | 51,518                        | 14,300          | 37,218        | 260.3%         |
| Specialty Personal Lines  | 14,504                        | 14,262          | 242           | 1.7%           |
| Hawaii and Alaska         | 3,550                         | 3,837           | (287)         | (7.5%)         |
| Other                     | 1,461                         | 1,731           | (270)         | (15.6%)        |
| Total premiums earned     | \$ 111,866                    | \$ 70,825       | \$ 41,041     | 57.9%          |

(a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition. Consequently, 2009 data does not include Vanliner's financial results.

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Our premiums earned increased \$41.0 million, or 57.9%, to \$111.8 million during the three months ended September 30, 2010 compared to \$70.8 million for the same period in 2009. Included in this increase was \$35.4 million in premiums earned related to Vanliner. Excluding Vanliner's premiums earned, the remaining \$5.6 million increase is primarily attributable to the alternative risk transfer component which grew \$4.1 million, or 11.3%, over 2009 mainly due to the new ART programs introduced throughout 2009.

*Nine months ended September 30, 2010 compared to September 30, 2009.* 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:

|                           | <b>Nine Months Ended</b>      |                 | <b>Change</b> |                |
|---------------------------|-------------------------------|-----------------|---------------|----------------|
|                           | <b>2010</b>                   | <b>2009 (a)</b> | <b>Amount</b> | <b>Percent</b> |
|                           | <b>September 30,</b>          |                 |               |                |
|                           | <b>(Dollars in thousands)</b> |                 |               |                |
| Premiums earned:          |                               |                 |               |                |
| Alternative Risk Transfer | \$ 113,206                    | \$ 105,680      | \$ 7,526      | 7.1%           |
| Transportation            | 80,701                        | 46,074          | 34,627        | 75.2%          |
| Specialty Personal Lines  | 43,188                        | 42,127          | 1,061         | 2.5%           |
| Hawaii and Alaska         | 10,230                        | 11,671          | (1,441)       | (12.3%)        |
| Other                     | 3,955                         | 4,375           | (420)         | (9.6%)         |
| Total premiums earned     | \$ 251,280                    | \$ 209,927      | \$ 41,353     | 19.7%          |

(a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition.

Consequently, 2009 data does not include Vanliner's financial results.

Our premiums earned increased \$41.4 million, or 19.7%, to \$251.3 million during the nine months ended September 30, 2010 compared to \$209.9 million for the same period in 2009. This increase includes \$35.4 of premiums earned attributable to Vanliner. Excluding Vanliner's premiums earned, the remaining \$6.0 million increase for the nine months ended September 30, 2010 is primarily due to the alternative risk transfer component, which grew \$7.5 million, or 7.1%, over 2009 mainly due to the new ART programs introduced throughout 2009. Our specialty personal lines component increased \$1.1 million, or 2.5%, resulting from the growth in our commercial vehicle product experienced throughout 2009 and into 2010. These increases were partially offset a \$1.4 million decrease in the Hawaii and Alaska component resulting from reductions in gross premiums written in 2009 and 2010, which were primarily attributable to the 2008-2009 economic downturn and the continuing soft insurance market.

**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.

Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. For the three and nine months ended September 30, 2010, we experienced a modest single digit decrease in rate levels on our renewal business due to the continued soft market.

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

|                        | <b>Three Months Ended</b>     |                 | <b>Nine Months Ended</b> |                 |
|------------------------|-------------------------------|-----------------|--------------------------|-----------------|
|                        | <b>2010</b>                   | <b>2009 (a)</b> | <b>2010</b>              | <b>2009 (a)</b> |
|                        | <b>September 30,</b>          |                 |                          |                 |
|                        | <b>(Dollars in thousands)</b> |                 |                          |                 |
| Gross premiums written | \$ 116,529                    | \$ 69,568       | \$ 333,059               | \$ 279,746      |
| Ceded reinsurance      | (16,005)                      | (10,584)        | (65,154)                 | (59,875)        |

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|   |            |           |            |            |
|---|------------|-----------|------------|------------|
| Net premiums written                      | 100,524    | 58,984    | 267,905    | 219,871    |
| Change in unearned premiums, net of ceded | 11,342     | 11,841    | (16,625)   | (9,944)    |
| Total premiums earned                     | \$ 111,866 | \$ 70,825 | \$ 251,280 | \$ 209,927 |
| Combined Ratios:                          |            |           |            |            |
| Loss and LAE ratio (b)                    | 76.2%      | 68.2%     | 69.4%      | 60.5%      |
| Underwriting expense ratio (c)            | 18.9%      | 24.6%     | 22.5%      | 24.1%      |
| Combined ratio                            | 95.1%      | 92.8%     | 91.9%      | 84.6%      |

- (a) The results of operation for Vanliner are consolidated only from the July 1, 2010 date of acquisition. Consequently, 2009 data does not include Vanliner's financial results.
- (b) The ratio of losses and LAE to premiums earned.
- (c) The ratio of the sum of commissions and other underwriting expenses, other operating expenses less other income to premiums earned.

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*Three months ended September 30, 2010 compared to September 30, 2009.* Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to accurately estimate losses and LAE at the time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period. Our consolidated loss and LAE ratio for the third quarter of 2010 increased 8.0 percentage points to 76.2% compared to 68.2% in the same period in 2009, which is several percentage points higher than our historical ratio for the third quarter. The standalone loss and LAE ratio for our legacy operations, which is exclusive of Vanliner, was 70.3% for the three months ended September 30, 2010. With the exception of our specialty personal lines component for which underwriting and pricing actions were initiated beginning in the fourth quarter of 2009, our legacy operations' elevated loss and LAE ratio for third quarter of 2010 is primarily due to an increase in claim severity among certain of our trucking products in both our alternative risk transfer and transportation components. We are in the process of examining the results of these trucking products in order to respond with the appropriate actions to bring their performance back in line with our expectations. For the third quarter of 2010, our legacy operations had favorable development from prior years' loss reserves of \$2.5 million, or 2.2 percentage points, compared to unfavorable development of \$0.3 million, or 0.5 percentage points, in the third quarter of 2009. This favorable development was primarily related to settlements below the established case reserves and revisions to our estimated future settlements on an individual case by case basis. The prior years' loss reserve development for both periods is not considered to be unusual or significant to prior years' reserves based on the history of our business and the timing of events in the claims adjustment process. 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. The consolidated underwriting expense ratio for the third quarter of 2010 decreased 5.7 percentage points to 18.9% compared to 24.6% for the same period in 2009, primarily due to the favorable impact of Vanliner. Excluding Vanliner, our legacy operations' underwriting expense ratio for the quarter ended September 30, 2010 was 22.5%, which is in line with management's expectations.

Although individually Vanliner had a favorable impact on our consolidated underwriting expense ratio and an unfavorable impact on our consolidated loss and LAE ratio, the net underwriting results were breakeven. Vanliner's impact on the individual components of our combined ratio were primarily attributable to adjustments from the initial fair value recording of Vanliner's opening balance sheet, which we anticipate will be less significant as we enter 2011, as well as the low underwriting expense structure associated with a large portion of the business which renews during the third quarter of each year.

*Nine months ended September 30, 2010 compared to September 30, 2009.* Our consolidated loss and LAE ratio for the nine months ended September 30, 2010 increased 8.9 percentage points to 69.4% compared to 60.5% in the same period in 2009 due to the factors discussed above for the three month period. Excluding Vanliner, our legacy operations' loss and LAE ratio for the first nine months of 2010 was 66.2%. For the first nine months of 2010, our legacy operations had favorable development from prior years' loss reserves of \$5.7 million, or 2.3 percentage points, compared to favorable development of prior years' loss reserves of \$0.2 million, or 0.1 percentage points in the first nine months of 2009.

The consolidated underwriting expense ratio for the nine months ended September 30, 2010 decreased 1.6 percentage points to 22.5% compared to 24.1% for the same period in 2009, primarily due to the impact of Vanliner as discussed above for the three month period. Excluding Vanliner, our expense ratio would have been 24.4% which is comparable to prior year and in line with management's expectations.

***Net Investment Income***

*2010 compared to 2009.* For the three and nine month periods ended September 30, 2010, net investment income was \$6.4 million and \$16.4 million, respectively, compared to \$4.5 million and \$14.4 million for the same periods in 2009. Included in both the three and nine months periods ended September 30, 2010 is the impact of Vanliner's net

investment income of \$2.2 million. After removing the impact of Vanliner, net investment income was relatively flat period over period due to the continued effect of the low interest rate environment that was present throughout 2009 and into 2010, as well as lost investment income from the use of funds to acquire Vanliner. Cash flows, including those from higher yielding investments that have matured are reinvested in similar, but often lower yielding securities that are available in the market.

**Table of Contents*****Net Realized Gains on Investments***

*2010 compared to 2009.* Pre-tax net realized gains on investments were \$1.0 million for the third quarter of 2010 compared to \$0.8 million for the third quarter of 2009. For the nine months ended September 30, 2010 and 2009, pre-tax net realized gains were \$3.5 million and \$1.8 million, respectively, all of which were attributable to our legacy operations, which is exclusive of Vanliner. The pre-tax net realized gains for the third quarter of 2010 were primarily generated from net realized gains from the sales of securities of \$1.0 million and gains associated with an equity partnership investment of \$0.4 million. Offsetting these gains were other-than-temporary impairment charges of \$0.2 million and losses associated with an equity partnership of \$0.2 million. For the nine months ended September 30, 2010, the net realized gains were primarily driven by net gains of \$3.4 million due to sales of securities, which include sales to generate funds for the July 1, 2010 acquisition of Vanliner and gains associated with an equity partnership investment of \$0.9 million. Offsetting these gains were credit loss other-than-temporary impairment charges of \$0.3 million, primarily relating to one mortgage-backed security of \$0.1 million and a corporate bond of \$0.2 million and losses associated with an equity partnership investment of \$0.5 million. The net realized gains for the third quarter of 2009 were primarily generated from net gains associated with an equity partnership investment of \$1.0 million and \$1.1 million of net realized gains associated with the sales of securities. Offsetting these gains was an other-than-temporary impairment charge of \$1.3 million taken during the third quarter of 2009 related to a corporate note. For the nine months ended September 30, 2009, the net realized gains were primarily driven by the equity partnership investment which generated net gains of \$3.1 million and net gains due to sales of securities of \$2.2 million. These gains were offset by a \$1.0 million realized loss on the conversion of a perpetual preferred stock to common stock on a financial institution holding, in addition to year-to-date other-than-temporary impairment charges of \$2.5 million. The \$2.5 million charge related to three corporate notes and two mortgage backed securities.

***Gain on Bargain Purchase***

In conjunction with the Vanliner acquisition, we recorded an estimated gain on bargain purchase of \$0.6 million during the third quarter of 2010. The estimated fair value of the net assets acquired of \$125.7 million was in excess of the total purchase consideration of \$125.1 million, due to having to recognize intangible assets under purchase accounting, resulting in the estimated gain on bargain purchase.

***Commissions and Other Underwriting Expenses***

*2010 compared to 2009.* During the third quarter of 2010, commissions and other underwriting expenses of \$18.4 million increased \$3.2 million, or 21.4%, from \$15.2 million in the comparable period in 2009. For the nine months ended September 30, 2010 and 2009, commissions and other underwriting expenses were \$48.0 million and \$43.6 million, respectively, increasing \$4.4 million, or 10.2%. Included in both the quarter and year-to-date increases are \$2.7 million of commissions and other underwriting expenses related to Vanliner. Excluding Vanliner results, commissions and other underwriting expenses increased \$0.5 million and \$1.9 million, respectively, for the three and nine months ended September 30, 2010. These increases are primarily due to growth in gross premiums written.

***Other Operating and General Expenses***

*2010 compared to 2009.* During the third quarter of 2010, other operating and general expenses of \$3.8 million increased \$0.7 million, or 23.1%, from \$3.1 million in the comparable period in 2009. For the nine months ended September 30, 2010 and 2009, other operating and general expenses were \$11.4 million and \$9.6 million, respectively, increasing \$1.8 million, or 19.2%. Excluding Vanliner related expenses of \$0.6 million, other operating and general expenses increased \$0.1 million and \$1.2 million, respectively, for the three and nine months ended September 30, 2010. Both the quarter and year-to-date increases relate to professional fees and other costs incurred primarily as a result of the Vanliner acquisition.

***Income Taxes***

*2010 compared to 2009.* The effective tax rate of 28.7% for the three month period ended September 30, 2010, increased 14.3 percentage points, from 14.4%, as compared to the same period in 2009. The 2010 year-to-date effective tax rate increased 0.9 percentage points to 28.8%, as compared to 27.9% for the same period in 2009. During 2009, income tax expense was favorably impacted by a reduction to our valuation allowance related to net realized losses due to both available tax strategies and the future realizability of previously impaired securities, thereby

decreasing our effective tax rate. No such adjustment was made during the third quarter of 2010, as no valuation allowance against deferred tax assets existed subsequent to March 31, 2010, thus creating an increase in the effective tax rate compared to the same periods in 2009.

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

At September 30, 2010, our investment portfolio contained \$898.2 million in fixed maturity securities and \$28.6 million in equity securities, all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At September 30, 2010, we had pre-tax net unrealized gains of \$21.3 million on fixed maturities and \$2.3 million on equity securities, respectively. Included in our investment portfolio at September 30, 2010 is \$412.5 million of fixed maturity securities relating to Vanliner, which had a pre-tax net unrealized gain of \$5.9 million. There were no holdings in equity securities at September 30, 2010 in the Vanliner investment portfolio.

At September 30, 2010, 95.9% 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 yields and lower degrees of risk than those that are unrated or non-investment grade.

Summary information for securities with unrealized gains or losses at September 30, 2010 is shown in the following table. Approximately \$2.1 million of fixed maturities and \$13.2 million of equity securities had no unrealized gains or losses at September 30, 2010.

|   | <b>Securities<br/>with<br/>Unrealized<br/>Gains<br/>(Dollars in thousands)</b> | <b>Securities with<br/>Unrealized<br/>Losses</b> |
|---|--|--|
| <b>Fixed Maturities:</b>                              |  |  |
| Fair value of securities                              | \$ 761,151   | \$ 134,953                                       |
| Amortized cost of securities                          | 734,809  | 140,033  |
| Gross unrealized gain or (loss)                       | \$ 26,342  | \$ (5,080)                                       |
| Fair value as a % of amortized cost                   | 103.6%   | 96.4%  |
| Number of security positions held                     | 680  | 77   |
| Number individually exceeding \$50,000 gain or (loss) | 189  | 15   |
| Concentration of gains or losses by type or industry: |  |  |
| U.S. Government and government agencies               | \$ 4,352   | \$ (52)  |
| Foreign governments                                   |  | (20)   |
| State, municipalities and political subdivisions      | 10,347   | (866)  |
| Residential mortgage-backed securities                | 4,217  | (2,965)  |
| Commercial mortgage-backed securities                 |  | (212)  |
| Banks, insurance and brokers                          | 2,625  | (732)  |
| Industrial and other                                  | 4,801  | (233)  |
| Percent rated investment grade (a)                    | 97.0%  | 90.4%  |
| <b>Equity Securities:</b>                             |  |  |
| Fair value of securities                              | \$ 15,416  | \$   |
| Cost of securities                                    | 13,109   |  |
| Gross unrealized gain or (loss)                       | \$ 2,307   | \$   |
| Fair value as a % of cost                             | 117.6%   |  |
| Number individually exceeding \$50,000 gain or (loss) | 9  |  |

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

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at September 30, 2010, based on their fair values. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.



|                                    | <b>Securities with<br/>Unrealized<br/>Gains</b> | <b>Securities with<br/>Unrealized<br/>Losses</b> |
|------------------------------------|---|--|
| <b>Maturity:</b>                   |   |  |
| One year or less                   | 2.8%  | 1.2%   |
| After one year through five years  | 35.4%   | 44.2%  |
| After five years through ten years | 34.0%   | 8.5%   |
| After ten years                    | 10.6%   | 10.2%  |
|                                    | 82.8%   | 64.1%  |
| Mortgage-backed securities         | 17.2%   | 35.9%  |
|                                    | 100.0%  | 100.0%   |

**Table of Contents**

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

|   | At September 30, 2010  |                                  | Fair Value         |
|---|------------------------|----------------------------------|--------------------|
|   | Aggregate Fair Value   | Aggregate Unrealized Gain (Loss) | as % of Cost Basis |
|   | (Dollars in thousands) |                                  |                    |
| <b>Fixed Maturities:</b>                  |                        |                                  |                    |
| <b>Securities with unrealized gains:</b>  |                        |                                  |                    |
| Exceeding \$50,000 and for:               |                        |                                  |                    |
| Less than one year (145 issues)           | \$ 265,982             | \$ 13,083                        | 105.2%             |
| More than one year (44 issues)            | 61,158                 | 5,259                            | 109.4%             |
| Less than \$50,000 (491 issues)           | 434,011                | 8,000                            | 101.9%             |
|   | \$ 761,151             | \$ 26,342                        |                    |
| <b>Securities with unrealized losses:</b> |                        |                                  |                    |
| Exceeding \$50,000 and for:               |                        |                                  |                    |
| Less than one year (1 issue)              | \$ 4,987               | \$ (53)                          | 98.9%              |
| More than one year (14 issues)            | 18,953                 | (4,533)                          | 80.7%              |
| Less than \$50,000 (62 issues)            | 111,013                | (494)                            | 99.6%              |
|   | \$ 134,953             | \$ (5,080)                       |                    |
| <b>Equity Securities:</b>                 |                        |                                  |                    |
| <b>Securities with unrealized gains:</b>  |                        |                                  |                    |
| Exceeding \$50,000 and for:               |                        |                                  |                    |
| Less than one year (9 issues)             | \$ 13,100              | \$ 2,188                         | 120.1%             |
| More than one year (0 issues)             |                        |                                  | 0.0%               |
| Less than \$50,000 (17 issues)            | 2,316                  | 119                              | 105.4%             |
|   | \$ 15,416              | \$ 2,307                         |                    |
| <b>Securities with unrealized losses:</b> |                        |                                  |                    |
| Exceeding \$50,000 and for:               |                        |                                  |                    |
| Less than one year (0 issues)             | \$                     | \$                               | 0.0%               |
| More than one year (0 issues)             |                        |                                  | 0.0%               |
| Less than \$50,000 (0 issues)             |                        |                                  | 0.0%               |
|   | \$                     | \$                               |                    |

When a decline in the value e:10pt;">

\$  
4,780

\$  
4,182

\$  
4,994

Real Estate

\$  
109

\$  
111

\$  
109

\$  
112

To estimate the fair value of long-term debt, we used the following valuation approaches:

- market approach – based on quoted market prices for the same types and issues of our debt; or
- income approach – based on the discounted value of the future cash flows using market yields for the same type and comparable issues of debt.

The inputs to the valuations are based on market data obtained from independent sources or information derived principally from observable market data.

The difference between the fair value and the carrying value represents the theoretical net premium or discount we would pay or receive to retire all debt at the measurement date.

#### FAIR VALUE OF OTHER FINANCIAL INSTRUMENTS

We believe that our other financial instruments, including cash, short-term investments, receivables, and payables, have net carrying values that approximate their fair values with only insignificant differences. This is primarily due to:

- the short-term nature of these instruments,
- carrying short-term investments at expected net realizable value and
- the allowance for doubtful accounts.

#### NOTE 9: LEGAL PROCEEDINGS, COMMITMENTS AND CONTINGENCIES

This note provides details about our:

- legal proceedings and
- environmental matters.



## LEGAL PROCEEDINGS

We are party to legal matters generally incidental to our business. The ultimate outcome of any legal proceeding: is subject to a great many variables and cannot be predicted with any degree of certainty.

However, whenever probable losses from litigation could reasonably be determined – we believe that we have established adequate reserves. In addition, we believe the ultimate outcome of the legal proceedings:

could have a material adverse effect on our results of operations, cash flows or financial position in any given quarter or year; but

will not have a material adverse effect on our long-term results of operations, cash flows or financial position.

## ENVIRONMENTAL MATTERS

Our environmental matters include:

site remediation,

asset retirement obligations, and

regulation of air emission in the U.S.

### Site Remediation

Under the Comprehensive Environmental Response Compensation and Liability Act – commonly known as the Superfund – and similar state laws, we:

are a party to various proceedings related to the cleanup of hazardous waste sites and

have been notified that we may be a potentially responsible party related to the cleanup of other hazardous waste sites for which proceedings have not yet been initiated.

As of June 30, 2013, our total accrual for future estimated remediation costs on the active Superfund sites and other sites for which we are responsible was approximately \$30 million. These reserves are recorded in "Accrued liabilities" and "Other liabilities" in our Consolidated Balance Sheet. The accrual has not changed materially since the end of 2012.

### Asset Retirement Obligations

We have obligations associated with the retirement of tangible long-lived assets consisting primarily of reforestation obligations related to forest management licenses in Canada and obligations to close, cap and monitor landfills. As of June 30, 2013, our total accruals for these obligations was \$63 million. These obligations are recorded in "Accrued liabilities" and "Other liabilities" in our Consolidated Balance Sheet. The accruals have not changed materially since the end of 2012.

Some of our sites have asbestos containing materials. We have met our current legal obligation to identify and manage these materials. In situations where we cannot reasonably determine when asbestos containing materials might be removed from the sites, we have not recorded an accrual because the fair value of the obligation cannot be reasonably estimated.

## Regulation of Air Emissions in the U.S.

In 2010, the EPA issued a final rule that would limit the growth in greenhouse gas emissions from new projects meeting certain emission thresholds. This rule, which would apply to our manufacturing operations on a project-by-project basis, originally included carbon dioxide from carbon-neutral biomass in the air permitting process. In 2011, the EPA issued a final rule deferring until mid-2014 greenhouse gas permitting requirements for carbon dioxide emissions from biomass while the EPA completed analysis and rulemaking on how biomass emissions should be treated. On July 12, 2013, the D.C Circuit Court of Appeals issued a decision to vacate the biomass deferral rule. The Court has not yet issued its mandate to the EPA and the EPA has not yet indicated how it may respond, so we are unable to predict the effect on our operations. However, more than 75 percent of energy for our operations is derived from biomass. If emissions from biomass are included in the air permitting process, it could significantly increase the burden and cost of the air permitting process.

## NOTE 10: CUMULATIVE OTHER COMPREHENSIVE INCOME (LOSS)

Changes in amounts included in our cumulative other comprehensive income (loss) by component are:

| DOLLAR AMOUNTS IN<br>MILLIONS  | PENSION   |                     |                           | OTHER<br>POSTRETIREMENT<br>BENEFITS |                             |  | Total     |
|--|---|---------------------|---------------------------|-------------------------------------|-----------------------------|--|-----------|
|  | Foreign<br>currency<br>translation<br>adjustments | Actuarial<br>losses | Prior<br>service<br>costs | Actuarial<br>losses                 | Prior<br>service<br>credits | Unrealized<br>gains on<br>available-for-sale<br>securities |           |
| Beginning balance as of<br>December 31, 2012   | \$413   | \$(1,942)           | \$(23)                    | \$(137)                             | \$127                       | \$ 4   | \$(1,558) |
| Other comprehensive income<br>(loss) before reclassifications                                  | (47)  | )33                 | —                         | 2                                   | (2)                         | )1   | (13)      |
| Income taxes   | —   | (8)                 | )—                        | —                                   | 1                           | —  | (7)       |
| Net other comprehensive<br>income (loss) before<br>reclassifications                           | (47)  | )25                 | —                         | 2                                   | (1)                         | )1   | (20)      |
| Amounts reclassified from<br>cumulative other<br>comprehensive income<br>(loss) <sup>(1)</sup> | —   | 111                 | 3                         | 7                                   | (12)                        | )—   | 109       |
| Income taxes   | —   | (37)                | )1                        | (4)                                 | )3                          | —  | (39)      |
| Net amounts reclassified<br>from cumulative other<br>comprehensive income (loss)               | —   | 74                  | 2                         | 3                                   | (9)                         | )—   | 70        |
| Total other comprehensive<br>income (loss)   | (47)  | )99                 | 2                         | 5                                   | (10)                        | )1   | 50        |
| Ending balance as of<br>June 30, 2013  | \$366   | \$(1,843)           | \$(21)                    | \$(132)                             | \$117                       | \$ 5   | \$(1,508) |

(1) Actuarial losses and prior service credits (cost) are included in the computation of net periodic benefit costs (credits). See [Note 5: Pension and Other Postretirement Benefit Plans](#).

**NOTE 11: SHARE-BASED COMPENSATION**

In year-to-date 2013, we granted 1,986,934 stock options, 728,853 restricted stock units and 388,394 performance share units. In addition, 443,708 outstanding restricted stock units and 157,386 outstanding performance share units vested during year-to-date 2013. A total of 6,417,318 shares of common stock were issued as a result of restricted stock unit vesting, performance share unit vesting and stock option exercises.

At our Annual Meeting of Shareholders held on April 11, 2013, our shareholders approved the Weyerhaeuser Company 2013 Long-Term Incentive Plan ("2013 Plan"). Shareholders approved 10 million shares of common stock for issuance under the 2013 Plan. In addition, approximately 9 million shares authorized for issuance under our 2004 Long-Term Incentive Plan that have not been issued and are not subject to outstanding awards are available for issuance under the 2013 Plan. Our Board of Directors had previously adopted and approved the 2013 Plan, subject to shareholder approval.

**STOCK OPTIONS**

The weighted average exercise price of all of the stock options granted in 2013 was \$30.54. The vesting and post-termination vesting terms for stock options granted in 2013 were as follows:

- options vest ratably over 4 years;
- options vest immediately in the event of disability or death while employed;
- options continue to vest upon retirement at an age of at least 62, but a portion of the grant is forfeited if retirement occurs before the one year anniversary of the grant depending on the number of months employed after grant date;
- options continue vesting for one year in the event of involuntary termination when the retirement criteria has not been met; and
- options stop vesting and are forfeited for all other situations including early retirement prior to age 62.

**Weighted Average Assumptions Used in Estimating the Value of Stock Options Granted in 2013**

|  | OPTIONS |   |
|--|---------|---|
| Expected volatility                    | 38.00   | % |
| Expected dividends                     | 2.23    | % |
| Expected term (in years)               | 4.97    |   |
| Risk-free rate                         | 0.92    | % |
| Weighted average grant date fair value | \$8.40  |   |

**RESTRICTED STOCK UNITS**

The weighted average fair value of the restricted stock units granted in 2013 was \$30.54. The vesting provisions for restricted stock units granted in 2013 were as follows:

- restricted stock units vest ratably over 4 years;
- restricted stock units vest immediately in the event of disability or death while employed;
- restricted stock units continue to vest upon retirement at an age of at least 62, but a portion of the grant is forfeited if retirement occurs before the one year anniversary of the grant depending on the number of months employed after grant date;
- restricted stock units continue vesting for one year in the event of involuntary termination when the retirement criteria has not been met; and
- restricted stock units will be forfeited upon termination of employment in all other situations including early retirement prior to age 62.

### PERFORMANCE SHARE UNITS

The weighted average grant date fair value of performance share units granted in 2013 was \$28.75. The vesting provisions for performance share units granted in 2013 and that are earned were as follows:

- units vest 50 percent, 25 percent and 25 percent on the second, third and fourth anniversaries of the grant date, respectively, as long as the individual remains employed by the company;
- units fully vest in the event of disability or death while employed;
- units continue to vest upon retirement at an age of at least 62, but a portion of the grant is forfeited if retirement occurs before the one year anniversary of the grant depending on the number of months employed after grant date;
- units continue vesting for one year in the event of involuntary termination when the retirement criteria has not been met; and
- units will be forfeited upon termination of employment in all other situations including early retirement prior to age 62.

#### Weighted Average Assumptions Used in Estimating the Value of Performance Share Units Granted in 2013

|                                    | Performance Share Units<br>1/1/2013 – 12/31/2014 |    |       |   |
|------------------------------------|--|----|-------|---|
| Performance period                 | 1/1/2013 – 12/31/2014                            |    |       |   |
| Valuation date closing stock price | \$30.48  |    |       |   |
| Expected dividends                 | 2.23   |    |       | % |
| Risk-free rate                     | 0.09   | %– | 0.46  | % |
| Expected volatility                | 22.09  | %– | 29.57 | % |

### STOCK APPRECIATION RIGHTS

Stock appreciation rights are remeasured to reflect the fair value at each reporting period. The following table shows the weighted average assumptions applied to all outstanding stock appreciation rights as of June 30, 2013.

#### Weighted Average Assumptions Used to Remeasure the Value of Stock Appreciation Rights as of June 30, 2013

|                             | JUNE 30,<br>2013 |   |
|-----------------------------|------------------|---|
| Expected volatility         | 29.02            | % |
| Expected dividends          | 2.91             | % |
| Expected term (in years)    | 1.59             |   |
| Risk-free rate              | 0.35             | % |
| Weighted average fair value | \$6.57           |   |

There were no stock appreciation rights granted in year-to-date 2013.



NOTE 12: OTHER OPERATING INCOME, NET

Other operating income, net:

includes both recurring and occasional income and expense items and can fluctuate from year to year.

Items Included in Other Operating Income, Net

| DOLLAR AMOUNTS IN MILLIONS                              | QUARTER ENDED |           | YEAR-TO-DATE ENDED |           |
|---|---------------|-----------|--------------------|-----------|
|   | JUNE 2013     | JUNE 2012 | JUNE 2013          | JUNE 2012 |
| Gain on postretirement plan amendment ( <u>Note 5</u> ) | \$—           | \$(51)    | \$—                | \$(103)   |
| Gain on disposition of assets                           | (7)           | (7)       | (13)               | (8)       |
| Foreign exchange losses                                 | 4             | 9         | 8                  | 2         |
| Land management income                                  | (7)           | (6)       | (13)               | (12)      |
| Other, net  | —             | 2         | (10)               | 2         |
| Total other operating income, net                       | \$(10)        | \$(53)    | \$(28)             | \$(119)   |

Foreign exchange losses result from changes in exchange rates, primarily related to our Canadian operations.

Land management income consists primarily of income derived from leasing, renting and granting easement and rights of way on our timberlands.

NOTE 13: INCOME TAXES

As a REIT, we generally are not subject to corporate level tax on income of the REIT that is distributed to shareholders. We will, however, be subject to corporate taxes on built-in-gains (the excess of fair market value over tax basis at January 1, 2010) on sales of real property (other than standing timber) held by the REIT during the first 10 years following the REIT conversion. We also will continue to be required to pay federal corporate income taxes on earnings of our TRS, which principally includes our manufacturing businesses, our real estate development business and the portion of our Timberlands segment income included in the TRS.

The 2013 provision for income taxes is based on the current estimate of the annual effective tax rate. Our 2013 estimated annual effective tax rate for our TRS is 32.0 percent, which is lower than the statutory federal tax rate primarily due to permanent tax deductions and lower foreign tax rates applicable to foreign earnings.

There were no significant discrete items excluded from the calculation of our effective income tax rate for 2013. 2012 items include:

DOLLAR AMOUNTS IN MILLIONS

First Quarter 2012:

Income taxes on postretirement plan amendment discussed in Note 5 \$(18 )

\$  
67

\$  
440

\$  
321

\$  
119

Land  
10

105

(95  
)

21

108

(87  
)  
Other  
—

1

(1  
)

2

4

(2  
)  
Total  
\$  
267

\$  
296

\$  
(29  
)

\$  
463

\$  
433

\$  
30

Net contribution to earnings

\$  
14

\$  
15

\$  
(1  
)

\$  
14

\$  
7

\$  
7

Here is a comparison of key statistics related to our single-family operations for the quarters and year-to-date periods ended June 30, 2013 and 2012:

SUMMARY OF SINGLE-FAMILY STATISTICS

|                                     | QUARTER ENDED |           | AMOUNT OF YEAR-TO-DATE CHANGE |           | AMOUNT OF CHANGE |               |
|-------------------------------------|---------------|-----------|-------------------------------|-----------|------------------|---------------|
|                                     | JUNE 2013     | JUNE 2012 | 2013 VS. 2012                 | JUNE 2013 | JUNE 2012        | 2013 VS. 2012 |
| Homes sold                          | 943           | 764       | 179                           | 1,763     | 1,461            | 302           |
| Homes closed                        | 636           | 508       | 128                           | 1,099     | 857              | 242           |
| Homes sold but not closed (backlog) | 1,438         | 1,033     | 405                           | 1,438     | 1,033            | 405           |
| Cancellation rate                   | 14.6 %        | 15.4 %    | (0.8 )%                       | 13.5 %    | 12.9 %           | 0.6 %         |
| Traffic                             | 20,080        | 17,677    | 2,403                         | 37,844    | 31,949           | 5,895         |

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|  |       |        |       |        |        |       |   |
|--|-------|--------|-------|--------|--------|-------|---|
| Average price of homes closed (in thousands) | \$405 | \$374  | \$31  | \$400  | \$375  | \$25  |   |
| Single-family gross margin <sup>(1)</sup>    | 21.6  | % 19.3 | % 2.3 | % 20.7 | % 18.4 | % 2.3 | % |

(1) Single-family gross margin equals revenue less cost of sales and period costs.

Comparing Second Quarter 2013 with Second Quarter 2012

Net sales

Net sales decreased \$29 million – 10 percent – primarily due to a decrease of \$95 million in revenue from land and lot sales. 2012 included the sale of a 3,200-acre master planned community in Houston, Texas. Land and lot sales are a routine part of our land development business but they do not occur evenly from period to period.

This was partially offset by an increase of \$67 million in revenue from single-family home sales. Home closing increased 25 percent from 508 in 2012 to 636 in 2013, with increased closings across all markets. The average price of homes closed increased 8 percent from \$374,000 in 2012 to \$405,000 in 2013, due to both increasing prices across our markets and changes in mix.

Net contribution to earnings

Net contribution to earnings decreased \$1 million, primarily due to the offsetting effects of:

- A \$19 million increase in earnings from single-family home sales. In addition to the higher volume and higher average revenues, single-family gross margins improved to 21.6 percent in 2013 compared to 19.3 percent in 2012 due to a change in mix. Changes in mix reflect changes in product lines (entry-level homes versus move-

up products), changes in specific communities that are open from period to period, and changes in geographic markets where the closing occur.

Earnings from land and lot sales decreased \$10 million.

- Selling, general and administrative expenses increased \$8 million, including volume-related increases in selling costs and additional costs associated with new community openings.

#### Comparing Year-to-Date 2013 with Year-to-Date 2012

##### Net sales

Net sales increased \$30 million – 7 percent – primarily due to an increase of \$119 million in revenue from single-family home sales. Home closings increased 28 percent from 857 in 2012 to 1,099 in 2013. The average price of homes closed increased 7 percent from \$375,000 in 2012 to \$400,000 in 2013, due to both increasing prices across our markets and changes in mix.

This was partially offset by a decrease of \$87 million in revenue from land and lot sales. 2012 included the sale of a 3,200-acre master planned community in Houston, Texas.

##### Net contribution to earnings

Net contribution to earnings increased \$7 million primarily due to a \$32 million increase in earnings from single-family home sales. In addition to the higher volume and higher average revenues, single-family gross margins improved to 20.7 percent in 2013 compared to 18.4 percent in 2012 due to a change in mix.

This improvement was partially offset by:

- \$11 million decrease in earnings from land and lot sales;

- \$12 million increase in selling, general and administrative expenses, including volume-related increases in selling costs and additional costs associated with new community openings.

#### UNALLOCATED ITEMS

Unallocated Items are gains or charges not related to or allocated to an individual operating segment. They include a portion of items such as: share-based compensation, pension and postretirement costs, foreign exchange transaction gains and losses associated with financing and the elimination of intersegment profit in inventory and the LIFO reserve.

#### NET CONTRIBUTION TO EARNINGS – UNALLOCATED ITEMS

| DOLLAR AMOUNTS IN MILLIONS                               | QUARTER ENDED |           | AMOUNT OF YEAR-TO-DATE CHANGE<br>2013 VS. 2012 | AMOUNT OF YEAR-TO-DATE ENDED |           | AMOUNT OF CHANGE<br>2013 VS. 2012 |
|--|---------------|-----------|--|------------------------------|-----------|-----------------------------------|
|  | JUNE 2013     | JUNE 2012 |  | JUNE 2013                    | JUNE 2012 |                                   |
| Unallocated corporate function expense                   | \$ (3 )       | \$ (3 )   | \$ —   | \$ (6 )                      | \$ (9 )   | \$ 3                              |
| Unallocated share-based compensation                     | 5             | (1)       | 6  | (2)                          | (6)       | 4                                 |
| Unallocated pension and postretirement costs             | (12)          | (7)       | (5)  | (22)                         | (14)      | (8)                               |
| Foreign exchange gains (losses)                          | (4)           | (8)       | 4  | (8)                          | (2)       | (6)                               |
| Elimination of intersegment profit in inventory and LIFO | 8             | (2)       | 10   | (16)                         | (14)      | (2)                               |
| Other  | (4)           | 35        | (39)   | (11)                         | 65        | (76)                              |
| Operating income (loss)                                  | (10)          | 14        | (24)   | (65)                         | 20        | (85)                              |
| Interest income and other                                | 10            | 9         | 1  | 19                           | 19        | —                                 |
| Net contribution to earnings                             | \$—           | \$23      | \$ (23)  | \$ (46)                      | \$39      | \$ (85)                           |

Unallocated Items included recognized gains of \$51 million during second quarter 2012 and \$103 million during first half 2012 related to a previously announced postretirement plan amendment.



## INTEREST EXPENSE

Our net interest expense incurred was:

\$81 million during second quarter 2013 and \$163 million during year-to-date 2013 and

\$86 million during second quarter 2012 and \$173 million during year-to-date 2012.

Interest expense incurred decreased primarily due to lower interest on a lower level of debt.

## INCOME TAXES

As a REIT, we generally are not subject to corporate level tax on income of the REIT that is distributed to shareholders. We will, however, be subject to corporate taxes on built-in-gains (the excess of fair market value over tax basis at January 1, 2010) on sales of real property (other than standing timber) held by the REIT during the first 10 years following the REIT conversion. We also will continue to be required to pay federal corporate income taxes on earnings of our TRS, which principally includes our manufacturing businesses, our real estate development business and the portion of our Timberlands segment income included in the TRS.

The 2013 provision for income taxes is based on the current estimate of the annual effective tax rate. Our 2013 estimated annual effective tax rate for our TRS is 32.0 percent, which is lower than the statutory federal tax rate primarily due to permanent tax deductions and lower foreign tax rates applicable to foreign earnings.

There were no significant discrete items excluded from the calculation of our effective income tax rate for 2013. 2012 items include:

### DOLLAR AMOUNTS IN MILLIONS

First Quarter 2012:

|  |       |   |
|--|-------|---|
| Income taxes on postretirement plan amendment discussed in <u>Note 5</u> | \$(18 | ) |
|--|-------|---|

|                              |     |  |
|------------------------------|-----|--|
| State income tax settlements | \$8 |  |
|------------------------------|-----|--|

Second Quarter 2012:

|  |       |   |
|--|-------|---|
| Income taxes on postretirement plan amendment discussed in <u>Note 5</u> | \$(18 | ) |
|--|-------|---|

|                        |      |   |
|------------------------|------|---|
| Income tax settlements | \$(3 | ) |
|------------------------|------|---|

It is reasonably possible that up to \$160 million in unrecognized tax benefits, primarily related to alternative fuel mixture credits, may be recognized within the next 12 months when tax examinations are expected to be completed.

## LIQUIDITY AND CAPITAL RESOURCES

We are committed to maintaining a sound and conservative capital structure that enables us to:

- protect the interests of our shareholders and lenders and

- have access at all times to all major financial markets.

Two important elements of our policy governing capital structure include:

- viewing the capital structure of Forest Products separately from that of Real Estate given the very different nature of their assets and business activity and

- minimizing liquidity risk by managing timing of debt maturities.

The amount of debt and equity for Forest Products and Real Estate will reflect the following:

- basic earnings capacity and

- liquidity characteristics of their respective assets.

## CASH FROM OPERATIONS

Consolidated net cash provided by our operations was:

\$313 million in 2013 and

\$207 million in 2012.

Comparing 2013 with 2012

Net cash from operations increased \$106 million in 2013 as compared with 2012, primarily due to a \$708 million increase in cash received from customers partially offset by a \$592 million increase in cash paid to employees, suppliers and others as sales and production increased in our Wood Products, Timberlands and Real Estate segments. Receivables, primarily in our Wood Products segment, increased significantly in 2013 compared to 2012 as sales increased.

### Expected Pension Contributions and Benefit Payments

We expect to make approximately \$79 million of required contributions to our Canadian registered and nonregistered pension plans in 2013. The decrease in the expectation was the result of the company electing to apply for Alberta Funding Relief effective December 31, 2012, for the plans registered in that province.

We also expect that in 2013 we will:

• make benefit payments of \$19 million on behalf of our U.S. nonqualified pension plans and

• make benefit payments of \$37 million on behalf of our U.S. and Canadian other postretirement plans.

We do not anticipate making a contribution to our U.S. qualified pension plan for 2013.

## CASH FROM INVESTING ACTIVITIES

Consolidated net cash used by investing activities was:

\$71 million in 2013 and

\$115 million in 2012.

### Summary of Capital Spending by Business Segment

| DOLLAR AMOUNTS IN MILLIONS | YEAR-TO-DATE ENDED |           |
|----------------------------|--------------------|-----------|
|                            | JUNE 2013          | JUNE 2012 |
| Timberlands                | \$36               | \$27      |
| Wood Products              | 26                 | 21        |
| Cellulose Fibers           | 34                 | 89        |
| Real Estate                | 4                  | 1         |
| Unallocated Items          | 3                  | 1         |
| Total                      | \$103              | \$139     |

We anticipate that our net capital expenditures for 2013 – excluding acquisitions – will be up to \$300 million.

### Variable Interest Entities

In second quarter 2013, we repaid a \$162 million note and received \$184 million related to one of our timber monetization special-purpose entities (SPEs) undertaken in 2003. Net proceeds were \$22 million. More information about these entities, which were formed in connection with the sale of nonstrategic timberlands in 2003, can be found in our annual reports on Form 10-K for 2012 and 2003.



## CASH FROM FINANCING ACTIVITIES

Consolidated net cash provided by (used in) financing activities was:

\$1,222 million in 2013 and

\$(184) million in 2012.

### Longview Timber Purchase

In order to finance our purchase of Longview Timber, see Note 14: Longview Timber Purchase, we issued the following:

29 million common shares on June 18, 2013, at the price of \$27.75 per share for net proceeds of \$781 million; and 13.8 million of our 6.375 percent Mandatory Convertible Preference Shares, Series A, par value \$1.00 and liquidation preference of \$50.00 per share on June 18, 2013, for net proceeds of \$669 million.

Subsequent to quarter end, we issued 4.4 million common shares on July 2, 2013, at the price of \$27.75 per share for net proceeds of \$117 million, in connection with the exercise of an overallotment option.

We paid \$11 million in fees related to a bridge loan in second quarter 2013. As of the close of the Longview Timber purchase, we never used the loan and these fees will be expensed in third quarter 2013. We expect to obtain an additional \$1.1 billion in debt financing in third quarter 2013 to repay existing indebtedness assumed as part of the Longview Timber acquisition.

### Debt

We repaid debt of:

\$177 million in year-to-date 2013 and

\$6 million in year-to-date 2012.

Excluding the assumption of Longview Timber indebtedness, debt maturities in the next 12 months are:

• \$163 million in third quarter 2013

and

\$69 million in fourth quarter 2013.

There are no maturities in first or second quarter 2014.

### Revolving credit facility

Weyerhaeuser Company and Weyerhaeuser Real Estate Company (WRECO) have a \$1.0 billion 4-year revolving credit facility that expires in June 2015. WRECO can borrow up to \$50 million under this facility. Neither of the entities is a guarantor of the borrowing of the other under this credit facility.

There were no net proceeds from the issuance of debt or from borrowings (repayments) under our available credit facility in year-to-date 2013 or 2012.

As of June 30, 2013 Weyerhaeuser Company and WRECO:

• had no borrowings outstanding under the credit facility and

• were in compliance with the credit facility covenants.

### Credit Ratings

On April 22, 2013, Moody's Investors Service upgraded our senior unsecured note rating to Baa3 from Ba1 and changed their outlook to stable.

#### Option Exercises

We received cash proceeds from the exercise of stock options of:

\$132 million in 2013 and

\$7 million in 2012.

The increase in exercises of stock options is primarily due to the increase in our average stock price. In year-to-date 2013, our average stock price was \$30.29, a 47 percent increase, compared to \$20.58 during year-to-date 2012.

#### Paying dividends and repurchasing stock

We paid dividends to common shareholders of:

\$202 million in 2013 and

\$161 million in 2012.

The increase in dividends paid is primarily due to the increase in our quarterly dividend from 15 cents per share to 17 cents per share in November 2012 and to 20 cents per share in April 2013, a 33 percent increase in our quarterly dividend.

In conjunction with the acquisition of Longview Timber and subject to Board approval, we intend to increase our quarterly dividend from 20 cents per share to 22 cents per share beginning with the third quarter dividend payable in September.

#### CRITICAL ACCOUNTING POLICIES

There have been no significant changes during year-to-date 2013 to our critical accounting policies presented in our 2012 Annual Report on Form 10-K.

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No changes occurred during year-to-date 2013 that had a material effect on the information relating to quantitative and qualitative disclosures about market risk that was provided in the company's Annual Report on Form 10-K for the year ended December 31, 2012.

#### CONTROLS AND PROCEDURES

##### EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls are controls and other procedures that are designed to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, to allow timely decisions regarding required disclosure. The company's principal executive officer and principal financial officer have concluded that the company's disclosure controls and procedures were effective as of June 30, 2013, based on an evaluation of the company's disclosure controls and procedures as of that date.

##### CHANGES IN INTERNAL CONTROLS

No changes occurred in the company's internal control over financial reporting during year-to-date 2013 that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

## LEGAL PROCEEDINGS

Refer to “Notes to Consolidated Financial Statements – Note 9: Legal Proceedings, Commitments and Contingencies.”

## RISK FACTORS

A discussion of our risk factors can be found in our 2012 Annual Report on Form 10-K. The information included below, including additional risks relating to the recent acquisition (the “Acquisition”) of Longview Timber LLC (“Longview Timber”) and the recent issuance of mandatory convertible preference shares, amends, updates and should be read in conjunction with the risk factors disclosed in our 2012 Annual Report on Form 10-K.

We may fail to realize the full benefits anticipated as a result of the acquisition of Longview Timber LLC.

There are a number of risks and uncertainties relating to the Acquisition. The success of the Acquisition will depend, in part, on our ability to realize the anticipated business opportunities and growth prospects from combining our businesses with those of Longview Timber. We may not fully realize these business opportunities and growth prospects. Integrating operations may require significant efforts and expenditures on the part of both us and Longview Timber. Our management might have its attention diverted while trying to integrate operations and corporate and administrative infrastructures and the cost of integration may exceed our expectations. We may also be required to make unanticipated capital expenditures or investments in order to maintain, improve or sustain Longview Timber's operations or assets or take write-offs or impairment charges or recognize amortization expenses resulting from the Acquisition and may be subject to unanticipated or unknown liabilities relating to Longview and its business. We might experience increased competition that limits our ability to expand our business, and we might not be able to capitalize on expected business opportunities, including retaining current customers. If any of these factors limit our ability to integrate the businesses successfully or on a timely basis, the expectations of future results of operations following the Acquisition might not be met.

One of Longview Timber's subsidiaries has elected to be taxed as a REIT for Federal income tax purposes and if this subsidiary fails to qualify as a REIT, it could result in the loss of our REIT status.

One of Longview Timber's subsidiaries that we acquired in the Acquisition has elected to be taxed as a REIT for Federal income tax purposes. If this subsidiary failed to meet the applicable requirements for qualification as a REIT or fails to meet those qualifications at any time in the future, such failure could jeopardize our qualification as a REIT. Such loss of status would have the effects described in the risk factor entitled "REIT Status and Tax implications" disclosed in our 2012 Annual Report on Form 10-K.

We have incurred transaction and acquisition-related costs in connection with the acquisition of Longview Timber LLC and we expect to incur additional acquisition-related and integration costs in the future, which future costs may be significant.

We have incurred transaction and acquisition-related costs in connection with the acquisition, which will affect our results of operations in the periods in which such charges are recorded or our cash flow in the period in which any related costs are actually paid. We also expect to incur additional acquisition-related and integration costs in the future. These acquisition-related and integration costs could be significant and thereby materially adversely affect our results of operations in the period in which such charges are recorded, or our cash flow in the period in which any related costs are actually paid.

Our Common Shares will rank junior to the recently issued mandatory convertible preference shares with respect to dividends and amounts payable in the event of our liquidation.

Our common shares will rank junior to the recently issued mandatory convertible preference shares with respect to the payment of dividends and amounts payable in the event of our liquidation, dissolution or winding-up. This means that,

unless full cumulative dividends have been paid or set aside for payment on all outstanding mandatory convertible preference shares for all past dividend periods and the then current dividend period, no dividends may be declared or paid on our common shares. Likewise, in the event of our voluntary or involuntary liquidation, dissolution or winding-up, no distribution of our assets may be made to holders of our common shares until we have paid to holders of the mandatory convertible preference shares a liquidation preference equal to \$50.00 per share plus accrued and unpaid dividends.

Certain provisions in the mandatory convertible preference shares could delay or prevent an otherwise beneficial takeover or takeover attempt of us and, therefore, the ability of holders to exercise their rights associated with a potential fundamental change.

Certain provisions in the recently issued mandatory convertible preference shares could make it more difficult or more expensive for a third party to acquire us. For example, if a fundamental change were to occur on or prior to July 1, 2016, holders of the mandatory convertible preference shares may have the right to convert their mandatory convertible preference shares, in whole or in part, at an increased conversion rate and will also be entitled to receive a fundamental change dividend make-whole amount equal to the present value of all remaining dividend payments on their mandatory convertible preference shares. These features of the mandatory convertible preference shares could increase the cost of acquiring us or otherwise discourage a third party from acquiring us or removing incumbent management.

The amount of our indebtedness could adversely affect our business.

The assumption of approximately \$1.07 billion of Longview Timber's outstanding indebtedness in connection with the Acquisition, the anticipated incurrence of \$1.1 billion in new borrowings to repay Longview Timber's outstanding indebtedness, as well as the issuance of the mandatory convertible preference shares will increase our annual cash obligations. If we are unable to generate sufficient cash to repay or to refinance our debt as it comes due or to pay cash dividends on our mandatory convertible preference shares, this would have a material adverse effect on our business and the market price of our common shares, our mandatory convertible preference shares and our debt securities. We also have the ability to incur a substantial amount of additional indebtedness, including under our \$1.0 billion bank credit facility. As a result, Weyerhaeuser Company and its subsidiaries could, in the future, incur indebtedness and enter into transactions that could negatively affect the market value of our common shares, our mandatory convertible preference shares and our debt securities.

EXHIBITS

- 2.1 Stock Purchase Agreement, dated as of June 14, 2013, by and among Longview Timber Holdings, Corp., the security holders listed on the signature pages thereto, Weyerhaeuser Columbia Holding Co., LLC and Weyerhaeuser Company (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission June 17, 2013 — Commission File Number 1-04825)
- 3.1 Articles of Incorporation (incorporated by reference to Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission May 6, 2011 — Commission File Number 1-4825) as amended by Articles of Amendment to Articles of Incorporation of Weyerhaeuser Company (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission June 17, 2013 — Commission File Number 001-04825)
- 10.1 Employment Agreement, dated June 17, 2013, by and between Weyerhaeuser Company and Doyle R. Simons (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission June 17, 2013 — Commission File Number 1-04825)
- 10.2 Weyerhaeuser Company Annual Incentive Plan (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission April 16, 2013 — Commission File Number 1-04825)
- 10.3 Form of Weyerhaeuser Company 2013 Long-Term Incentive Plan Stock Option Terms and Conditions (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission April 16, 2013 — Commission File Number 1-04825)
- 10.4 Form of Weyerhaeuser Company 2013 Long-Term Incentive Plan Restricted Stock Units Terms and Conditions (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission April 16, 2013 — Commission File Number 1-04825)
- 10.5 Form of Weyerhaeuser Company 2013 Long-Term Incentive Plan Performance Share Units Terms and Conditions (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission April 16, 2013 — Commission File Number 1-04825)
- 10.6 Weyerhaeuser Company 2013 Long Term Incentive Plan (incorporated by reference to Current Report on Form 8-K filed with the Securities and Exchange Commission February 19, 2013 — Commission File Number 1-04825)
- 12 Statements regarding computation of ratios
- 31 Certification pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
- 32 Certification pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350)

100.INS XBRL Instance Document

100.SCH XBRL Taxonomy Extension Schema Document

100.CAL XBRL Taxonomy Extension Calculation Linkbase Document

100.DEF XBRL Taxonomy Extension Definition Linkbase Document

100.LAB XBRL Taxonomy Extension Label Linkbase Document

100.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Signature

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.

WEYERHAEUSER COMPANY

Date: July 31, 2013

By: /s/ JERALD W. RICHARDS

Jerald W. Richards

Chief Accounting Officer