State Auto Financial CORP
Form 10-Q
November 08, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2006

or

¨ Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from __________ to __________

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio	31-1324304
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
518 East Broad Street, Columbus, Ohio	43215-3976
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Yes ¨ No x

On November 2, 2006, the Registrant had 41,026,790 Common Shares outstanding.

Table of Contents

Index to Form 10-Q Quarterly Report for the three- and nine-month periods ended September 30, 2006

Part I. Financial Information

Item 1.	Financial Statements (Unaudited)	
	Condensed Consolidated Balance Sheets September 30, 2006 and December 31, 2005	1
	Condensed Consolidated Statements of Income Three months ended September 30, 2006 and 2005	2
	Condensed Consolidated Statements of Income Nine months ended September 30, 2006 and 2005	3
	Condensed Consolidated Statements of Cash Flows Nine months ended September 30, 2006 and 2005	4
	Notes to Condensed Consolidated Financial Statements September 30, 2006	5
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	28
Item 4.	Controls and Procedures	29

Part II. Other Information

Item 1.	Legal Proceedings	29
Item 1A.	Risk Factors	29
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 3.	Defaults upon Senior Securities	29
Item 4.	Submission of Matters to a Vote of Security Holders	30
Item 5.	Other Information	30
Item 6.	Exhibits	30
	Signatures	31

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

PART I FINANCIAL STATEMENTS

Item 1. Condensed Consolidated Balance Sheets

($ millions, except per share amount)	**September 30 2006** (unaudited)	December 31 2005 (see note 1)
Assets		
Fixed maturities, available for sale, at fair value (amortized cost $1,608.8 and $1,597.3, respectively)	**$ 1,626.6**	1,617.3
Equity securities, available for sale, at fair value (cost $217.9 and $224.8, respectively)	**257.3**	255.6
Other invested assets	**6.0**	7.0
Total investments	**1,889.9**	1,879.9
Cash and cash equivalents	**70.3**	28.7
Securities lending collateral		99.0
Accrued investment income and other assets	**48.1**	45.1
Deferred policy acquisition costs	**108.1**	106.0
Net prepaid pension expense	**63.6**	59.2
Reinsurance recoverable on losses and loss expenses payable (affiliates $3.2 and $5.5, respectively)	**14.0**	17.4
Prepaid reinsurance premiums (affiliates none and $0.2, respectively)	**5.7**	6.1
Due from affiliate	**14.9**	7.1
Current federal income taxes	**11.3**	3.7
Deferred federal income taxes	**9.7**	10.1
Property and equipment, at cost (net of accumulated depreciation of $5.0 and $4.8, respectively)	**12.5**	12.6
Total assets	**$ 2,248.1**	2,274.9
Liabilities and Stockholders Equity		
Losses and loss expenses payable (affiliates $292.4 and $302.6, respectively)	**$ 703.9**	728.7
Unearned premiums (affiliates $124.4 and $128.4, respectively)	**444.7**	432.9
Notes payable (affiliates $15.5 and $15.5, respectively)	**118.5**	118.7
Postretirement benefit liabilities	**95.3**	89.2
Securities lending obligation		99.0
Other liabilities	**39.6**	42.9
Total liabilities	**1,402.0**	1,511.4
Stockholders equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 45.7 and 45.1 shares issued, respectively, at stated value of $2.50 per share	**114.2**	112.8
Less 4.7 and 4.6 treasury shares, at cost, respectively	**(58.0)**	(56.8)
Additional paid-in capital	**84.7**	70.2
Accumulated other comprehensive income	**38.1**	34.3
Retained earnings	**667.1**	603.0

Total stockholders equity		**846.1**	763.5
Total liabilities and stockholders equity	**$**	**2,248.1**	2,274.9

See accompanying notes to condensed consolidated financial statements.

1

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

($ millions, except per share amounts)	Three months ended September 30	
(unaudited)	**2006**	2005
Earned premiums (ceded to affiliates $172.6 and $172.1, respectively)	**$ 255.8**	262.9
Net investment income	**20.6**	20.1
Net realized gains on investments	**2.0**	4.4
Other income (affiliates $0.7 and $0.7, respectively)	**1.2**	1.1
Total revenues	**279.6**	288.5
Losses and loss expenses (ceded to affiliates $99.6 and $139.4, respectively)	**145.0**	182.2
Acquisition and operating expenses	**87.6**	81.3
Interest expense (affiliates $0.4 and $0.7, respectively)	**1.9**	2.2
Other expenses, net	**2.7**	2.6
Total expenses	**237.2**	268.3
Income before federal income taxes	**42.4**	20.2
Federal income tax expense	**11.2**	3.4
Net income	**$ 31.2**	16.8
Earnings per common share:		
Basic	**$ 0.76**	0.41
Diluted	**$ 0.75**	0.41
Dividends paid per common share	**$ 0.100**	0.090

See accompanying notes to condensed consolidated financial statements.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

($ millions, except per share amounts)	Nine months ended September 30	
(unaudited)	**2006**	2005
Earned premiums (ceded to affiliates $513.8 and $512.5, respectively)	**$ 768.6**	789.7
Net investment income	**61.6**	58.4
Net realized gains on investments	**2.5**	6.8
Other income (affiliates $2.2 and $2.2, respectively)	**3.7**	3.7
Total revenues	**836.4**	858.6
Losses and loss expenses (ceded to affiliates $305.4 and $325.8, respectively)	**466.3**	461.7
Acquisition and operating expenses	**256.0**	248.7
Interest expense (affiliates $1.1 and $2.1, respectively)	**5.6**	6.6
Other expenses, net	**9.6**	9.2
Total expenses	**737.5**	726.2
Income before federal income taxes	**98.9**	132.4
Federal income tax expense	**23.4**	36.0
Net income	**$ 75.5**	96.4
Earnings per common share:		
Basic	**$ 1.85**	2.39
Diluted	**$ 1.82**	2.35
Dividends paid per common share	**$ 0.280**	0.180

See accompanying notes to condensed consolidated financial statements.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Cash Flows

($ millions)	Nine months ended September 30	
(unaudited)	**2006**	2005
Cash flows from operating activities:		
Net income	**$ 75.5**	96.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	**7.5**	7.1
Share-based compensation	**5.4**	0.6
Net realized gains on investments	**(2.5)**	(6.8)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	**(2.0)**	(7.0)
Accrued investment income and other assets	**(0.1)**	3.3
Net prepaid pension expense	**(4.4)**	(5.1)
Postretirement benefit liabilities	**6.1**	6.7
Other liabilities and due to/from affiliates, net	**(11.4)**	(12.0)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	**3.8**	15.6
Losses and loss expenses payable	**(24.8)**	24.6
Unearned premiums	**11.8**	9.5
Federal income taxes	**(8.9)**	(15.9)
Cash provided from adding Meridian Security Insurance Company and Meridian Citizens Mutual Insurance Company business to the reinsurance pool, effective 1/1/2005		54.0
Net cash provided by operating activities	**56.0**	171.0
Cash flows from investing activities:		
Purchase of fixed maturities available-for-sale	**(172.1)**	(453.1)
Purchase of equity securities available-for-sale	**(65.2)**	(70.5)
Purchase of other invested assets	**(0.6)**	(2.8)
Maturities, calls and pay downs of fixed maturities available-for-sale	**61.0**	86.7
Sale of fixed maturities available-for-sale	**86.3**	236.6
Sale of equity securities available-for-sale	**77.4**	30.0
Sale of other invested assets	**1.7**	
Net additions of property and equipment	**(0.2)**	(0.2)
Net cash used in investing activities	**(11.7)**	(173.3)
Cash flows from financing activities:		
Proceeds from stock option exercises	**6.2**	2.8
Change in securities lending collateral	**99.0**	24.5
Change in securities lending obligation	**(99.0)**	(24.5)
Payment of common stock dividends	**(11.4)**	(4.9)
Excess tax benefits on share-based awards	**2.5**	
Net cash used in financing activities	**(2.7)**	(2.1)
Net increase (decrease) in cash and cash equivalents	**41.6**	(4.4)

Cash and cash equivalents at beginning of period		**28.7**	64.3
Cash and cash equivalents at end of period	**$**	**70.3**	59.9
Supplemental disclosures:			
Federal income taxes paid	**$**	**29.4**	51.9
Interest paid (affiliates $1.1 and $2.0, respectively)	**$**	**4.2**	5.1

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation (State Auto Financial or the Company) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2005 (the 2005 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2005 Form 10-K.

Certain items in the prior period consolidated financial statements have been reclassified to conform to the 2006 presentation.

In September 2005, the Accounting Standards Executive Committee issued Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts (SOP 05-1), which is to be effective for fiscal years beginning after December 15, 2006, with earlier adoption encouraged. SOP 05-1 provides guidance on accounting for deferred acquisition costs on internal replacements of insurance contracts that are modifications to product features that occur by the exchange of a contract for a new contract. Insurance contracts issued by the Company include nonintegrated contract features as defined in SOP 05-1. Those nonintegrated contract features that provide coverage that is underwritten and priced only for that incremental insurance coverage do not result in reunderwriting or repricing of other components of the contract. Nonintegrated contract features do not change the existing base contract and do not require further evaluation under SOP 05-1. Given the nature of the policies written by the Company, the impact of SOP 05-1 upon implementation is not expected to be material.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which is to be effective for fiscal years beginning after December 15, 2006, with earlier adoption encouraged. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently assessing the impact of this new guidance, but does not believe it will be material. The Company will adopt this new guidance effective January 1, 2007.

In February 2006, the FASB issued FASB Statement 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155) , which is to be effective for all financial instruments acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. SFAS 155 permits fair value remeasurement for any hybrid financial instruments that contains an embedded derivative that would otherwise require bifurcation, clarifies which interest only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The Company is currently assessing the impact of this new guidance, but does not believe it will be material. The Company will adopt this guidance effective January 1, 2007.

In September 2006, the FASB issued FASB Statement 157, Fair Value Measurements (SFAS 157), which is to be effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair-value measurements. The statement imposes no requirements for additional fair-value measures in financial statements. The

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Company is currently assessing the impact of this new guidance, but does not believe it will be material. The Company will adopt this guidance effective January 1, 2008.

In September 2006, the FASB issued FASB 158, Employers Accounting for Defined Benefit Pension and other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires employers to recognize on their balance sheets the funded status of pension and other postretirement benefit plans as of December 31, 2006. SFAS 158 also requires recognition of actuarial gains and losses, prior service cost, and any remaining transition amounts from the initial application of Statements 87 and 106 as a component of other comprehensive income, net of tax. In addition, SFAS 158 requires a fiscal year end measurement of plan assets and benefit obligations, eliminating the use of earlier measurement dates currently permissible. But the new measurement date requirement will not be effective until fiscal years ended after December 15, 2008. Currently the Company utilizes a measurement date of September 30th. The Company is currently evaluating the impact SFAS 158 will have on its consolidated financial statements. Based on information available within the Company s audited financial statements included in the 2005 Form 10-K, the Company currently estimates that its stockholders equity as of September 30, 2006 would have decreased by approximately $60 $65 million if SFAS 158 had been effective for the third quarter of 2006. The actual impact of implementing SFAS 158 could vary materially from this estimate based upon the completion of the Company s actuarial valuation as of the measurement date for 2006. We do not believe implementing SFAS 158 will have a significant impact on the Company s debt covenants. The Company plans to adopt this guidance as required on the dates indicated above.

2. Earnings per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

($ millions, except per share amounts)	Three months ended September 30		Nine months ended September 30	
	2006	2005	**2006**	2005
Numerator:				
Net income for basic earnings per share	**$ 31.2**	16.8	**$ 75.5**	96.4
Denominator:				
Basic weighted average shares outstanding	**41.0**	40.4	**40.8**	40.3
Effect of dilutive share-based awards	**0.6**	0.8	**0.8**	0.7
Diluted weighted average shares outstanding	**41.6**	41.2	**41.6**	41.0
Basic earnings per share	**$ 0.76**	0.41	**$ 1.85**	2.39
Diluted earnings per share	**$ 0.75**	0.41	**$ 1.82**	2.35

The following number of options to purchase shares of common stock was not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

(number of options in millions)	Three months ended September 30		Nine months ended September 30	
	2006	2005	**2006**	2005
Number of options	0.3		0.3	0.4

3. Share-Based Awards

Prior to January 1, 2006, the Company accounted for share-based compensation plans for employees and non-employee directors under the measurement and recognition provisions of Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, and related Interpretations, as permitted by Statement of Financial Accounting Standards 123, Accounting for Stock-Based Compensation (SFAS 123). Accordingly, share-based compensation was included as a pro forma disclosure in the financial

6

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

statement footnotes. For share-based awards granted to the Company s independent insurance agencies, the Company recognized share-based compensation within its financial statements in accordance with SFAS 123 and related Interpretations.

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), Share-Based Payment (SFAS 123(R)), using the modified-prospective transition method. Under this transition method, share-based compensation expense in 2006 includes the expense associated with awards vesting in the period for (1) the unvested portion of all share-based awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and (2) all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

For the three-month periods ended September 30, 2006 and 2005, results of operations include pre-tax expense of $1.2 million and none, respectively, relating to share-based awards for employees, non-employee directors, and independent insurance agencies of the Company. For the nine-month periods ended September 30, 2006 and 2005, results of operations include pre-tax expense of $5.4 million and $0.3 million, respectively. For the three- and nine-month periods ended September 30, 2006, basic and diluted earnings per share were reduced by $0.02 and $0.10, respectively. At September 30, 2006, there was $6.9 million of total unrecognized share-based compensation expense related to non-vested awards. This expense is expected to be recognized as follows: $1.2 million in 2006, $3.5 million in 2007, $1.8 million in 2008 and $0.4 million in 2009. Unearned share-based compensation is amortized over the vesting period for the particular grant and is recognized as a component of loss and loss expenses and acquisition and operating expenses in a manner consistent with other employee compensation in the accompanying Condensed Consolidated Statements of Income.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to share-based employee and non-employee director compensation for the three- and nine-month periods ended September 30, 2005:

($ millions, except per share amounts)		Three months ended September 30, 2005	Nine months ended September 30, 2005
Net income, as reported	$	16.8	96.4
Deduct: Total stock-based employee and non- employee director compensation expense determined under fair value based method for all awards, net of related tax effects		(1.1)	(2.9)
Pro-forma, net income	$	15.7	93.5
Earnings per share:			
Basic as reported	$	0.41	2.39
Basic pro-forma	$	0.39	2.32
Diluted as reported	$	0.41	2.35
Diluted pro-forma	$	0.37	2.24

The share-based compensation plan for key employees is the Amended and Restated Equity Incentive Compensation Plan (the Equity Plan). In May 2005, the Company s shareholders approved amendments to, and a restatement of, the Equity Plan, which was formerly called the 2000 Stock Option Plan. The share-based compensation plan for outside directors is the Outside Directors Restricted Share Unit Plan (the Outside Directors RSU Plan), which was approved by the Company s shareholders in May 2005. The Outside Directors RSU Plan replaced the 2000 Directors Stock Option Plan for outside directors (the Outside Directors Stock Option Plan).

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Equity Plan

The 2000 Stock Option Plan provided only for the award of qualified and nonqualified stock options. The Equity Plan now provides for the award of qualified and nonqualified stock options, restricted shares, performance shares, performance units and other stock-based awards. The Company has reserved 3.5 million common shares under the Equity Plan (5.0 million common shares under the 2000 Stock Option Plan). As of September 30, 2006, a total of 1.5 million common shares were available for issuance under the Equity Plan. The Equity Plan provides that (i) no more than 33% of the common shares authorized for issuance under the Equity Plan may be granted in the form of awards other than stock options, (ii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year is equal to 1.5% of the total number of common shares of the Company outstanding as of December 31 of the prior year, and (iii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year to any individual is 250,000 shares. The Equity Plan automatically terminates on July 1, 2010.

The Equity Plan provides that qualified stock options may be granted at an option price not less than the fair market value of the common shares at date of grant and that nonqualified stock options may be granted at any price determined by the Compensation Committee of the Board of Directors. Options granted generally vest over a three-year period, with one-third of the options vesting on each anniversary of the grant date, and must be exercised no later than ten years from the date of grant. There were no stock options granted under the Equity Plan for the three months ended September 30, 2006 and 2005. Stock options granted under the Equity Plan for the nine months ended September 30, 2006 and 2005 were 314,800 and 376,500, respectively.

The Equity Plan provides for the granting of restricted shares subject to a vesting schedule based on the employee s continued employment (Restriction Period), for which vesting is generally on the third anniversary after the date of grant. The Company recognizes compensation expense based on the number of restricted shares granted at the then grant date fair value over the Restricted Period. There were no restricted shares granted for the three months ended September 30, 2006. Restricted shares granted for the nine months ended September 30, 2006 were 10,500 with an average grant date fair value of $31.94. There were no restricted shares granted by the Company prior to January 1, 2006.

Employee Stock Purchase Plan

The Company also has a broad-based employee stock purchase plan with a dividend reinvestment feature, under which employees of the Company may choose at two different specified time intervals each year to have up to 6% of their annual base earnings withheld to purchase the Company s common shares. The purchase price of the common shares is 85% of the lower of its beginning-of-interval or end-of-interval market price. There were no shares issued for the three months ended September 30, 2006 and 2005. There were 37,730 and 40,644 shares issued for the nine months ended September 30, 2006 and 2005, respectively.

Non-Employee Directors Plan

Under the Outside Directors Stock Option Plan, following each annual meeting of shareholders outside directors received nonqualified options to purchase 4,200 common shares at an option price equal to the fair market value of the common shares at the close of business on the last trading day immediately prior to the date of the annual meeting. These nonqualified options vested upon grant and are exercisable for 10 years from the date of grant. On May 11, 2005 (the date of the Company s 2005 annual meeting of shareholders), the Outside Directors Stock Option Plan was amended to prohibit the grant of further options under the plan.

The Outside Directors RSU Plan is an unfunded deferred compensation plan which provides each outside director with an award of 1,400 restricted share units (the RSU award) following each annual meeting of shareholders, however, the amount of the award may change from year to year, based on the provision described below. The RSU awards are fully vested upon grant. RSU awards are not common shares of the Company and, as such, no participant has any rights as a holder of common shares under the Outside Directors RSU Plan. RSU awards represent the right to receive an amount, payable in cash or common shares of the Company, as previously elected by the outside director, equal to the value of a specified number of common shares of the Company at the end of the restricted period. Such election may be changed within the constraints set forth in the RSU Plan. The restricted period for the RSU awards begins on the date of grant and expires on the date the outside director retires from or otherwise terminates service as a director of the Company. During the restricted period, outside directors are credited with dividends, equivalent in value to those declared and paid on the Company s common shares, on all RSU awards granted to them. At the end of the restricted period, outside directors receive distributions of their RSU awards either (i) in a single lump sum payment, or (ii) in annual installment payments over a five- or ten-year period, as previously elected by the outside director. The administrative committee for the Outside Directors RSU Plan (currently the Company s Compensation Committee) retains the right to increase the annual number of RSU awards granted to each outside director to as many as 5,000 or to decrease such annual number to not less than 500, without seeking shareholder approval, if such increase or decrease is deemed appropriate by the administrative committee to maintain director compensation at

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

appropriate levels. The Outside Directors RSU Plan automatically terminates on May 31, 2015. The Company accounts for the Outside Directors RSU Plan as a liability plan. There were no RSUs granted in the three months ended September 30, 2006 and 2005, and 9,800 RSUs were granted in the nine months ended September 30, 2006 and 2005. During the nine months ended September 30, 2006, 1,695 units were distributed in the form of common shares of the Company. No shares were distributed during the three months ended September 30, 2006.

Agent Stock Option Plan

The Company has a stock option incentive plan for certain designated independent insurance agencies (Agent Stock Option Plan) that represent the Company and its affiliates. The Company has reserved 0.4 million shares of common stock under this plan. As of September 30, 2006, a total of 0.2 million shares were available for issuance under the Agent Stock Option Plan. The plan provides that the options become exercisable on the first day of the calendar year following the agency s achievement of specific production and profitability requirements over a period not greater than two calendar years from the date of grant or a portion thereof in the first calendar year in which an agency commences participation under the plan. Options granted under this plan have a ten-year term. Stock options granted for the nine months ended September 30, 2006 and 2005 were 16,452 and 29,505, respectively. Stock options granted for the three months ended September 30, 2006 and 2005 were none and 2,445, respectively.

Stock Options

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes closed-form pricing model. The following tables present the weighted-average assumptions used in the option pricing model for options granted to employees and non-employees (independent insurance agencies) during the three- and nine-month periods ended September 30, 2006 and 2005. The expected life of the options for employees represents the period of time the options are expected to be outstanding and is based on historical trends. For non-employees the expected life of the option approximates the remaining contractual term of the option. Expected stock price volatility is based on the historical volatility of the Company s stock for a period approximating the expected life and the expected dividend yield is based on the Company s most recent period s dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term equal to the expected life.

The weighted average fair values and related assumptions for options granted to employees for the three- and nine-month periods ended September 30, 2006 were as follows:

	2006	2005
Fair value	**$ 13.77**	$ 11.26
Dividend yield	**1.1%**	0.7%
Risk free interest rate	**5.2%**	3.7%
Expected volatility factor	**33.6%**	36.5%
Expected life in years	**7.0**	7.2

For options granted under the Agency Stock Option Plan the fair value was estimated at the reporting date or vesting date. The weighted average fair value and related assumptions for the three- and nine-month periods ended September 30, 2006 and 2005 were as follows:

	2006	2005
Fair value	**$ 13.63**	$ 14.49
Dividend yield	**1.30%**	1.14%
Risk free interest rate	**4.7%**	4.3%
Expected volatility factor	**35.4%**	34.9%
Expected life in years	**8.6**	6.7

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

A summary of the Company s stock option activity for the three- and nine-month periods ended September 30, 2006 and 2005 is as follows:

(number of options in millions)	Three months ended September 30				Nine months ended September 30			
	2006		2005		**2006**		2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning	**2.6**	**$ 21.65**	2.7	$ 18.59	**2.6**	**$ 18.72**	2.6	$ 16.48
Granted				30.67	**0.4**	**33.51**	0.4	26.44
Exercised	**(0.1)**	**15.34**		13.82	**(0.5)**	**12.27**	(0.3)	9.47
Cancelled		**30.40**				**28.31**		17.45
Outstanding, ending	**2.5**	**$ 22.01**	2.7	$ 18.71	**2.5**	**$ 22.01**	2.7	$ 18.71

Intrinsic value for stock options is defined as the difference between the current market value and the grant price. For the three months ended September 30, 2006 and 2005, the total intrinsic value of stock options exercised was $2.2 million and $1.1 million, respectively. For the nine months ended September 30, 2006 and 2005, the total intrinsic value of stock options exercised was $11.6 million and $5.2 million, respectively. The tax benefit for tax deductions from stock options exercised totaled $0.5 million and $0.2 million for the three months ended September 30, 2006 and 2005, respectively. The tax benefit for tax deductions from share-based awards totaled $3.4 million and $1.5 million for the nine months ended September 30, 2006 and 2005, respectively.

A summary of information pertaining to all options outstanding and exercisable at September 30, 2006 is as follows:

(number of options in millions)	**Options Outstanding**			**Options Exercisable**	
Range of Exercise Prices	**Number**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Number**	**Weighted Average Exercise Price**
Less than $10.00		1.2	$ 9.30		$ 9.30
$10.01 - $20.00	1.3	4.5	15.34	1.3	15.34
$20.01 - $30.00	0.4	8.5	26.31	0.2	26.18
$30.01 - $40.00	0.8	8.5	32.07	0.3	30.94

Total	2.5	6.3	$ 22.01	1.8	$ 18.85

Aggregate intrinsic value for total options outstanding at September 30, 2006 is $54.0 million. Aggregate intrinsic value for total options exercisable at September 30, 2006 is $33.8 million.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

4. Comprehensive Income

The components of accumulated other comprehensive income (loss), net of related tax, included in stockholders equity at September 30, 2006 and 2005, include unrealized holding gains (losses), net of tax. The components of comprehensive income (loss), net of related tax, are as follows:

($ millions)	Three months ended September 30		Nine months ended September 30	
	2006	2005	**2006**	2005
Net income	**$ 31.2**	16.8	**$ 75.5**	96.4
Unrealized holding gains (losses), net of tax	**28.5**	(18.9)	**3.9**	(19.7)
Comprehensive income (loss)	$ 59.7	(2.1)	$ 79.4	76.7

5. Reinsurance

The following table provides a summary of the Company s reinsurance transactions with other insurers and reinsurers, as well as reinsurance transactions with affiliates:

($ millions)	Three months ended September 30		Nine months ended September 30	
	2006	2005	**2006**	2005
Premiums earned:				
Assumed from other insurers and reinsurers	**$ 1.6**	1.5	**$ 5.5**	4.5
Assumed under State Auto Pool and other affiliate arrangements	**244.9**	250.1	**734.4**	748.6
Ceded to other insurers and reinsurers	**(4.6)**	(4.3)	**(14.0)**	(12.3)
Ceded under State Auto Pool and other affiliate arrangements	**(172.6)**	(172.1)	**(513.8)**	(512.5)
Net assumed premiums earned	**$ 69.3**	75.2	**$ 212.1**	228.3
Losses and loss expenses incurred:				
Assumed from other insurers and reinsurers	**$ 0.8**	1.4	**$ 8.8**	5.1
Assumed under State Auto Pool and other affiliate arrangements	**137.4**	174.0	**441.8**	434.0
Ceded to other insurers and reinsurers	**(1.4)**	(0.2)	**(2.5)**	(1.7)
Ceded under State Auto Pool and other affiliate arrangements	**(99.6)**	(139.4)	**(305.4)**	(325.8)

Net assumed losses and loss expenses incurred	**$**	**37.2**	35.8	**$ 142.7**	111.6

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

6. Pension and Postretirement Benefit Plans

The following table provides components of net periodic cost for the State Auto Group of Companies pension and postretirement benefit plans:

($ millions)	Three months ended September 30				Nine months ended September 30			
	Pension		Postretirement		Pension		Postretirement	
	2006	2005	**2006**	2005	**2006**	2005	**2006**	2005
Service cost	**$ 2.5**	2.0	**$ 1.2**	1.1	**$ 7.5**	6.0	**$ 3.6**	3.3
Interest cost	**2.9**	2.8	**1.6**	1.6	**8.7**	8.4	**4.7**	4.8
Expected return on plan assets	**(4.2)**	(4.2)	**(0.1)**		**(12.7)**	(12.6)	**(0.2)**	(0.1)
Amortization of prior service costs	**0.1**	0.1	**0.2**	0.1	**0.3**	0.3	**0.4**	0.3
Amortization of transition assets	**(0.2)**	(0.2)			**(0.5)**	(0.5)		
Amortization of net loss	**0.7**	0.3	**0.1**	0.2	**2.2**	0.9	**0.4**	0.6
Net periodic cost	**$ 1.8**	0.8	**$ 3.0**	3.0	**$ 5.5**	2.5	**$ 8.9**	8.9

During September 2006, the Company contributed $10.0 million in cash to its pension plan.

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

7. Segment Information

At September 30, 2006, the Company has two reportable segments: standard insurance and nonstandard insurance. Interim financial data by segment is as follows:

	Three months ended		Nine months ended	
($ millions)	September 30		September 30	
	2006	2005	**2006**	2005
Revenues from external customers:				
Standard insurance	$ **264.0**	268.8	$ **791.7**	802.7
Nonstandard insurance	**12.0**	13.8	**37.2**	44.2
All other	**1.3**	1.2	**4.0**	4.0
Total revenues from external customers	$ **277.3**	283.8	$ **832.9**	850.9
Intersegment revenues:				
Standard insurance	$		$ **0.1**	0.1
All other	**2.3**	2.3	**6.7**	6.7
Total intersegment revenues	$ **2.3**	2.3	$ **6.8**	6.8
Segment profit (loss):				
Standard insurance	$ **40.2**	15.1	$ **97.5**	124.1
Nonstandard insurance	**2.8**	1.5	**7.7**	4.8
All other	**(0.3)**	2.1	**(0.6)**	6.3
Total segment profit	**42.7**	18.7	**104.6**	135.2
Reconciling items:				
Corporate expenses	**(2.3)**	(2.9)	**(8.2)**	(9.6)
Net realized gains	**2.0**	4.4	**2.5**	6.8
Total consolidated income before federal income taxes	$ **42.4**	20.2	$ **98.9**	132.4
Segment assets:				
Standard insurance			**$ 2,217.9**	2,145.6
Nonstandard insurance			**110.3**	120.8
All other			**19.4**	21.7
Total segment assets			**$ 2,347.6**	2,288.1

Table of Contents

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operation

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for the Company s condensed consolidated balance sheets as of September 30, 2006 and December 31, 2005, and for the condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2006 and 2005. This discussion and analysis should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations included in the Company s Annual Report on Form 10-K for its year ended December 31, 2005 (the 2005 Form 10-K), and in particular the discussions in those sections thereof entitled Executive Summary and Critical Accounting Policies. Readers are encouraged to review the entire 2005 Form 10-K, as it includes information regarding the Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of the Company s current period financial results.

The discussion and analysis presented below includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, project, believe or continue or the ne variations thereon or similar terminology. Forward-looking statements speak only as of the date the statements were made. Although State Auto Financial believes that the expectations reflected in forward-looking statements have a reasonable basis, it can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause State Auto Financial s actual results to differ materially from those projected, see Risk Factors in Item 1A of the 2005 Form 10-K, which information is incorporated in this Form 10-Q by reference, updated by Part II, Item 1A of this Form 10-Q. Except to the limited extent required by applicable law, State Auto Financial undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

OVERVIEW

State Auto Financial Corporation (State Auto Financial or STFC) is a property and casualty insurance holding company primarily engaged in writing both personal and commercial lines of insurance. The State Auto Group (defined below) writes a broad line of property and casualty insurance products through approximately 22,800 independent insurance agents associated with approximately 3,000 agencies in 27 states.

State Auto Financial s insurance subsidiaries are State Auto Property and Casualty Insurance Company (State Auto P&C), Milbank Insurance Company (Milbank), Farmers Casualty Insurance Company (Farmers), State Auto Insurance Company of Ohio (SA Ohio) and State Auto National Insurance Company (SA National). State Auto Financial and its consolidated subsidiaries are collectively referred to as the Company.

State Automobile Mutual Insurance Company (State Auto Mutual) owns approximately 65% of State Auto Financial s outstanding common shares. State Auto Mutual is one of only 14 companies in the United States to have been rated A+ (Superior) or higher by A.M. Best Company every year since 1954. State Auto Mutual s insurance subsidiaries and affiliates are State Auto Florida Insurance Company (SA Florida), State Auto Insurance Company of Wisconsin (SA Wisconsin), Meridian Security Insurance Company (Meridian Security) and Meridian Citizens Mutual Insurance Company (Meridian Citizens Mutual). Meridian Security and Meridian Citizens Mutual together comprise the Meridian Insurers.

The Pooled Companies (defined below) provide a broad line of property and casualty insurance, such as standard personal and commercial automobile, homeowners and farmowners, commercial multi-peril, workers compensation, general liability and fire insurance. SA National provides nonstandard personal automobile insurance to the nonstandard insurance market. The Pooled Companies and SA National are collectively referred to as the State Auto Group or State Auto.

State Auto P&C, Milbank, Farmers and SA Ohio (the STFC Pooled Companies) participate in a quota share reinsurance pooling arrangement (the Pooling Arrangement) with State Auto Mutual, SA Wisconsin, SA Florida and the Meridian Insurers (the Mutual Pooled Companies and, together with the STFC Pooled Companies, the Pooled Companies). The Pooling Arrangement covers all the property and casualty insurance written by the Pooled Companies except voluntary assumed reinsurance written by State Auto Mutual, State Auto Middle Market Insurance (as defined in the current pooling agreement among the Pooled Companies) and intercompany catastrophe reinsurance written by State Auto P&C.

Under the Pooling Arrangement, each of the Pooled Companies cedes premiums, losses and expenses on all of its business to State Auto Mutual, and State Auto Mutual in turn cedes to each of the

Table of Contents

Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies respective pooling percentages. State Auto Mutual then retains the balance of the pooled business. The participation percentage for the STFC Pooled Companies has remained at 80% since October 1, 2001.

The Company s subsidiaries operate in two insurance segments. State Auto P&C, Milbank, Farmers and SA Ohio comprise the standard segment of the Company s operations, and SA National comprises the nonstandard segment. As discussed above and illustrated below, State Auto P&C, Milbank, Farmers and SA Ohio participate in the Pooling Arrangement.

The Pooled Companies are rated A+ (Superior) by the A.M. Best Company.

The following table sets forth a chronology of the participants and participant percentage changes that have occurred in the Pooling Arrangement since January 1, 2004:

	STFC Pooled Companies					Mutual Pooled Companies					
Year	**State Auto P&C**	**Milbank**	**Farmers**	**SA Ohio**	***Sub Total***	**Mutual**	**SA Wisconsin**	**SA Florida**	**Meridian Security**	**Meridian Citizens Mutual**	***Sub Total***
2004	59.0	17.0	3.0	1.0	80.0	18.3	1.0	0.7	N/A	N/A	20.0
2005 current	59.0	17.0	3.0	1.0	80.0	19.5	0.0	0.0	0.0	0.5	20.0

The terms State Auto Financial, STFC, our Company, we, us and our as used in the following discussion refer to State Auto Financial consolidated subsidiaries.

RESULTS OF OPERATIONS

The following table summarizes certain key performance metrics for the three- and nine-month periods ended September 30, 2006 and 2005 that we use to monitor our financial performance:

($ millions, except per share amounts)	Three months ended September 30		Nine months ended September 30	
GAAP Basis:	**2006**	2005	**2006**	2005
Total revenue	**$ 279.6**	288.5	**$ 836.4**	858.6
Net income	**$ 31.2**	16.8	**$ 75.5**	96.4
Stockholders equity	**$ 846.1**	735.5	**$ 846.1**	735.5
Book value per share	**$ 20.63**	18.20	**$ 20.63**	18.20
Loss and LAE ratio(1)	**56.7%**	69.3	**60.7%**	58.5
Expense ratio(1)	**34.2%**	30.9	**33.3%**	31.5
Combined ratio(1)	**90.9%**	100.2	**94.0%**	90.0
Catastrophe loss and LAE points	**8.0**	16.0	**11.7**	6.6
Premium written growth(2)	**(1.7%)**	2.1	**(2.5%)**	6.0
Premium earned growth	**(2.7%)**	3.7	**(2.7%)**	4.6
Investment yield	**4.4%**	4.4	**4.4%**	4.4

	Twelve months ended September 30	
Statutory Basis:	**2006**	2005

Net premiums written to surplus[3]	**1.3**	1.5

[1] Loss and LAE ratio is losses and loss expenses as a percentage of earned premiums. Expense ratio is acquisition and operating expenses as a percentage of earned premiums. Combined ratio is the sum of the loss and LAE ratio and the expense ratio.

[2] 4.6 points of the increase for the nine months ended September 30, 2005 relates to $23.9 million of unearned premium transferred to us in connection with the addition of the Meridian Insurers to the Pooling Arrangement. The addition of the Meridian Insurers to the Pooling Arrangement was effective January 1, 2005.

Table of Contents

(3) We use the statutory net premiums written to surplus ratio as there is no comparable GAAP measure. This ratio, also called the leverage ratio, measures a company s statutory surplus available to absorb losses.

The following table provides a summary of our insurance segments GAAP underwriting profit (in dollars) and GAAP combined ratio, along with related segment net investment income, for the three- and nine-month periods ended September 30, 2006 and 2005. The tabular information provided is net of adjustments for transactions with other segments.

($ millions)	**Three months ended September 30, 2006**					
	Standard	**% Ratio**	**Nonstandard**	**% Ratio**	**Total**	**% Ratio**
Written premiums	**$ 253.3**		**$ 10.7**		**$ 264.0**	
Earned premiums	**244.8**		**11.0**		**255.8**	
Losses and loss expenses	**138.8**	**56.7**	**6.2**	**56.3**	**145.0**	**56.7**
Acquisition and operating expenses	**84.9**	**34.7**	**2.7**	**24.5**	**87.6**	**34.2**
GAAP underwriting profit and combined ratio	**$ 21.1**	**91.4**	**$ 2.1**	**80.8**	**$ 23.2**	**90.9**
Net investment income	**$ 22.9**		**$ 1.1**		**$ 24.0**	

($ millions)	Three months ended September 30, 2005					
	Standard	% Ratio	Nonstandard	% Ratio	Total	% Ratio
Written premiums	$ 255.8		$ 12.7		$ 268.5	
Earned premiums	250.2		12.7		262.9	
Losses and loss expenses	173.7	69.5	8.5	67.1	182.2	69.3
Acquisition and operating expenses	78.2	31.2	3.1	24.3	81.3	30.9
GAAP underwriting profit and combined ratio	$ (1.7)	100.7	$ 1.1	91.4	$ (0.6)	100.2
Net investment income	$ 16.8		$ 0.9		$ 17.7	

Table of Contents

($ millions)	Nine months ended September 30, 2006					
	Standard	**% Ratio**	**Nonstandard**	**% Ratio**	**Total**	**% Ratio**
Written premiums	**$ 747.5**		**$ 33.3**		**$ 780.8**	
Earned premiums	**734.4**		**34.2**		**768.6**	
Losses and loss expenses	**446.3**	**60.8**	**20.0**	**58.5**	**466.3**	**60.7**
Acquisition and operating expenses	**247.6**	**33.7**	**8.4**	**24.5**	**256.0**	**33.3**
GAAP underwriting profit and combined ratio	**$ 40.5**	**94.5**	**$ 5.8**	**83.0**	**$ 46.3**	**94.0**
Net investment income	**$ 57.3**		**$ 2.9**		**$ 60.2**	

($ millions)	Nine months ended September 30, 2005					
	Standard	% Ratio	Nonstandard	% Ratio	Total	% Ratio
Written premiums	$ 785.9(1)		$ 38.8		$ 824.7	
Earned premiums	748.7		41.0		789.7	
Losses and loss expenses	433.5	57.9	28.2	68.9	461.7	58.5
Acquisition and operating expenses	239.6	32.0	9.1	22.1	248.7	31.5
GAAP underwriting profit and combined ratio	$ 75.6	89.9	$ 3.7	91.0	$ 79.3	90.0