

State Auto Financial CORP
Form 10-Q
August 05, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

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

Commission File Number 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

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

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

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

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

Yes ý No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ý No ¨

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

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

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

Yes ¨ No ý

On July 31, 2015, the Registrant had 41,223,677 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

PART I – FINANCIAL STATEMENTS

Item 1. Condensed Consolidated Balance Sheets

(\$ and shares in millions, except per share amounts)	June 30, 2015 (unaudited)	December 31, 2014
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,927.1 and \$1,831.3, respectively)	\$ 1,959.1	\$ 1,891.9
Equity securities, available-for-sale, at fair value (cost \$230.0 and \$235.5, respectively)	297.4	310.4
Other invested assets, available-for-sale, at fair value (cost \$54.6 and \$50.5, respectively)	89.3	80.3
Other invested assets	5.3	5.3
Notes receivable from affiliate	70.0	70.0
Total investments	2,421.1	2,357.9
Cash and cash equivalents	50.6	86.3
Accrued investment income and other assets	35.0	33.8
Deferred policy acquisition costs (affiliated net assumed \$53.1 and \$46.8, respectively)	133.5	126.5
Reinsurance recoverable on losses and loss expenses payable	9.0	9.6
Prepaid reinsurance premiums	6.4	6.1
Due from affiliate	35.5	40.1
Current federal income taxes	3.0	1.1
Net deferred federal income taxes	98.7	97.4
Property and equipment, at cost	7.7	8.1
Total assets	\$ 2,800.5	\$ 2,766.9
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliated net assumed \$507.0 and \$494.3, respectively)	\$ 1,023.0	\$ 983.2
Unearned premiums (affiliated net assumed \$223.1 and \$201.7, respectively)	632.3	612.4
Notes payable (affiliates \$15.5 and \$15.5, respectively)	100.8	100.8
Postretirement and pension benefits (affiliated net ceded \$61.2 and \$63.2, respectively)	113.7	117.3
Other liabilities (affiliated net ceded \$3.4 and \$5.1, respectively)	53.2	80.3
Total liabilities	1,923.0	1,894.0
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued	—	—
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued	—	—
Common stock, without par value. Authorized 100.0 shares; 47.9 and 47.7 shares issued, respectively, at stated value of \$2.50 per share	119.8	119.3
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(116.2	) (116.0
Additional paid-in capital	146.7	143.2
Accumulated other comprehensive income (affiliated net ceded \$62.3 and \$65.1, respectively)	53.4	71.7
Retained earnings	673.8	654.7

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Total stockholders' equity	877.5	872.9
Total liabilities and stockholders' equity	\$2,800.5	\$2,766.9

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

(\$ in millions, except per share amounts)

(unaudited)	Three months ended June 30	
	2015	2014
Earned premiums (affiliated net assumed \$102.9 and \$51.5, respectively)	\$311.5	\$268.3
Net investment income (affiliated \$1.2 and \$1.2, respectively)	19.8	20.5
Net realized gains on investments:		
Total other-than-temporary impairment losses	(0.8	) (0.3
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	6.2	5.6
Total net realized gains on investments	5.4	5.3
Other income from affiliates	0.7	0.3
Total revenues	337.4	294.4
Losses and loss expenses (affiliated net assumed \$59.4 and \$47.6, respectively)	224.6	190.4
Acquisition and operating expenses (affiliated net assumed \$58.8 and \$42.3, respectively)	105.9	97.3
Interest expense (affiliated \$0.2 and \$0.1, respectively)	1.4	1.3
Other expenses	2.1	2.3
Total expenses	334.0	291.3
Income before federal income taxes	3.4	3.1
Federal income tax expense:		
Current	0.2	0.1
Deferred	0.5	—
Total federal income tax expense	0.7	0.1
Net income	\$2.7	\$3.0
Earnings per common share:		
Basic	\$0.06	\$0.07
Diluted	\$0.06	\$0.07
Dividends paid per common share	\$0.10	\$0.10

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Income

(\$ in millions, except per share amounts)

(unaudited)	Six months ended June 30	
	2015	2014
Earned premiums (affiliated net assumed \$208.3 and \$98.6, respectively)	\$ 626.8	\$ 530.8
Net investment income (affiliate \$2.4 and \$2.4, respectively)	35.2	38.1
Net realized gains on investments:		
Total other-than-temporary impairment losses	(1.3	) (1.2
Portion of loss recognized in other comprehensive income	—	—
Other net realized investment gains	10.5	17.2
Total net realized gains on investments	9.2	16.0
Other income from affiliates	1.1	0.8
Total revenues	672.3	585.7
Losses and loss expenses (affiliated net assumed \$133.5 and \$78.0, respectively)	419.6	362.2
Acquisition and operating expenses (affiliated net assumed \$136.1 and \$81.2, respectively)	209.3	185.8
Interest expense (affiliates \$0.4 and \$0.3, respectively)	2.7	2.6
Other expenses	4.1	4.3
Total expenses	635.7	554.9
Income before federal income taxes	36.6	30.8
Federal income tax expense:		
Current	0.6	0.7
Deferred	8.6	—
Total federal income tax expense	9.2	0.7
Net income	\$ 27.4	\$ 30.1
Earnings per common share:		
Basic	\$ 0.67	\$ 0.74
Diluted	\$ 0.66	\$ 0.73
Dividends paid per common share	\$ 0.20	\$ 0.20

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income (\$ in millions, except per share amounts) (unaudited)	Three months ended June 30		
	2015	2014	
Net income	\$2.7	\$3.0	
Other comprehensive (loss) income, net of tax:			
Net unrealized holding (losses) gains on investments:			
Unrealized holding (losses) gains	(38.6	) 34.9	
Reclassification adjustments for gains realized in net income	(5.4	) (5.3)
Income tax benefit (expense)	15.4	(3.5)
Total net unrealized holding (losses) gains on investments	(28.6	) 26.1	
Net unrecognized benefit plan obligations:			
Net actuarial loss arising during period	—	(1.6)
Reclassification adjustments for amortization to statements of income:			
Negative prior service cost	(1.4	) (1.4)
Net actuarial loss	2.9	2.2	
Income tax expense	(0.5) —	
Total net unrecognized benefit plan obligations	1.0	(0.8)
Other comprehensive (loss) income	(27.6	) 25.3	
Comprehensive (loss) income	\$(24.9	) \$28.3	

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income (\$ in millions, except per share amounts) (unaudited)	Six months ended June 30	
	2015	2014
Net income	\$27.4	\$30.1
Other comprehensive (loss) income, net of tax:		
Net unrealized holding (losses) gains on investments:		
Unrealized holding (losses) gains	(21.6	) 57.9
Reclassification adjustments for gains realized in net income	(9.6	) (16.0
Income tax benefit (expense)	10.9	(7.7
Total net unrealized holding (losses) gains on investments	(20.3	) 34.2
Net unrecognized benefit plan obligations:		
Net actuarial loss arising during period	—	(1.6
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	(2.8	) (2.8
Net actuarial loss	5.8	3.8
Income tax expense	(1.0) —
Total net unrecognized benefit plan obligations	2.0	(0.6
Other comprehensive (loss) income	(18.3	) 33.6
Comprehensive income	\$9.1	\$63.7

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Condensed Consolidated Statements of Cash Flows

(\$ in millions)

(unaudited)

Cash flows from operating activities:

Net income

Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation and amortization, net

Share-based compensation

Net realized gains on investments

Changes in operating assets and liabilities:

Deferred policy acquisition costs

Accrued investment income and other assets

Postretirement and pension benefits

Other liabilities and due to/from affiliates, net

Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums

Losses and loss expenses payable

Unearned premiums

Excess tax benefits on share-based awards

Federal income taxes

Cash provided from December 31, 2014 unearned premium transfer related to the homeowners quota share arrangement

Net cash provided by operating activities

Cash flows from investing activities:

Purchases of fixed maturities available-for-sale

Purchases of equity securities available-for-sale

Purchases of other invested assets

Maturities, calls and pay downs of fixed maturities available-for-sale

Sales of fixed maturities available-for-sale

Sales of equity securities available-for-sale

Sales of other invested assets available-for-sale

Net additions of property and equipment

Net cash used in investing activities

Cash flows from financing activities:

Proceeds from issuance of common stock

Payments to acquire treasury stock

Payment of dividends

Net cash used in financing activities

Net decrease in cash and cash equivalents

Cash and cash equivalents at beginning of period

Cash and cash equivalents at end of period

Supplemental disclosures:

Interest paid (affiliates \$0.3 and \$0.3, respectively)

Federal income taxes paid

Six months ended June 30

2015

2014

\$27.4

\$30.1

7.3

4.4

2.4

2.4

(9.2

) (16.0

)

(7.0

) (10.2

)

(0.6

) 0.4

(1.6

) (2.7

)

(87.8

) (36.6

)

0.3

(0.2

)

39.8

2.9

19.9

30.5

0.1

—

7.8

(0.2

)

63.5

—

62.3

4.8

(317.9

) (226.7

)

(26.1

) (84.9

)

(4.3

) (0.9

)

147.5

138.3

68.9

101.8

39.8

64.8

0.3

0.3

(0.1

) —

(91.9

) (7.3

)

2.4

2.1

(0.2

) (0.1

)

(8.3

) (8.3

)

(6.1

) (6.3

)

(35.7

) (8.8

)

86.3

80.3

\$50.6

\$71.5

\$2.6

\$2.6

\$2.4

\$1.0

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

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

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

Adoption of Accounting Pronouncements

Simplifying the Presentation of Debt Issuance Costs

In April 2015, the FASB issued updated guidance to clarify the required presentation of debt issuance costs. The amended guidance requires that debt issuance costs be presented in the balance sheet as a direct reduction from the carrying amount of the recognized debt liability, consistent with the treatment of debt discounts and amortization of debt issuance costs is to be reported as interest expense. The recognition and measurement guidance for debt issuance costs is not affected by the updated guidance. The guidance is effective for reporting periods beginning after December 15, 2015 and early adoption is permitted. The adoption of this guidance will not have any effect on the Company’s results of operations, financial position or liquidity.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

2. Investments

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

(\$ millions)

June 30, 2015	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$274.5	\$13.3	\$(2.7)	) \$285.1
Obligations of states and political subdivisions	844.5	17.5	(8.6)	) 853.4
Corporate securities	341.6	7.8	(3.7)	) 345.7
U.S. government agencies mortgage-backed securities	466.5	13.0	(4.6)	) 474.9
Total fixed maturities	1,927.1	51.6	(19.6)	) 1,959.1
Equity securities:				
Large-cap securities	177.2	48.9	(1.3)	) 224.8
Small-cap securities	52.8	19.8	—	) 72.6
Total equity securities	230.0	68.7	(1.3)	) 297.4
Other invested assets	54.6	34.7	—	) 89.3
Total available-for-sale securities	\$2,211.7	\$155.0	\$(20.9)	) \$2,345.8

(\$ millions)

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
June 30, 2015									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$40.6	\$(1.6)	11	\$20.7	\$(1.1)	6	\$61.3	\$(2.7)	17
Obligations of states and political subdivisions	333.6	(8.5)	60	6.7	(0.1)	3	340.3	(8.6)	63
Corporate securities	77.0	(2.3)	12	49.8	(1.4)	9	126.8	(3.7)	21
U.S. government agencies mortgage-backed securities	109.5	(3.8)	17	34.7	(0.8)	12	144.2	(4.6)	29
Total fixed maturities	560.7	(16.2)	100	111.9	(3.4)	30	672.6	(19.6)	130
Large-cap equity securities	9.0	(1.3)	3	—	—	—	9.0	(1.3)	3
Total temporarily impaired securities	\$569.7	\$(17.5)	103	\$111.9	\$(3.4)	30	\$681.6	\$(20.9)	133

(\$ millions, except # of positions)	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
December 31, 2014									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$19.9	\$(0.3)	4	\$52.0	\$(1.2)	17	\$71.9	\$(1.5)	21
Obligations of states and political subdivisions	6.1	—	5	30.9	(0.4)	9	37.0	(0.4)	14
Corporate securities	43.5	(0.9)	8	56.1	(2.1)	11	99.6	(3.0)	19
U.S. government agencies mortgage-backed securities	44.0	(0.3)	8	37.5	(1.5)	13	81.5	(1.8)	21
Total fixed maturities	113.5	(1.5)	25	176.5	(5.2)	50	290.0	(6.7)	75
Large-cap equity securities	7.2	(0.6)	2	—	—	—	7.2	(0.6)	2
Total temporarily impaired securities	\$120.7	\$(2.1)	27	\$176.5	\$(5.2)	50	\$297.2	\$(7.3)	77

The Company reviewed its investments at June 30, 2015, and determined that no additional other-than-temporary impairment existed in the gross unrealized holding losses other than those listed in the table below. The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three and six months ended June 30, 2015 and 2014:

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(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Equity securities:				
Large-cap securities	\$—	\$—	\$—	\$(0.3)
Small-cap securities	(0.8)) (0.3)) (1.3)) (0.9)
Total other-than-temporary impairments	\$ (0.8)) \$ (0.3)) \$ (1.3)) \$ (1.2)

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The Company regularly monitors its investments that have fair values less than cost or amortized cost for signs of other-than-temporary impairment, an assessment that requires significant management judgment regarding the evidence known. Such judgments could change in the future as more information becomes known, which could negatively impact the amounts reported. Among the factors that management considers for fixed maturity securities are the financial condition of the issuer including receipt of scheduled principal and interest cash flows, and intent to sell including, if it is more likely than not that the Company will be required to sell the investments before recovery. When a fixed maturity has been determined to have an other-than-temporary impairment, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings as a realized loss, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.

Among the factors that management considers for equity securities and other invested assets are the length of time and/or the significance of decline below cost, the Company's ability and intent to hold these securities through their recovery periods, the current financial condition of the issuer and its future business prospects, and the ability of the market value to recover to cost in the near term. When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, the cost basis of the security is adjusted to fair value. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at June 30, 2015:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$ 35.3	\$ 35.9
Due after 1 year through 5 years	355.2	367.0
Due after 5 years through 10 years	304.3	313.4
Due after 10 years	765.8	767.9
U.S. government agencies mortgage-backed securities	466.5	474.9
Total	\$ 1,927.1	\$ 1,959.1

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay the obligations with or without call or prepayment penalties.

At June 30, 2015, State Auto P&C had U.S. government agencies mortgage-backed fixed maturity securities, with a carrying value of approximately \$85.0 million, that were pledged as collateral for the Federal Home Loan Bank of Cincinnati ("FHLB") Loan. In accordance with the terms of the FHLB Loan, State Auto P&C retains all rights regarding these securities.

Fixed maturities with fair values of \$8.9 million and \$8.8 million were on deposit with insurance regulators as required by law at June 30, 2015 and December 31, 2014, respectively. The Company retains all rights regarding these securities.

The following table sets forth the components of net investment income for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Fixed maturities	\$ 17.4	\$ 17.9	\$ 30.3	\$ 33.3

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Equity securities	1.7	1.7	3.3	3.1
Cash and cash equivalents, and other	1.3	1.4	2.7	2.7
Investment income	20.4	21.0	36.3	39.1
Investment expenses	0.6	0.5	1.1	1.0
Net investment income	\$ 19.8	\$ 20.5	\$ 35.2	\$ 38.1

The Company's current investment strategy does not rely on the use of derivative financial instruments.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Proceeds on sales of available-for-sale securities were \$109.0 million and \$166.9 million for the six months ended June 30, 2015 and 2014.

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30		
	2015	2014	2015	2014	
Realized gains:					
Fixed maturities	\$0.4	\$0.4	\$1.5	\$2.5	
Equity securities	5.9	5.2	10.0	14.7	
Other invested assets	0.1	—	0.1	0.1	
Total realized gains	6.4	5.6	11.6	17.3	
Realized losses:					
Equity securities:					
Sales	(0.2) —	(0.7) (0.1)
OTTI	(0.8) (0.3) (1.3) (1.2)
Total realized losses	(1.0) (0.3) (2.0) (1.3)
Net realized gains on investments	\$5.4	\$5.3	\$9.6	\$16.0	
Change in unrealized holding gains, net of tax:					
Fixed maturities	\$(38.0	) \$19.6	\$(28.6	) \$34.0
Equity securities	(6.5	) 6.2	(7.5	) 1.7
Other invested assets	0.5	3.8	4.9	6.2	
Deferred federal income tax liability	15.4	(10.3) 10.9	(14.6)
Valuation allowance	—	6.8	—	6.9	
Change in net unrealized holding gains, net of tax	\$(28.6) \$26.1	\$(20.3) \$34.2	

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

3. Fair Value of Financial Instruments

Below is the fair value hierarchy that categorizes into three levels the inputs to valuation techniques that are used to measure fair value:

Level 1 includes observable inputs which reflect quoted prices for identical assets or liabilities in active markets at the measurement date.

Level 2 includes observable inputs for assets or liabilities other than quoted prices included in Level 1, and it includes valuation techniques which use prices for similar assets and liabilities.

Level 3 includes unobservable inputs which reflect the reporting entity's estimates of the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At June 30, 2015 and December 31, 2014, the Company did not adjust any of the prices received from the pricing service.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs.

Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three and six months ended June 30, 2015 and 2014.

The following sections describe the valuation methods used by the Company for each type of financial instrument it holds that are carried at fair value:

Fixed Maturities

The Company utilizes a third party pricing service to estimate fair value measurements for the majority of its fixed maturities. The fair value estimate of the Company's fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. The fixed maturity portfolio pricing obtained from the pricing service is reviewed for reasonableness. The Company regularly selects a random sample of security prices which are compared to one or more alternative pricing sources for reasonableness. Any discrepancies with the pricing are returned to the pricing service for further explanation and, if necessary, adjustments are made. To date, the Company has not identified any significant discrepancies in the pricing provided by its third party pricing service.

Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for a security discussed below), and U.S. government agencies mortgage-backed securities. All unadjusted estimates of fair value for fixed maturities priced by the pricing service are included in the amounts disclosed in Level 2 of the hierarchy. If market inputs are unavailable, then no fair value is provided by the pricing service. For these securities, fair value is determined either by requesting brokers who are knowledgeable about these securities to provide a quote; or the Company internally determines the fair values by employing widely accepted pricing valuation models, and depending on the level of observable market inputs, renders the fair value estimate as Level 2 or Level 3. The Company holds one fixed maturity corporate security included in Level 3 and estimates its fair value using the present value of the future cash flows. Due to the limited amount of observable market information for this security, the Company includes the fair value estimate in Level 3.

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Equities

The fair value of each equity security is based on an observable market price for an identical asset in an active market and is priced by the same pricing service discussed above. All equity securities are recorded using unadjusted market prices and have been disclosed in Level 1.

Other Invested Assets

Included in other invested assets are two international funds (“the funds”) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of \$81.1 million and \$72.9 million at June 30, 2015 and December 31, 2014, respectively, which was determined using each fund’s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund’s audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. Due to the Company’s ability to redeem its investment in the funds at net asset value per share at the measurement date, the funds have been disclosed in Level 2.

The remainder of the Company’s other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its prices for these publicly-traded mutual funds based on an observable market price for an identical asset in an active market reflect their fair values and consequently these securities have been disclosed in Level 1.

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The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at June 30, 2015 and December 31, 2014:

(\$ millions)	Total	Level 1	Level 2	Level 3
June 30, 2015				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 285.1	\$—	\$ 285.1	\$—
Obligations of states and political subdivisions	853.4	—	853.4	—
Corporate securities	345.7	—	342.2	3.5
U.S. government agencies mortgage-backed securities	474.9	—	474.9	—
Total fixed maturities	1,959.1	—	1,955.6	3.5
Equity securities:				
Large-cap securities	224.8	224.8	—	—
Small-cap securities	72.6	72.6	—	—
Total equity securities	297.4	297.4	—	—
Other invested assets	89.3	8.2	81.1	—
Total available-for-sale investments	\$2,345.8	\$ 305.6	\$ 2,036.7	\$ 3.5

(\$ millions)	Total	Level 1	Level 2	Level 3
December 31, 2014				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 309.3	\$—	\$ 309.3	\$—
Obligations of states and political subdivisions	769.5	—	769.5	—
Corporate securities	340.6	—	331.2	9.4
U.S. government agencies mortgage-backed securities	472.5	—	472.5	—
Total fixed maturities	1,891.9	—	1,882.5	9.4
Equity securities:				
Large-cap securities	242.2	242.2	—	—
Small-cap securities	68.2	68.2	—	—
Total equity securities	310.4	310.4	—	—
Other invested assets	80.3	7.4	72.9	—
Total available-for-sale investments	\$2,282.6	\$ 317.8	\$ 1,955.4	\$ 9.4

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For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three and six months ended June 30, 2015 and the year ended December 31, 2014, separately for each major category of assets:

(\$ millions)	Fixed maturities	
Balance at January 1, 2015	\$9.4	
Total realized gains – included in earnings	0.2	
Total unrealized losses – included in other comprehensive income	(0.2)
Purchases	—	
Sales	(5.9)
Transfers into Level 3	—	
Transfers out of Level 3	—	
Balance at March 31, 2015	\$3.5	
Total realized gains – included in earnings	—	
Total unrealized losses – included in other comprehensive income	(0.1)
Purchases	0.1	
Sales	—	
Transfers into Level 3	—	
Transfers out of Level 3	—	
Balance at June 30, 2015	\$3.5	

(\$ millions)	Fixed maturities	
Balance at January 1, 2014	\$8.9	
Total realized gains – included in earnings	—	
Total unrealized gains – included in other comprehensive income	0.2	
Purchases	0.3	
Sales	—	
Transfers into Level 3	—	
Transfers out of Level 3	—	
Balance at December 31, 2014	\$9.4	

The following sections describe the valuation methods used by the Company for each type of financial instrument it holds that is not measured at fair value but for which fair value is disclosed:

Financial Instruments Disclosed, But Not Carried, At Fair Value

Other Invested Assets

Included in other invested assets are common stock of the Federal Home Loan Bank of Cincinnati ("FHLB") and the Trust Securities. The Trust Securities and FHLB common stock are carried at cost, which approximates fair value. The fair value of the FHLB common stock at June 30, 2015 was \$4.8 million and the fair value of the Trust Securities was \$0.5 million. The investments have been placed in Level 3 of the fair value hierarchy.

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Notes Receivable from Affiliate

In May 2009, the Company entered into two separate credit agreements with State Automobile Mutual Insurance Company (“State Auto Mutual”) pursuant to which it loaned State Auto Mutual a total of \$70.0 million. The Company estimates the fair value of the notes receivable from affiliate using market quotations for U.S. treasury securities with similar maturity dates and applies an appropriate credit spread. Consequently this has been placed in Level 2 of the fair value hierarchy.

(\$ millions, except interest rates)	June 30, 2015			December 31, 2014			
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate	
Notes receivable from affiliate	\$ 70.0	\$ 74.7	7.00	% \$ 70.0	\$ 74.6	7.00	%

Notes Payable

Included in notes payable are the FHLB Loan and Subordinated Debentures. The Company estimates the fair value of the FHLB Loan by discounting cash flows using a borrowing rate currently available to the Company for a loan with similar terms. This has been placed in Level 3 of the fair value hierarchy. The carrying amount of the Subordinated Debentures approximates its fair value as the interest rate adjusts quarterly and has been disclosed in Level 3.

(\$ millions, except interest rates)	June 30, 2015			December 31, 2014			
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate	
FHLB Loan due 2033: issued \$85.0, July 2013 with fixed interest	\$ 85.3	\$ 85.9	5.03	% \$ 85.3	\$ 86.4	5.03	%
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.48	% 15.5	15.5	4.44	%
Total notes payable	\$ 100.8	\$ 101.4		\$ 100.8	\$ 101.9		

4. Reinsurance

The insurance subsidiaries of State Auto Financial, including State Auto Property & Casualty Insurance Company (“State Auto P&C”), Milbank Insurance Company and State Auto Insurance Company of Ohio (collectively referred to as the “STFC Pooled Companies”) participate in a quota share reinsurance pooling arrangement (“the Pooling Arrangement”) with State Auto Mutual and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin, Meridian Security Insurance Company, Patrons Mutual Insurance Company of Connecticut, Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company and Bloomington Compensation Insurance Company, (collectively referred to as the “Mutual Pooled Companies”).

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The following table sets forth a summary of the Company's external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Premiums earned:				
Assumed from external insurers and reinsurers	\$ 1.0	\$ 1.1	\$ 2.1	\$ 2.1
Assumed under Pooling Arrangement	311.5	268.3	626.8	530.8
Ceded to external insurers and reinsurers	(8.5	) (6.0	) (17.4	) (12.0
Ceded under Pooling Arrangement	(208.6	) (216.8	) (418.5	) (432.2
Net assumed premiums earned	\$ 95.4	\$ 46.6	\$ 193.0	\$ 88.7
Losses and loss expenses incurred:				
Assumed from external insurers and reinsurers	\$ 0.6	\$ 0.8	\$ 1.4	\$ 1.5
Assumed under Pooling Arrangement	225.0	191.1	420.3	363.7
Ceded to external insurers and reinsurers	(2.5	) (1.3	) (2.4	) (3.7
Ceded under Pooling Arrangement	(165.6	) (143.5	) (286.8	) (285.7
Net assumed losses and loss expenses incurred	\$ 57.5	\$ 47.1	\$ 132.5	\$ 75.8

Subject to the terms and conditions of the expired Homeowners Quota Share Arrangement ("HO QS Arrangement"), the participating reinsurers' margin was capped at 9.0%, with any excess returned to the State Auto Group in the form of profit commission. For the three and six months ended June 30, 2015, the Company recognized \$1.4 million and \$2.7 million, respectively, of profit commission, which was reflected as a reduction in acquisition and operating expenses on our consolidated statements of income.

5. Income Taxes

The following table sets forth the reconciliation between actual federal income tax expense and the amount computed at the indicated statutory rate for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30				Six months ended June 30			
	2015	2014	2015	2014	2015	2014	2015	2014
Amount at statutory rate	\$ 1.2	35 %	\$ 1.1	35 %	\$ 12.8	35 %	\$ 10.8	35 %
Tax-exempt interest and dividends received deduction	(2.3	) (67	) (2.1	) (68	) (4.5	) (12	) (4.2	) (14
Other, net	1.8	52	0.7	24	0.9	2	0.9	3
Valuation allowance	—	—	0.4	12	—	—	(6.8) (22
Federal income tax expense and effective rate	\$ 0.7	20 %	\$ 0.1	3 %	\$ 9.2	25 %	\$ 0.7	2 %

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6. Pension and Postretirement Benefit Plans

The following table sets forth the components of net periodic cost for the Company's pension and postretirement benefit plans for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Pension		Postretirement		Pension		Postretirement	
	Three months ended June 30				Six months ended June 30			
	2015	2014	2015	2014	2015	2014	2015	2014
Service cost	\$ 1.9	\$ 1.3	\$—	\$—	\$ 3.9	\$ 2.6	\$—	\$—
Interest cost	2.9	2.8	0.2	0.2	5.7	5.6	0.4	0.5
Expected return on plan assets	(3.5)	(3.1)	—	—	(6.9)	(6.3)	—	—
Amortization of:								
Negative prior service cost	—	—	(1.4)	(1.4)	—	—	(2.8)	(2.8)
Net actuarial loss	2.8	2.1	0.1	0.1	5.5	3.5	0.3	0.3
Net periodic cost (benefit)	\$ 4.1	\$ 3.1	\$(1.1)	\$(1.1)	\$ 8.2	\$ 5.4	\$(2.1)	\$(2.0)

The Company's share of contributions were \$6.5 million for the six months ended June 30, 2015 and expects its remaining share of contributions to be an additional \$6.5 million to the pension plan during 2015.

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7. Other Comprehensive Income and Accumulated Other Comprehensive Income

The following table sets forth the changes in the Company's accumulated other comprehensive income component (AOCI), net of tax, for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
Beginning balance at April 1, 2015	\$ 118.3	\$(37.3)	) \$81.0
Other comprehensive income before reclassifications	(25.1)	) —	(25.1)
Amounts reclassified from AOCI ^(a)	(3.5)	) 1.0	(2.5)
Net current period other comprehensive (loss) income	(28.6)	) 1.0	(27.6)
Ending balance at June 30, 2015	\$ 89.7	\$(36.3)	) \$53.4
Beginning balance at April 1, 2014	\$ 92.7	\$(3.6)	) \$89.1
Other comprehensive income before reclassifications	31.4	(1.6)	) 29.8
Amounts reclassified from AOCI ^(a)	(5.3)	) 0.8	(4.5)
Net current period other comprehensive income (loss)	26.1	(0.8)	) 25.3
Ending balance at June 30, 2014	\$ 118.8	\$(4.4)	) \$114.4

(a) See separate table below for details about these reclassifications

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
Beginning balance at January 1, 2015	\$ 110.0	\$(38.3)	) \$71.7
Other comprehensive income before reclassifications	(14.1)	) —	(14.1)
Amounts reclassified from AOCI ^(a)	(6.2)	) 2.0	(4.2)
Net current period other comprehensive (loss) income	(20.3)	) 2.0	(18.3)
Ending balance at June 30, 2015	\$ 89.7	\$(36.3)	) \$53.4
Beginning balance at January 1, 2014	\$ 84.6	\$(3.8)	) \$80.8
Other comprehensive income before reclassifications	50.2	(1.6)	) 48.6
Amounts reclassified from AOCI ^(a)	(16.0)	) 1.0	(15.0)
Net current period other comprehensive income (loss)	34.2	(0.6)	) 33.6
Ending balance at June 30, 2014	\$ 118.8	\$(4.4)) \$114.4

(a) See separate table below for details about these reclassifications

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's condensed consolidated statement of income for the three and six months ended June 30, 2015 and 2014:

(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Three months ended June 30		Affected line item in the Condensed Consolidated Statements of Income
	2015	2014	
Unrealized gains on available for sale securities	\$ 5.4	\$ 5.3	Realized gain on sale of securities
	5.4	5.3	Total before tax
	(1.9	) —	Tax expense
	3.5	5.3	Net of tax
Amortization of benefit plan items			
Negative prior service cost	1.4	1.4	(a)
Net actuarial loss	(2.9	) (2.2	) (a)
	(1.5	) (0.8	) Total before tax
	0.5	—	Tax benefit
	(1.0	) (0.8	) Net of tax
Total reclassifications for the period	\$ 2.5	\$ 4.5	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension and postretirement benefit plans footnote for additional details).

(\$ millions)

Details about Accumulated Other Comprehensive Income Components	Six months ended June 30		Affected line item in the Condensed Consolidated Statements of Income
	2015	2014	
Unrealized gains on available for sale securities	\$ 9.6	\$ 16.0	Realized gain on sale of securities
	9.6	16.0	Total before tax
	(3.4	) —	Tax expense
	6.2	16.0	Net of tax
Amortization of benefit plan items			
Negative prior service cost	2.8	2.8	(a)
Net actuarial loss	(5.8	) (3.8	) (a)
	(3.0	) (1.0	) Total before tax
	1.0	—	Tax benefit
	(2.0	) (1.0	) Net of tax
Total reclassifications for the period	\$ 4.2	\$ 15.0	

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension and postretirement benefit plans footnote for additional details).

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8. Net Earnings per Common Share

The following table sets forth the compilation of basic and diluted earnings per common share for the three and six months ended June 30, 2015 and 2014:

(\$ and shares in millions, except per share amounts)

	Three months ended		Six months ended	
	June 30		June 30	
	2015	2014	2015	2014
Numerator:				
Net income for basic earnings per common share	\$2.7	\$3.0	\$27.4	\$30.1
Denominator:				
Weighted average shares for basic net earnings per common share	41.0	40.8	41.0	40.8
Effect of dilutive share-based awards	0.5	0.4	0.5	0.4
Adjusted weighted average shares for diluted net earnings per common share	41.5	41.2	41.5	41.2
Basic net earnings per common share	\$0.06	\$0.07	\$0.67	\$0.74
Diluted net earnings per common share	\$0.06	\$0.07	\$0.66	\$0.73

The following table sets forth common stock options and restricted share units ("RSU award") provided to each outside director of the Company that were not included in the computation of diluted earnings per common share because the exercise price of the options, or awards, was greater than the average market price or their inclusion would have been antidilutive for the three and six months ended June 30, 2015 and 2014.

(shares in millions)	Three months ended June		Six months ended June 30	
	30		30	
	2015	2014	2015	2014
Total number of antidilutive options and awards	1.8	1.7	1.8	1.7

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9. Segment Information

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve, the products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures. The specialty insurance segment provides commercial coverages, including workers' compensation for both the legacy State Auto Group and RTW's insurance subsidiaries, that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services.

The Company evaluates the performance of its insurance segments using industry financial measurements based on Statutory Accounting Practices ("SAP"), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net written premiums. One of the most significant differences between SAP and GAAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred and amortized over the same period the premium is earned.

The investment operations segment is evaluated based on investment returns of assets managed by Stateco. Asset information by segment is not reported for the insurance segments because the Company does not produce such information internally.

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The following table sets forth financial information regarding the Company's reportable segments for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended June 30		Six months ended June 30	
	2015	2014	2015	2014
Revenue from external sources:				
Insurance segments				
Personal insurance	\$ 148.2	\$ 113.7	\$ 298.2	\$ 228.0
Business insurance	96.5	95.9	192.6	189.4
Specialty insurance	66.8	58.7	136.0	113.4
Total insurance segments	311.5	268.3	626.8	530.8
Investment operations segment				
Net investment income	19.8	20.5	35.2	38.1
Net realized capital gains	5.4	5.3	9.6	16.0
Total investment operations segment	25.2	25.8	44.8	54.1
All other	0.7	0.3	0.7	0.8
Total revenue from external sources	337.4	294.4	672.3	585.7
Intersegment revenue	1.4	1.3	2.8	2.6
Total revenue	338.8	295.7	675.1	588.3
Reconciling items:				
Eliminate intersegment revenues	(1.4	) (1.3	) (2.8	) (2.6
Total consolidated revenues	\$ 337.4	\$ 294.4	\$ 672.3	\$ 585.7
Segment income before federal income tax:				
Insurance segments SAP underwriting (loss) income				
Personal insurance	\$(10.2	) \$(10.7	) \$ 7.2	) \$(4.6
Business insurance	(14.8	) (5.9	) (16.2	) (15.3
Specialty insurance	(1.0	) (12.1	) (1.8	) (12.7
Total insurance segments	(26.0	) (28.7	) (10.8	) (32.6
Investment operations segment				
Net investment income	19.8	20.5	35.2	38.1
Net realized capital gains	5.4	5.3	9.6	16.0
Total investment operations segment	25.2	25.8	44.8	54.1
All other	0.1	(0.1	) (0.3) —
Total segment (loss) income before tax expense	(0.7	) (3.0	) 33.7	) 21.5
Reconciling items:				
GAAP expense adjustments	6.5	8.9	7.7	14.2
Interest expense on corporate debt	(1.4	) (1.3	) (2.7	) (2.6
Corporate expenses	(1.0	) (1.5	) (2.1	) (2.3
Total reconciling items	4.1	6.1	2.9	9.3
Total consolidated income before federal income tax expense	\$ 3.4	\$ 3.1	\$ 36.6	\$ 30.8

For the three and six months ended June 30, 2015, the specialty insurance segment results reflect the impact of a correction of reinsurance amounts related to the Company's reinsurance agreement covering casualty risks within the segment. As a result of the correction, net written and earned premiums were reduced by \$7.6 million and \$5.5 million, respectively, losses were reduced by \$2.1 million and acquisition and operating expenses were reduced by

\$1.6 million.

Investable assets attributable to the Company's investment operations segment totaled \$2,471.7 million and \$2,444.2 million at June 30, 2015 and December 31, 2014, respectively.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

10. Contingencies and Litigation

In accordance with the Contingencies Topic of the Financial Accounting Standards Board's Accounting Standards Codification, the Company accrues for a litigation-related liability when it is probable that such a liability has been incurred and the amount can be reasonably estimated. The Company reviews all litigation on an ongoing basis when making accrual and disclosure decisions. For certain legal proceedings, the Company cannot reasonably estimate losses or a range of loss, if any, particularly for proceedings that are in their early stages of development or where the plaintiffs seek indeterminate damages. Various factors, including, but not limited to, the outcome of potentially lengthy discovery and the resolution of important factual questions, may need to be determined before probability can be established or before a loss or range of loss can be reasonably estimated. If the loss contingency in question is not both probable and reasonably estimable, the Company does not establish an accrual and the matter will continue to be monitored for any developments that would make the loss contingency both probable and reasonably estimable. Based on currently available information known to the Company, it believes that its reserves for litigation-related liabilities are reasonable. However, in the event that a legal proceeding results in a substantial judgment against, or settlement by, the Company, there can be no assurance that any resulting liability or financial commitment would not have a material adverse effect on the financial condition, results of operations or cash flows of the consolidated financial statements of the Company.

The Company is involved in lawsuits in the ordinary course of its business arising out of or otherwise related to its insurance policies. Additionally, from time to time the Company may be involved in lawsuits, including class actions, in the ordinary course of business but not arising out of or otherwise related to its insurance policies. These lawsuits are in various stages of development. The Company generally will contest these matters vigorously but may pursue settlement if appropriate. Based on currently available information, the Company does not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to its results of operations or have a material adverse effect on its consolidated financial position or cash flows.

Additionally, the Company may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope originally contemplated in its insurance policies. The Company believes that the effects, if any, of such regulatory actions and published court decisions are not likely to have a material adverse effect on its financial or cash flow position.

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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 Operations

The term “State Auto Financial” as used below refers only to State Auto Financial Corporation and the terms “our Company,” “we,” “us,” and “our” as used below refer to State Auto Financial Corporation and its consolidated subsidiaries.

The term “second quarter” as used below refers to the three months ended June 30, for the time period then ended. For a glossary of terms for State Auto Financial Corporation and its subsidiaries and affiliates and a glossary of selected insurance and accounting terms, see the section entitled “Important Defined Terms Used in this Form 10-K” included in our Annual Report on Form 10-K for the year ended December 31, 2014 (the “2014 Form 10-K”).

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of June 30, 2015 and December 31, 2014, and for the consolidated statements of income for the three and six month periods ended June 30, 2015 and 2014. This discussion and analysis should be read together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in the 2014 Form 10-K, and in particular the discussions in those sections thereof entitled “Overview,” “Executive Summary” and “Critical Accounting Policies.” Readers are encouraged to review the entire 2014 Form 10-K, as it includes information regarding our Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of our 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 negative thereof or variations thereon or similar terminology.

Forward-looking statements speak only as of the date the statements were made available. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we 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 our actual results to differ materially from those projected, see “Risk Factors” in Item 1A of the 2014 Form 10-K, updated by Part II, Item 1A of this Form 10-Q. Except to the limited extent required by applicable law, we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services. See “Personal and Business Insurance” and “Specialty Insurance” in Item 1 of the 2014 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2015 is set forth in Note 9 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

POOLING ARRANGEMENT

The STFC Pooled Companies and the Mutual Pooled Companies participate in a quota share reinsurance pooling arrangement referred to as the “Pooling Arrangement.” Under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the Pooled Companies and in turn cedes to each of the 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.

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The following table sets forth the participants and their participation percentages in the Pooling Arrangement:

STFC Pooled Companies:

State Auto P&C	51.0	%
Milbank	14.0	
SA Ohio	—	
Total STFC Pooled Companies	65.0	%

State Auto Mutual Pooled Companies:

State Auto Mutual	34.5	%
SA Wisconsin	—	
Meridian Security	—	
Patrons Mutual	0.5	
RIC	—	
Plaza	—	
American Compensation	—	
Bloomington Compensation	—	
Total State Auto Mutual Pooled Companies	35.0	%

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RESULTS OF OPERATIONS

Our pre-tax income for the three and six months ended June 30, 2015 was \$3.4 million and \$36.6 million, respectively, compared to pre-tax income of \$3.1 million and \$30.8 million, respectively, for the same 2014 periods. Our pre-tax income for the three and six months ended June 30, 2014 was impacted by reserve strengthening of \$11.4 million and \$11.6 million, respectively, for terminated RED programs and severance expenses of \$4.4 million recognized as a result of the reorganization of our information technology department. Excluding the impact of these items and the impact of the expired HO QS Arrangement for the three and six months ended June 30, 2014, our pre-tax income for the three and six months ended June 30, 2015 decreased when compared to the same 2014 periods. The decrease was primarily due to an increase in non-catastrophe losses in both personal and commercial auto and other & product liability lines, declines in net investment income and net realized gains.

The following table sets forth certain key performance indicators we use to monitor our operations for the three and six months ended June 30, 2015 and 2014:

(\$ millions, except per share amounts)	Three months ended June 30		Six months ended June 30		
	2015	2014	2015	2014	
GAAP Basis:					
Total revenues	\$337.4	\$294.4	\$672.3	585.7	
Net income	\$2.7	\$3.0	\$27.4	30.1	
Basic earnings per share	\$0.06	\$0.07	\$0.67	0.74	
Diluted earnings per share	\$0.06	\$0.07	\$0.66	0.73	
Stockholders' equity	\$877.5	\$843.7			
Return on average equity (LTM)	12.2	% 8.4	%		
Book value per share	\$21.35	\$20.65			
Debt to capital ratio	10.3	% 10.7	%		
Cat loss and ALAE ratio	11.4	% 7.9	% 6.4	% 5.2	%
Non-cat loss and LAE ratio	60.7	% 63.1	% 60.5	% 63.0	%
Loss and LAE ratio	72.1	% 71.0	% 66.9	% 68.2	%
Expense ratio	34.0	% 36.3	% 33.4	% 35.0	%
Combined ratio	106.1	% 107.3	% 100.3	% 103.2	%
Premium written growth	15.0	% 3.5	% 15.3	% 2.1	%
Investment yield	3.5	% 3.8	% 3.1	% 3.6	%
SAP Basis:					
Cat loss and ALAE ratio	11.4	% 7.9	% 6.4	% 5.2	%
Non-cat loss and ALAE ratio	54.2	% 56.9	% 54.2	% 57.0	%
ULAE ratio	6.6	% 6.5	% 6.5	% 6.3	%
Loss and LAE ratio	72.2	% 71.3	% 67.1	% 68.5	%
Expense ratio	33.2	% 35.8	% 33.6	% 35.6	%
Combined ratio	105.4	% 107.1	% 100.7	% 104.1	%
(\$ millions)	Twelve months ended June 30				
	2015	2014			
Net premiums written to surplus	1.6	1.4			

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Homeowners Quota Share Arrangement

To reduce risk and volatility in our homeowners line of business, while at the same time providing additional catastrophe reinsurance protection, the State Auto Group entered into a quota share reinsurance agreement on December 31, 2011 with a syndicate of unaffiliated reinsurers covering its homeowners line of business (the “HO QS Arrangement”). Under the HO QS Arrangement, the State Auto Group ceded to the reinsurers 75% of its homeowners business under policies in force at December 31, 2011 and new and renewal policies thereafter issued during the term of the agreement. The HO QS Arrangement expired on December 31, 2014. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Reinsurance Arrangements” in Item 7 of the 2014 Form 10-K for a discussion of the expired HO QS Arrangement.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following tables set forth, on an as reported and pro forma GAAP basis, certain of our key performance indicators before and after the impact of our HO QS Arrangement cession for the three and six months ended June 30, 2014:

Reconciliation Tables 1 - 2

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession	Cession	
Three months ended June 30, 2014				
Net written premiums	\$ 295.1	\$ 48.6	\$ 343.7	
Earned premiums	268.3	44.1	312.4	
Losses and LAE incurred:				
Cat loss and ALAE	21.2	15.6	36.8	
Non-cat loss and LAE	169.2	18.3	187.5	
Total Loss and LAE incurred	190.4	33.9	224.3	
Acquisition and operating expenses	97.3	12.8	110.1	
Net underwriting loss	\$ (19.4)	\$ (2.6)	\$ (22.0)	
Cat loss and ALAE ratio	7.9	% 35.3	% 11.8	%
Non-cat loss and LAE ratio	63.1	% 41.7	% 60.0	%
Total Loss and LAE ratio	71.0	% 77.0	% 71.8	%
Expense ratio	36.3	% 29.0	% 35.2	%
Combined ratio	107.3	% 106.0	% 107.0	%

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession	Cession	
Six months ended June 30, 2014				
Net written premiums	\$ 560.5	\$ 86.5	\$ 647.0	
Earned premiums	530.8	88.3	619.1	
Losses and LAE incurred:				
Cat loss and ALAE	27.5	18.0	45.5	
Non-cat loss and LAE	334.7	38.8	373.5	
Total Loss and LAE incurred	362.2	56.8	419.0	
Acquisition and operating expenses	185.8	25.6	211.4	
Net underwriting (loss) gain	\$ (17.2)	\$ 5.9	\$ (11.3)	
Cat loss and ALAE ratio	5.2	% 20.4	% 7.3	%
Non-cat loss and LAE ratio	63.0	% 43.9	% 60.4	%
Total Loss and LAE ratio	68.2	% 64.3	% 67.7	%
Expense ratio	35.0	% 29.0	% 34.1	%
Combined ratio	103.2	% 93.3	% 101.8	%

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following tables set forth, on an as reported and pro forma SAP basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the three and six months ended June 30, 2014:

Reconciliation Tables 3 - 4

(\$ millions)	SAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Three months ended June 30, 2014				
Net written premiums	\$ 295.1	\$ 48.6		\$ 343.7
Earned premiums	268.3	44.1		312.4
Losses and LAE incurred:				
Cat loss and ALAE	21.2	15.6		36.8
Non-cat loss and ALAE	152.5	18.3		170.8
Total Loss and ALAE	173.7	33.9		207.6
ULAE	17.5	—		17.5
Total Loss and ALAE incurred	191.2	33.9		225.1
Underwriting expenses	105.8	14.1		119.9
Net underwriting loss	\$(28.7)	\$(3.9)		\$(32.6)
Cat loss and ALAE ratio	7.9	% 35.3		% 11.8
Non-cat loss and ALAE ratio	56.9	% 41.7		% 54.7
Total loss and ALAE ratio	64.8	% 77.0		% 66.5
ULAE ratio	6.5	% —		5.6
Total loss and LAE ratio	71.3	% 77.0		% 72.1
Expense ratio	35.8	% 29.0		% 34.9
Combined ratio	107.1	% 106.0		% 107.0

(\$ millions)	SAP HO QS Arrangement Cession - Overall Results			Pro-Forma without HO QS Cession
	As Reported	HO QS Cession		
Six months ended June 30, 2014				
Net written premiums	\$ 560.5	\$ 86.5		\$ 647.0
Earned premiums	530.8	88.3		619.1
Losses and LAE incurred:				
Cat loss and ALAE	27.5	18.0		45.5
Non-cat loss and ALAE	302.9	38.8		341.7
Total Loss and ALAE	330.4	56.8		387.2
ULAE	33.4	—		33.4
Total Loss and ALAE incurred	363.8	56.8		420.6
Underwriting expenses	199.6	25.1		224.7
Net underwriting (loss) gain	\$(32.6)	\$ 6.4		\$(26.2)
Cat loss and ALAE ratio	5.2	% 20.4		% 7.3

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Non-cat loss and ALAE ratio	57.0	% 43.9	% 55.2	%
Total loss and ALAE ratio	62.2	% 64.3	% 62.5	%
ULAE ratio	6.3	% —	5.4	%
Total loss and LAE ratio	68.5	% 64.3	% 67.9	%
Expense ratio	35.6	% 29.0	% 34.7	%
Combined ratio	104.1	% 93.3	% 102.6	%

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See additional pro forma reconciliation tables for the impact of the HO QS Arrangement cession on our homeowners line of business at Reconciliation Tables 5 and 6 and our personal insurance segment at Reconciliation Tables 7 and 8.

Use of Non-GAAP Financial Measures

In discussing the results of our insurance segments, we sometimes refer to GAAP financial measures in the context of “as reported” and to non-GAAP financial measures in the context of “pro forma.” In the personal insurance segment, these pro forma amounts or percentages exclude the impact of the expired HO QS Arrangement cession for the three and six months ended June 30, 2014. In the specialty insurance segment, these pro forma amounts or percentages exclude the impact of a correction of reinsurance amounts for the three and six months ended June 30, 2015 relating to a casualty reinsurance agreement covering casualty risks within this segment. We believe the use of these non-GAAP financial measures will enable investors to (a) better understand the impact of the reinsurance arrangement cession and the reinsurance correction on our reported results for the three and six months ended June 30, 2015 and 2014, and (b) perform a meaningful comparison of our results of operations for the three and six months ended June 30, 2015 and 2014. We have also included Reconciliation Tables 1 - 8, Tables 1 - 9, and tables in footnotes on pages 35 and 41 for readers to better understand the use and calculation of these non-GAAP financial measures.

Insurance Segments

The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners coverages to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages requiring specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources.

We measure our top-line growth for our insurance segments based on net written premiums, which provide us with an indication of how well we are doing in terms of revenue growth before it is actually earned. Our policies provide a fixed amount of coverage for a stated period of time, often referred to as the “policy term.” As such, our written premiums are recognized as earned ratably over the policy term. The unearned portion of written premiums, called unearned premiums, is reflected on our balance sheet as a liability and represents our obligation to provide coverage for the unexpired term of the policies.

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments and reward our employees.

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see “Critical Accounting Policies – Deferred Acquisition Costs” section included in Item 7 of our 2014 Form 10-K.

All references to financial measures or components thereof in this discussion are calculated on a GAAP basis, unless otherwise noted.

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The following tables sets forth our insurance segments' SAP underwriting (loss) gain and SAP combined ratios for the three and six months ended June 30, 2015 and 2014:

(\$ millions)	Three months ended							
	June 30, 2015							
	Personal	% Ratio	Business	% Ratio	Specialty	% Ratio	Total	% Ratio
Net written premiums	\$ 155.9		\$ 107.8		\$ 75.6		\$ 339.3	
Earned premiums	148.2		96.5		66.8		311.5	
Cat loss and ALAE	24.4	16.5	10.9	11.3	0.2	0.2	35.5	11.4
Non-cat loss and ALAE	77.7	52.3	54.1	56.1	37.2	55.9	169.0	54.2
ULAE	11.3	7.7	5.7	5.8	3.5	5.2	20.5	6.6
Underwriting expenses	45.0							