MERCURY GENERAL CORP
Form 10-Q
July 31, 2013

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the Quarter Ended June 30, 2013
Commission File No. 001-12257

MERCURY GENERAL CORPORATION
(Exact name of registrant as specified in its charter)

California	95-2211612
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4484 Wilshire Boulevard, Los Angeles, California	90010
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (323) 937-1060

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 o

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 o

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

Large accelerated filer	ý	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the Registrant is a shell company (as defined in the Rule 12b-2 of the Exchange Act). Yes o No ý

At July 26, 2013, the Registrant had issued and outstanding an aggregate of 54,958,642 shares of its Common Stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Investments, at fair value:		
Fixed maturity securities (amortized cost $2,413,895; $2,270,903)	$2,482,052	$2,408,354
Equity securities (cost $492,573; $475,959)	528,725	477,088
Short-term investments (cost $165,783; $294,607)	165,520	294,653
Total investments	3,176,297	3,180,095
Cash	180,331	158,183
Receivables:		
Premiums	356,061	345,387
Accrued investment income	33,783	31,109
Other	17,846	17,756
Total receivables	407,690	394,252
Deferred policy acquisition costs	189,599	185,910
Fixed assets, net	154,884	161,940
Current income taxes	0	7,058
Deferred income taxes	17,689	0
Goodwill	42,796	42,796
Other intangible assets, net	44,593	47,589
Other assets	17,941	11,863
Total assets	$4,231,820	$4,189,686
LIABILITIES AND SHAREHOLDERS' EQUITY		
Losses and loss adjustment expenses	$1,007,036	$1,036,123
Unearned premiums	938,112	920,429
Notes payable	140,000	140,000
Accounts payable and accrued expenses	116,561	96,220
Current income taxes	2,395	0
Deferred income taxes	0	445
Other liabilities	193,848	153,972
Total liabilities	2,397,952	2,347,189
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value: Authorized 70,000 shares; issued and outstanding 54,959; 54,922	80,857	79,380
Retained earnings	1,753,011	1,763,117
Total shareholders' equity	1,833,868	1,842,497
Total liabilities and shareholders' equity	$4,231,820	$4,189,686

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended June 30,	
	2013	2012
Revenues:		
Net premiums earned	$675,787	$637,247
Net investment income	31,674	31,673
Net realized investment losses	(67,415)	(23,759)
Other	2,521	2,544
Total revenues	642,567	647,705
Expenses:		
Losses and loss adjustment expenses	486,906	497,251
Policy acquisition costs	126,393	117,726
Other operating expenses	54,015	51,203
Interest	212	378
Total expenses	667,526	666,558
Loss before income taxes	(24,959)	(18,853)
Income tax benefit	(15,695)	(13,589)
Net loss	$(9,264)	$(5,264)
Net loss per share:		
Basic	$(0.17)	$(0.10)
Diluted (1)	$(0.17)	$(0.10)
Weighted average shares outstanding:		
Basic	54,941	54,895
Diluted (1)	54,941	54,895
Dividends paid per share	$0.6125	$0.61

(1) The dilutive impact of incremental shares is excluded from loss position in accordance with U.S. generally accepted accounting principles (“GAAP”).

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(in thousands)
(unaudited)

	Three Months Ended June 30,	
	2013	2012
Net loss	$(9,264)	$(5,264)
Other comprehensive income, before tax:		
Gains on hedging instrument	0	0
Other comprehensive income, before tax:	0	0
Income tax expense related to gains on hedging instrument	0	0
Other comprehensive income, net of tax:	0	0
Comprehensive loss	$(9,264)	$(5,264)

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Six Months Ended June 30, 2013	2012
Revenues:		
Net premiums earned	$1,338,382	$1,273,059
Net investment income	62,849	63,159
Net realized investment (losses) gains	(23,365)	28,904
Other	4,854	5,258
Total revenues	1,382,720	1,370,380
Expenses:		
Losses and loss adjustment expenses	953,966	947,167
Policy acquisition costs	250,115	235,156
Other operating expenses	112,078	104,128
Interest	526	788
Total expenses	1,316,685	1,287,239
Income before income taxes	66,035	83,141
Income tax expense	8,838	15,049
Net income	$57,197	$68,092
Net income per share:		
Basic	$1.04	$1.24
Diluted	$1.04	$1.24
Weighted average shares outstanding:		
Basic	54,931	54,886
Diluted	54,948	54,915
Dividends paid per share	$1.2250	$1.22

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Six Months Ended June 30, 2013	2012
Net income	$57,197	$68,092
Other comprehensive income, before tax:		
Gains on hedging instrument	0	0
Other comprehensive income, before tax:	0	0
Income tax expense related to gains on hedging instrument	0	0
Other comprehensive income, net of tax:	0	0
Comprehensive income	$57,197	$68,092

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$57,197	$68,092
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,919	18,700
Net realized investment losses (gains)	23,365	(28,904)
Bond amortization, net	5,714	3,981
Excess tax benefit from exercise of stock options	(252)	(116)
Increase in premiums receivables	(10,674)	(28,639)
Change in current and deferred income taxes	(8,429)	(13,878)
Increase in deferred policy acquisition costs	(3,689)	(7,685)
Decrease in unpaid losses and loss adjustment expenses	(29,087)	(6,958)
Increase in unearned premiums	17,683	39,014
Increase in accounts payable and accrued expenses	21,671	6,343
Share-based compensation	(100)	(85)
Changes in other payables	8,020	1,611
Other, net	(1,880)	(2,095)
Net cash provided by operating activities	96,458	49,381
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturities available-for-sale in nature:		
Purchases	(430,984)	(260,626)
Sales	117,076	56,117
Calls or maturities	163,734	189,772
Equity securities available-for-sale in nature:		
Purchases	(326,896)	(144,919)
Sales	322,250	75,024
Calls	0	923
Changes in securities payable and receivable	24,450	(3,348)
Net decrease in short-term investments	128,282	56,301
Purchase of fixed assets	(8,361)	(7,775)
Sale of fixed assets	453	1,393
Other, net	1,413	1,610
Net cash used in investing activities	(8,583)	(35,528)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(67,303)	(66,973)
Excess tax benefit from exercise of stock options	252	116
Proceeds from stock options exercised	1,324	2,098
Net cash used in financing activities	(65,727)	(64,759)
Net increase (decrease) in cash	22,148	(50,906)
Cash:		
Beginning of the year	158,183	211,393
End of period	$180,331	$160,487
SUPPLEMENTAL CASH FLOW DISCLOSURE		

Interest paid	$582	$927
Income taxes paid	$17,266	$28,927

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General

Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the “Company”). For the list of the Company’s subsidiaries, see Note 1 “Summary of Significant Accounting Policies” of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

The condensed consolidated financial statements have been prepared in conformity with GAAP, which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions and balances have been eliminated.

The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company’s financial position at June 30, 2013 and the results of operations, comprehensive income (loss), and cash flows for the periods presented. These statements were prepared in accordance with the instructions for interim reporting and do not contain certain information in the annual financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Readers are urged to review the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more complete descriptions and discussions. Operating results and cash flows for the six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates (See Note 1 “Summary of Significant Accounting Policies” of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012).

Earnings per Share

Potentially dilutive securities representing approximately 69,000 and 64,000 shares of common stock for the three months ended June 30, 2013 and 2012, respectively, and 87,000 and 63,000 shares of common stock for the six months ended June 30, 2013 and 2012, respectively, were excluded from the computation of diluted earnings per common share for these periods because their effect would have been anti-dilutive.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company’s deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts. Deferred policy acquisition cost amortization was $126.4 million and $117.7 million for the three months ended June 30, 2013 and 2012, respectively, and $250.1 million and $235.2 million for the six months ended June 30, 2013 and 2012, respectively. The Company does not defer advertising expenses but expenses them as incurred. The Company recorded net advertising expenses of approximately $11 million and $10 million for the six months ended June 30, 2013 and 2012, respectively.

2. Recently Issued Accounting Standards

In February 2013, the Financial Accounting Standards Board ("FASB") issued a new standard that requires entities to disclose additional information about items reclassified out of accumulated other comprehensive income in their financial statements. Entities are required to include information about changes in accumulated other comprehensive income balances by component and additional information about significant items reclassified out of accumulated other comprehensive income in their interim

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reporting periods. The Company adopted the new standard which became effective for the interim period ended March 31, 2013. The adoption of the new standard did not have any impact on the Company's consolidated financial statements.

3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, interest rate swap agreements, accounts payable, equity contracts, and secured notes payable. Due to their short-term maturity, the carrying values of receivables and accounts payable approximate their fair market values. The following table presents the estimated fair values of financial instruments at June 30, 2013 and December 31, 2012.

	June 30, 2013	December 31, 2012
	(Amounts in thousands)	
Assets		
Investments	$3,176,297	$3,180,095
Liabilities		
Interest rate swap agreements	$0	$103
Equity contracts	$331	$175
Secured notes	$140,000	$140,000

Methods and assumptions used in estimating fair values are as follows:

Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment (losses) gains. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5.

Interest rate swap agreements

The fair value of interest rate swap agreements reflects the estimated amounts that the Company would pay at June 30, 2013 and December 31, 2012 in order to terminate the contracts based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in estimating fair values of interest rate swap agreements, see Note 5.

Equity contracts

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5.

Secured notes payable

The fair value of the Company's $120 million and $20 million secured notes, classified as Level 2 in the fair value hierarchy described in Note 5, is estimated based on assumptions and inputs, such as the market value of underlying collateral and reset rates, for similarly termed notes that are observable in the market.

4. Fair Value Option

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment (losses) gains in the Company's consolidated statements of operations, while interest and dividend income on investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company's consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

The following table presents (losses) gains due to changes in fair value of investments that are measured at fair value pursuant to application of the fair value option:

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	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
	(Amounts in thousands)			
Fixed maturity securities	$(59,562)	$9,812	$(69,973)	$30,815
Equity securities	(19,003)	(33,972)	35,023	(5,476)
Short-term investments	(161)	(628)	(309)	(784)
Total	$(78,726)	$(24,788)	$(35,259)	$24,555

5. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price. Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in non-active markets; or
- Either directly or indirectly observable inputs as of the reporting date.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on approximately 98% of its portfolio from an independent pricing service. For approximately 2% of its portfolio, classified as Level 3, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from at least one knowledgeable outside security broker to determine the fair value as of June 30, 2013.

Level 1 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets.

Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.
U.S. government bonds and agencies: Valued using unadjusted quoted market prices for identical assets in active markets.
Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

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Money market instruments: Valued based on unadjusted quoted prices for identical assets.
Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.
Level 2 Measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.
Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.
Mortgage-backed securities: Comprised of securities that are collateralized by mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of $12.4 million and $4.3 million at June 30, 2013 and December 31, 2012, respectively, in commercial mortgage-backed securities.
Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.
Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.
Interest rate swap agreements: Valued based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract.
Level 3 Measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.
Collateralized debt obligations/Partnership interest in a private credit fund: Valued based on underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets; taking into consideration unobservable inputs related to liquidity assumptions.
The Company’s financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment (losses) gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.
The following tables present information about the Company’s assets and liabilities measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

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	June 30, 2013			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$15,965	$0	$0	$15,965
Municipal securities	0	2,143,070	0	2,143,070
Mortgage-backed securities	0	34,176	0	34,176
Corporate securities	0	249,849	0	249,849
Collateralized debt obligations	0	0	38,992	38,992
Equity securities:				
Common stock:				
Public utilities	107,942	0	0	107,942
Banks, trusts and insurance companies	23,603	0	0	23,603
Energy and other	358,411	0	0	358,411
Non-redeemable preferred stock	0	26,779	0	26,779
Partnership interest in a private credit fund	0	0	11,990	11,990
Short-term bonds	0	34,800	0	34,800
Money market instruments	130,720	0	0	130,720
Total assets at fair value	$636,641	$2,488,674	$50,982	$3,176,297
Liabilities				
Equity contracts	$331	$0	$0	$331
Total liabilities at fair value	$331	$0	$0	$331

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$14,204	$0	$0	$14,204
Municipal securities	0	2,165,095	0	2,165,095
Mortgage-backed securities	0	30,703	0	30,703
Corporate securities	0	155,551	0	155,551
Collateralized debt obligations	0	0	42,801	42,801
Equity securities:				
Common stock:				
Public utilities	85,106	0	0	85,106
Banks, trusts and insurance companies	22,166	0	0	22,166
Energy and other	346,809	0	0	346,809
Non-redeemable preferred stock	0	11,701	0	11,701
Partnership interest in a private credit fund	0	0	11,306	11,306
Short-term bonds	0	24,530	0	24,530
Money market instruments	270,123	0	0	270,123
Total assets at fair value	$738,408	$2,387,580	$54,107	$3,180,095
Liabilities				
Equity contracts	$175	$0	$0	$175
Interest rate swap agreements	0	103	0	103
Total liabilities at fair value	$175	$103	$0	$278

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The following tables present a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value.

	Three Months Ended June 30,			
	2013		2012	
	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund
	(Amounts in thousands)			
Beginning Balance	$39,723	$11,592	$52,983	$10,510
Realized (losses) gains included in earnings	(731)	398	(1,658)	520
Purchase	0	0	25,000	0
Ending Balance	$38,992	$11,990	$76,325	$11,030
The amount of total (losses) gains for the period included in earnings attributable to assets still held at June 30	$(731)	$398	$(1,658)	$520

	Six Months Ended June 30,			
	2013		2012	
	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund	Collateralized Debt Obligations	Partnership Interest in a Private Credit Fund
	(Amounts in thousands)			
Beginning Balance	$42,801	$11,306	$47,503	$10,008
Realized gains included in earnings	377	684	3,822	1,022
Purchase	0	0	25,000	0
Sales	(4,186)	0	0	0
Ending Balance	$38,992	$11,990	$76,325	$11,030
The amount of total gains for the period included in earnings attributable to assets still held at June 30	$894	$684	$3,822	$1,022

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the six months ended June 30, 2013 and 2012.

At June 30, 2013, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial liabilities.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are intended to manage the interest rate risk associated with the Company’s debts with fixed or floating rates.

On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on a $120 million credit facility for a fixed rate of 1.93% that matured on January 3, 2012. The purpose of the swap was to offset the variability of cash flows resulting from the variable interest rate. The swap was not designated as a hedge and changes in the fair value were adjusted through the consolidated statement of operations in the period of change.

On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on a Bank of America $18 million LIBOR plus 50 basis points loan for a fixed rate of 4.25% that matured on March 1, 2013. On October 4, 2011, the Company refinanced the $18 million loan that was scheduled to mature on March 1, 2013 with a Union

Bank $20 million LIBOR plus 40 basis points loan that matures on January 2, 2015. The related swap became ineffective and was no longer designated as a hedge. Changes in the fair value were adjusted through the consolidated statement of operations in the period of change. The fair market value of the interest rate swap was $0 and $103,000 as of June 30, 2013 and December 31, 2012, respectively.

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Fair value amounts, and gains and losses on derivative instruments

The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains in the consolidated statements of operations:

	Liability Derivatives	
	2013	December 31, 2012
	(Amount in thousands)	
Non-hedging derivatives		
Interest rate swap agreements - Other liabilities	$0	$103
Equity contracts - Other liabilities	331	175
Total derivatives	$331	$278

	Gain Recognized in Income (Loss)			
	Three Months Ended June 30,		Six Months Ended June 30,	
Derivatives Not Designated as Hedging Instruments	2013	2012	2013	2012
	(Amounts in thousands)			
Interest rate swap agreements - Other revenue	$0	$147	$103	$271
Equity contracts - Net realized investment (losses) gains	961	368	1,179	1,585
Total	$961	$515	$1,282	$1,856

Most equity contracts consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. For additional disclosures regarding equity contracts, see Note 5.

7. Goodwill and Other Intangible Assets

Goodwill

There were no changes in the carrying amount of goodwill for the six months ended June 30, 2013. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indications were identified during any of the periods presented.

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Other Intangible Assets

The following table presents the components of other intangible assets as of June 30, 2013 and December 31, 2012.

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Useful Lives
	(Amounts in thousands)			(in years)
As of June 30, 2013:				
Customer relationships	$51,755	$(22,039)	$29,716	11
Trade names	15,400	(2,888)	12,512	24
Technology	4,300	(1,935)	2,365	10
Favorable leases	1,725	(1,725)	0	3
Software	550	(550)	0	2
Total intangible assets, net	$73,730	$(29,137)	$44,593	
As of December 31, 2012:				
Customer relationships	$51,755	$(19,585)	$32,170	11
Trade names	15,400	(2,567)	12,833	24
Technology	4,300	(1,720)	2,580	10
Favorable leases	1,725	(1,719)	6	3
Software	550	(550)	0	2
Total intangible assets, net	$73,730	$(26,141)	$47,589	

Intangible assets are amortized on a straight-line basis over their useful lives. Intangible assets amortization expenses were $1.5 million for each of the three months ended June 30, 2013 and 2012, and $3.0 million and $3.1 million for the six months ended June 30, 2013 and 2012, respectively. The following table presents the estimated future amortization expenses related to intangible assets as of June 30, 2013:

Year Ending	Amortization Expense
	(Amounts in thousands)
Remainder of 2013	$2,990
2014	5,980
2015	5,980
2016	5,980
2017	5,253
Thereafter	18,410
Total	$44,593

8. Share-Based Compensation

Share-based compensation expense for all share-based payment awards granted or modified is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of four or five years for options granted prior to 2008 and four years for options granted subsequent to January 1, 2008, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

Under the Company's 2005 Incentive Award Plan (the “Plan”), the Compensation Committee of the Company’s Board of Directors granted performance vesting restricted stock units to the Company’s senior management and key employees as follows:

	Grant Year		
	2013	2012	2011
Three-year performance period ending December 31,	2015	2014	2013
Vesting shares, target	84,500	89,000	80,000
Vesting shares, maximum	190,125	200,250	120,000

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The restricted stock units vest at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's performance during the performance period achieves the threshold established by the Compensation Committee of the Company's Board of Directors. For 2011 grants, vesting will be based on the Company's cumulative underwriting income. For 2012 grants, vesting will be based on the Company's cumulative underwriting income and net premium written growth. For 2013 grants, vesting will be based on the Company's cumulative underwriting income, annual underwriting income, and net premiums written growth.

The fair value of each restricted share grant was determined based on the market price on the grant date. Compensation cost is recognized based on management's best estimate that performance goals will be achieved. If such goals are not met, no compensation cost is recognized and any recognized compensation cost would be reversed. For the 2012 and 2011 grants, the achievement of the performance condition set by the Compensation Committee was no longer considered probable, and previously recognized compensation costs were reversed.

9. Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return once a "more-likely-than-not" threshold has been met. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements.

There were no material changes to the total amount of unrecognized tax benefits related to tax uncertainties during the six months ended June 30, 2013. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2009 through 2011 for federal taxes and 2003 through 2011 for California state taxes. Tax year 2010 is currently under examination by the Internal Revenue Service. The Company is currently under examination by the California Franchise Tax Board ("FTB") for tax years 2003 through 2010. The FTB has issued Notices of Proposed Assessments to the Company for tax years 2003 through 2006. The Company has filed protests with the FTB in response to these assessments and presented its case in a hearing before the FTB. No assessments have been received for tax years 2007 through 2010. Management believes that the resolution of these examinations and assessments will not have a material impact on the condensed consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established.

At June 30, 2013, the Company's deferred income taxes were in a net asset position which included a combination of ordinary and capital deferred tax benefits. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

10. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

The Company also establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company’s pending actions is generally not yet determinable, the Company does not believe that the

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ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows.
In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2012.
11. Subsequent Event

On July 2, 2013, the Company entered into a $200 million five-year revolving credit facility with Bank of America and Union Bank of California. The interest rate on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is above 25%. Commitment fees for undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is above 25%. The credit facility expires on June 30, 2018. As of July 30, 2013, there have been no draws made against the credit facility.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statements
Certain statements in this Quarterly Report on Form 10-Q or in other materials the Company has filed or will file with the Securities and Exchange Commission ("SEC") (as well as information included in oral statements or other written statements made or to be made by the Company) contain or may contain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results, and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects, and results of operations to differ materially from the historical information contained in this Quarterly Report on Form 10-Q and from those that may be expressed or implied by the forward-looking statements contained in this Quarterly Report on Form 10-Q and in other reports or public statements made by the Company.
Factors that could cause or contribute to such differences include, among others: the competition currently existing in the automobile insurance markets in California and the other states in which the Company operates; the cyclical and generally competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserves or other estimates; the accuracy and adequacy of the Company's pricing methodologies; the Company's success in managing its business in states outside of California; the impact of potential third party "bad-faith" legislation, changes in laws, regulations or new interpretations of existing laws and regulations, tax position challenges by the FTB, and decisions of courts, regulators and governmental bodies, particularly in California; the Company's ability to obtain and the timing of required regulatory approvals of premium rate changes for insurance policies issued in states where the Company operates; the Company's reliance on independent agents to market and distribute its policies; the investment yields the Company is able to obtain on its investments and the market risks associated with the Company's investment portfolio; the effect government policies may have on market interest rates; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions, trends in litigation, and health care and auto repair costs; adverse weather conditions or natural disasters, including those which may be related to climate change, in the markets served by the Company; the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives; the Company's ability to realize current deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; and other uncertainties, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when a Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.
The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking

statements, which speak only as of the date of this Quarterly Report on Form 10-Q or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report, or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed

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or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in "Item 1A. Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 and in Item 1A. Risk Factors in Part II - Other Information of this Quarterly Report on Form 10-Q.

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OVERVIEW

A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a large impact on the Company's ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's condensed consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

B. Business

The Company is primarily engaged in writing personal automobile insurance through 13 insurance subsidiaries ("Insurance Companies") in 13 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical breakdown, fire, and umbrella insurance. These policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the Company with competitive advantages because they allow the Company to charge lower prices while realizing better margins than many competitors.

The direct premiums written during the six months ended June 30, 2013 and 2012 by state and line of business were:

Six Months Ended June 30, 2013
(Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	$868,887	$131,033	$25,566	$35,285	$1,060,771	78.1 %
Florida (1)	70,546	0	9,259	3,491	83,296	6.1 %
Other states (2)	143,553	35,104	13,065	22,485	214,207	15.8 %
Total	$1,082,986	$166,137	$47,890	$61,261	$1,358,274	100.0 %
	79.8 %	12.2 %	3.5 %	4.5 %	100.0 %	

Six Months Ended June 30, 2012
(Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	$823,903	$124,759	$20,091	$31,529	$1,000,282	76.1 %
Florida (1)	82,569	(174)	7,576	4,049	94,020	7.2 %
Other states (2)	156,701	28,657	8,611	25,734	219,703	16.7 %
Total	$1,063,173	$153,242	$36,278	$61,312	$1,314,005	100.0 %
	80.9 %	11.7 %	2.7 %	4.7		