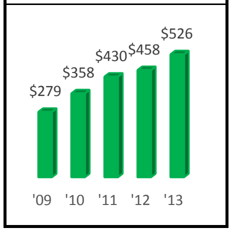
SELECTIVE
WEALTH MANAGEMENT

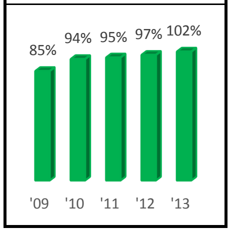
National Interstate Corp
December 12, 2013

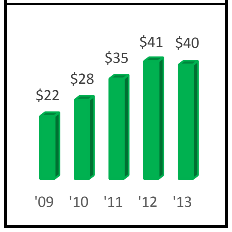
General Overview

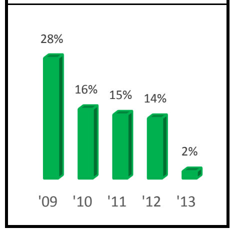
National Interstate is a small insurance company with $1.6 billion in assets and $340 million in equity. The company underwrites risks for the commercial vehicle industry, such as mass transit or commercial trucking. Historically the business has posted profits for 24 straight years and had underwriting profits in 22 of those 24 years. This is an incredible feat for an insurance company and National Interstate is one of the best in the business.

Net Premiums	Combined Ratio	Investment Gains	Return On Equity	Book Value Per Share
$525,710,000	102%	$39,913,000	1.7%	$17.82
5-Year CAGR = 17.2%	5-Year AVG = 94.9%	5-Year CAGR = 16.2%	5-Year AVG = 15.0%	5-Year CAGR = 6.2%









This year their underwriting results were *very* poor and will likely be over 100% (meaning they did not underwrite profitability for the third time in their history). The CEO is taking the necessary actions to correct this and we believe they will return to their historic levels. Insurance is a tough business and occasionally posting losses is expected. It is not a reflection of poor management or permanent changes in the business. It just happens. In fact, if you never post insurance losses chances are you do not understand the business or are doing something fraudulent. I believe National Interstate has operates as close to perfectly as you can in this business and their management is unchanged and equally motivated.

When they return to historical underwriting results of roughly 90% they will earn nearly $50 million (this compared to $17 million they earned last year). We paid $500 million or $25.25 per share to purchase our stake in the business. This equates to roughly 10 times future earnings.

This particular company tends to allocate their capital by paying out dividends (25%) and retaining earnings for continued growth (75%, sometimes spent on acquisitions).

One of the major deciding factors for this purchase was management's willingness to walk away from unprofitable business. They did not renew $35 million in policies in the first six months of 2013 because prices were too low. This was roughly 12% of all their business and a very bold move. Shrinking the business when prices are not adequate to cover claims *must* occur for the best insurance companies. I am impressed they made this decision and am glad they walked away. This is one of the major reasons I truly believe management will return to their historical levels of 90% for the combined ratio.

Divisions

They underwrite insurance for passenger transportation, trucking, moving and storage industries, general commercial insurance for small businesses in Alaska and Hawaii, and owners of RVs. They break these activities down into four divisions, Alternative Risk Transfer (ART), Transportation, Specialty Personal Lines, and Hawaii and Alaska.

Problem & Solution

Problem

People get in accidents in their semi-trucks, RVs, moving trucks, etc. When these accidents occur the expenses can be large and random. People want to be able to spread their risk and share it with others to keep their costs predictable.

Solution

National Interstate Corporation sells insurance to spread this risk among many parties to disperse the damage done when accidents occur. This helps stabilize costs for all businesses. Great service.

Products & Services

They offer 40 products – all of which are 'niche' insurance products. This could be underwriting the risk for recreational vehicles (RVs) or commercial trucking. The term 'niche' for insurance is extremely common. Most companies claim to underwrite unusual risks and be one of the few providers for that particular risk. When you underwrite an obscure risk this is known as a 'niche' market. The advantage of niche markets is they are generally less competitive than populated markets, like general automobile insurance. However, most companies that claim to underwrite in 'niche' markets actually don't. There is a lot of competition all over the place in the insurance industry. The way you can tell if an insurance company truly has a niche is by their ability to raise prices meaningfully and not lose customers. National Interstate is not able to do this. When they raise prices they tend to lose some premium, which is ok, but demonstrates they are not in as 'niche' a market as they would claim. It is less populated with competition than other types of insurance and National Interstate is an all-star in this particular category.

In addition to offering traditional insurance they also offer 'captive' insurance for many of the businesses they partner with. These captive insurance companies are partnerships between National Interstate and the company they are underwriting for. In these captive agreements the company actually will insure itself and share in the profits and losses with National Interstate. They share in the underwriting and investment gains. Typically these 'captive' insurance companies have higher retention rates (meaning they renew their policies more often) at about a mid-90% level. Most traditional insurance has renewal rates of between 70 and 80%. The profit share arrangements typically have customers assume between 30% and 50% of the profits and losses, depending on the contract. The Alternative Risk Transfer (ART) division is entirely made up of captives. This is 55% of the National Interstates business and my favorite division.

In addition to insuring transportation liabilities they also offer workers compensation liability for transportation professionals. This is growing very quickly and is more difficult to underwrite and are new products. This could be a potential spot of concern. We will careful monitor the worker's compensation line in the future.

Customers

Their customers are large transportation companies, RV owners, moving and storage companies, and small businesses in Alaska and Hawaii.

They typically select the product based on price, quality of service, ability to share in profits or loss (for the case of captives), financial strength of the insurer (to make sure they can fulfil their promise), but the primary driving factor is price.

The customers want the product to spread the risk of accidents that could have a dramatic impact on earnings, profitability, ability to pay debt, etc. in any single year. It spreads the risk to make operating the business more predictable and safer.

No one customer accounted for 10% of their revenues in 2012. They insurance approximately 360 transportation companies through ART programs (remember, these have renewal rates of mid-90%, which is amazing). Decent diversification of revenue.

Distribution

They find new customers by utilizing independent agents and brokers. The top ten independent agents/brokers accounted for an aggregate of 27.9% of the gross premiums written. Their top two agents/brokers accounted for 12.1%. Attracting and retaining these independent agents/brokers is a very important part of their business strategy. In 2012 they had roughly 88% of their gross premiums written generated through agents/brokers.

They pay commissions to these independent brokers and is a major source of their expenses.

Revenue Creation

They generate revenue by charging premiums for insurance coverage.

The revenue is broken down into the following categories:

<u>Alternative Risk Transfer (ART) (55%)</u>

The ART products are the same thing as captives. That means 55% of their premium volume comes from the high retention captive business.

They insure truck transportation, passenger transportation, and moving and storage ART insurance products. ART products utilize insurance companies that are owned or "rented" by the participants in the program. They support two types of ART programs – member owned and rented. In a rental ART program, the reinsurance company is formed, capitalized and managed by someone other than the participants. The participants in a rental ART program pay a fee to the reinsurance company owner to use the reinsurance facility in their ART program; in other words, the participants "rent" it.

In a member-owned ART program, the participants own and manage their own reinsurance company, which includes general management responsibilities, financial statement preparation, actuarial analysis, investment management, corporate governance, regulatory management and legal affairs.

They insure approximately 360 transportation companies in ART programs. No one customer account for more than 10% of their revenues for this component in 2012.

Or in other words: Several companies pool together and join in an ART program. If the ART program is profitable then a portion of the underwriting profit and investment income is paid to the plan participants. This shared agreement reduces the severity (how much an accident costs) and frequency (how often an accident occurs) to limit the total losses. When companies are monetarily incentivized to operate safer they do.

<u>Transportation (31%)</u>

They underwrite commercial auto liability, general liability, physical damage and motor truck cargo and related coverage for truck and passenger operators. They started writing worker's compensation insurance for passenger transportation operations. This line is likely to lose money since it is new and in a difficult industry to earn profits. Passenger transportation includes charter and tour bus companies, municipal transit systems, school transportation contractors, limousine companies, inter-city bus services and community service and paratransit operations. No one customer account for more than 10% of their revenues for this component in 2012.

Specialty Personal Lines (9%)

This is an insurance program for people that own RVs. They offer coverage for campsite liability, vehicle replacement coverage and coverage for trailers, golf carts, and campsite storage facilities. They also offer companion auto products for autos owned by RV policy holders.

Hawaii & Alaska (3%)

They underwrite commercial transportation for business owners in Hawaii and Alaska. This is a very tiny portion of their overall business at 3%.

Other (1%)

I could not find a description of the risks that are underwritten for this segment. It is only $7 million in premiums out of gross premiums of $573 million. Not very material.

	Year Ended December 31,					
	2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent
			(Dollars in thousands)			
Alternative Risk Transfer	$ 316,114	55.2%	$ 285,352	54.2%	$ 229,844	52.4%
Transportation	180,786	31.5%	162,870	30.9%	123,752	28.2%
Specialty Personal Lines	51,026	8.9%	53,729	10.2%	61,662	14.1%
Hawaii and Alaska	18,383	3.2%	18,137	3.5%	18,104	4.1%
Other	7,161	1.2%	6,225	1.2%	5,268	1.2%
Gross premiums written	$ 573,470	100.0%	$ 526,313	100.0%	$ 438,630	100.0%

The table below shows the direct premiums written by statutory line of business:

	Year Ended December 31,			
	2012		2011	
	Volume	Percent of Total	Volume	Percent of Total
		(Dollars in thousands)		
Auto and other liability	$ 311,532	55.2%	$ 301,343	58.3%
Workers' compensation	159,994	28.3%	120,674	23.3%
Auto physical damage	78,557	13.9%	81,827	15.8%
All other lines	14,518	2.6%	13,074	2.6%
Direct premiums written	$ 564,601	100.0%	$ 516,918	100.0%

Workers compensation is the most dangerous of these lines and is the fastets growing. It is more dangerous because it has a longer tail and the claims can be for perpetuity. We'll keep an eye on this going forward.

Their renewal rate on captive business is in the high 90%, whereas the renewal rate for traditional customers is between 70-80%.

The captive business creates a relationship rather than a transaction.

The gross premiums written represents all the money they will collected based on their current insurance contracts with all their customers. A portion of these contracts is 'ceded' to reinsurance companies, where a reinsurance company shares the risk that NATL underwrites. After subtracting the 'ceded'premiums we arrive at their Net Premiums Written, which was $492 million in 2012. This is the number that really matters.

Expenses

They have a total of 546 employees. None of the employees are covered by collective bargaining agreements, meaning they aren't in unions.

The claims department has 168 people and operates out of three regional offices. Their underwriting departments function very autonomously. That means that each manager is in charge of overseeing one of their 40 different insurance products they offer. That manager is in charge of maintaining certain levels of profitability and the entire unit's compensation is tied to underwriting profits. This autonomous and independent management style breeds an ownership mentality and typically improves underwriting performance.

Their expense ratio is roughly 21% as of the last quarter in 2013. This is a very attractive expense ratio. This means that if they charge you $100 for an insurance policy per month - $21 of that is used to cover the expenses required to underwrite your policy (Administrative costs). This is better than the industry average for this type of insurance product. When the competition is based on price efficiency is king.

The biggest expense for most insurance companies is their loss and loss adjustment expenses. These represent all expenses paid for settling claims, which ranges from paying the insured to paying lawyers to fight in court for settlement amounts. It's all included in the loss and loss adjustment expenses.

Here are their Losses and LAE as a percentage of premiums earned for 2012, 2011, & 2010:

Selected GAAP Ratios:					
Losses and loss adjustment expense ratio(4)	74.4%	71.7%	71.5%	60.8%	64.7%
Underwriting expense ratio(5)	23.1%	23.7%	22.7%	24.1%	24.6%
Combined ratio(6)	97.5%	95.4%	94.2%	84.9%	89.3%

The rising Losses and LAE is a bad sign (and is the biggest contributor to the increasing combined ratio). The number one way to drive down LAE is by increasing prices. Another avenue to drive down LAE is to attempt to reduce the number of accidents that occur through safety programs. National Interstate attempts to implement a lot of these at their captives. They also are installing cameras in the larger vehicles they insure, such as semi-trucks. With an installed camera the drivers tend to perform better and they have video evidence of exactly how accidents occurred. The reduces legal fees because when people falsely sue the driver when the driver was not at fault the video evidence quickly ends the case without wasting people's time. This could help drive down Loss and LAE in the future.

Real Income

They have posted an underwriting profit in 22 of the 24 years of their existence and have been profitable every single year. This is an extremely impressive record because insurance is a 'lumpy' industry by nature.

Their real income is derived from two sources: Underwriting profits and investments. The underwriting profits are impossible to predict for a single year and are the primary driver of their income. However, over the course of time their underwriting profit has been extremely large. We expect these high quality underwriting results to continue and for them to earn reasonable returns on capital (10%-15%).

Their income is reported as 'operating income' and 'other comprehensive income'. The operating income is the sum of interest and dividends received on investments plus underwriting profits. This is the lion's share of their total income. The 'other comprehensive income' comes from gains on investments, like stocks or bonds that appreciate in value (not the interest or dividends), and this number is typically zero. The reason it is zero is that they purchase bonds at par and hold them to maturity, which means there were no gains apart from the interest received. They also have a very small stock portfolio that has contributed zero to their 'other comprehensive income'.

However, in the last few years they have been reporting operating income of roughly $35 million dollars with an additional $15 million in 'other comprehensive income'. The operating income of $35 million was from $15 million in underwriting profits and $35 million in interest and dividends, less taxes. The $15 million from 'other comprehensive income' came from appreciating value of their bond portfolio that was driven by falling interest rates. This will reverse back to zero if interest rates rise or they hold the bonds to maturity (they have been selling them, which is intelligent). Going forward I am anticipating 'other comprehensive income' of zero – on average.

When underwriting returns to normal, meaning a combined ratio in the low 90%, I expected their operating income to be roughly $50 million ($35 million from underwriting and $35 million from interest and dividends, less taxes) and their 'other comprehensive income' to be zero. This would mean we paid roughly 10x earnings for the business after taxes (We paid just under $500 million).

Growth

Their growth lately has come almost exclusively from the worker's compensation line. In 2012 they increased their premiums written by roughly $48 million and $40 million of that increase was attributed to workers comp. This might not prove to be a profitable line for them, but growth in premiums is not required for this investment to be profitable for us. In fact, walking away from premiums is often appropriate. They have demonstrated their willingness to walk away from unprofitable business.

Here is one of my favorite quotes from their annual report:

We are not 'top-line' oriented and are willing to sacrifice premium volume during periods that we believe exhibit unrealistic rate competition. Accordingly, should competitors determine to "buy" market share with unprofitable rates, our insurance subsidiaries could experience limited growth or a decline in business until market pricing returns to what we view as profitable levels. –Page 15, 2013 10-K

This type of mentality is required to run an insurance operation. A lot firms state things like this, but few walk away from the business. National Interstate walked away from 12% of all their premium revenue ($35 million worth) in the first six months of 2013. This effectively shrinks their business, but keeps them from taking on business that causes them to lose money. I believe their growth will be very bumpy, but over time this disciplined approach will lead to solid growth in their key insurance lines.

Competition

They compete against a lot of players – such as – Lancer Insurance Company, RLI Corporation, Great West Casualty Company, Northland Insurance Company (Subsidiary of Travelers), Sentry Insurance, Liberty Mutual Insurance, and AIG.

The competition is based on price, coverage offered, product and program designs, claims handling, and customer service quality.

Consolidated Balance Sheet

Balance sheets are critical for the insurance industry. Understanding every line item in detail is very important.

They are relatively conservative in their investment approach. They aim to preserve capital and use the investment income only to supplement income earned from profitable underwriting.

Assets

Their average return on investments was 4.1% in 2012, 3.6% in 2011, and 3.9% in 2010.

Fixed Maturities: They have $944 million in fixed income securities. These include state and local government obligations (35.7%), Corporate Obligations (20.5%), Residential MBS (19.2%), US Government obligations (11.1%), Commercial MBS (4.7%).

Their portfolio is rated as follows:

AAA, AA, or A = 76.6%, BBB = 14.2% [Total investment grade 90.8%], BB = 1.9%, B = 2.8%, CCC or less 4.5%. I should look into these securities further.

Equity: They have $31 million in equity securities. Their equity portfolio has underperformed the market by -6.3%, -4.9%, and – 7.0% in 2012, 2011, and 2010, repsectively. This is only 2.5% of their assets, but 9% of their equity. An improvement in their ability to invest in equities would greatly increase the value of the business.

Remaing balance sheet items were lost in the data corrupt file.

Loss Triangle

Historically National Interstate has set enough money aside to pay for claims (this is known as reserving). Typically they reserve more than is necessary which is a safer means of operation. Below is their loss triangle for the last 10 years:

Net Liability for Unpaid Losses And LAE:	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
					(Dollars in thousands)						
As originally estimated	$ 67,162	$ 86,740	$ 111,644	$ 151,444	$ 181,851	$ 210,302	$ 262,440	$ 276,419	$ 596,136	$ 594,448	$ 607,604
As re-estimated at December 31, 2012	61,687	78,285	97,368	134,686	163,279	197,482	248,675	266,085	553,526	578,705	
Liability re-estimated as of:											
One year later	63,462	84,485	106,409	143,991	176,179	209,448	261,154	269,747	583,663	578,705	
Two years later	64,687	83,862	103,416	142,929	173,860	207,281	250,185	267,995	553,526		
Three years later	63,037	81,991	99,768	139,994	169,879	199,142	248,851	266,085			
Four years later	62,564	79,673	99,487	138,108	166,043	198,852	248,675				
Five years later	60,551	79,084	99,362	135,635	163,855	197,482					
Six years later	61,268	79,163	98,005	134,328	163,279						
Seven years later	62,437	78,797	97,312	134,686							
Eight years later	61,794	78,330	97,368								
Nine years later	61,636	78,285									
Ten years later	61,687										
Net cumulative redundancy[1]	5,475	8,455	14,276	16,758	18,572	12,820	13,765	10,334	42,610	15,743	
Net cumulative redundancy — %	8.2%	9.7%	12.8%	11.1%	10.2%	6.1%	5.2%	3.7%	7.1%	2.6%	
Cumulative paid of:											
One year later	22,792	29,616	37,049	51,901	63,314	67,673	91,615	90,410	182,652	201,717	
Two years later	36,927	48,672	59,038	85,193	95,752	111,841	145,279	146,378	302,821		
Three years later	48,660	61,001	76,617	101,340	119,984	141,484	182,163	189,177			
Four years later	53,531	68,594	84,070	112,474	133,976	159,410	209,272				
Five years later	57,697	71,904	89,821	117,073	140,160	170,085					
Six years later	59,035	74,938	91,206	119,461	144,133						
Seven years later	61,179	75,137	91,919	121,566							
Eight years later	61,021	75,280	93,116								
Nine years later	60,992	75,781									
Ten years later	61,476										

Accounting Quality

Their accounting is solid. They changed the way they reported deferred policy acquisition costs in 2012, but the change was appropriate and no need for concern. Their historically conservative levels of reserving is highly encouraging. Ernst and Young gave them an unqualified opinion.

Legal

They are subject to claims, lawsuits and legal proceedings that arise from the ordinary course of business. All legal actions related to claims under insurance policies are considered in the establishment of loss and LAE reserves.

Outside of the normal course of business they do not have any other legal proceedings.

Market

The market is large but not growing materially. The market is assumed to be flat for the sake of this investment thesis. Growth is not a critical element to our investment success in this purchase.

Corporate Governance

David Michelson is their chief executive officer and has held that position since 2008. He has done a very impressive job and answer questions with great clarity during conference calls. He is extremely impressive and one of the major reasons we made this purchase.

Their share based compensation is kept to a minimum to ensure that Great American maintains their 51% stake in the business. Excess share issuances would decrease their stake below the majority level. For this reason I expect share compensation to be relatively minor.

Allocation of Capital

They pay out roughly 25% of their earnings in dividends and retain the rest for growth. They recently acquired Vanliner in a very successful acquisition that came with a loss reserve guarantee. This was a very successful acquisition (completed in 2010). They are looking for additional opportunities to make similar acquisitions. They do not buy back any shares.

Works Cited

1) *NATL Annual Report - SEC Filing 10-K.* EDGAR, 2012.

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