

State Auto Financial CORP
Form 10-Q
May 01, 2014
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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 March 31, 2014

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 (I.R.S. Employer
incorporation or organization) 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 file ¨ 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 April 25, 2014, the Registrant had 40,860,803 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)

	March 31, 2014	December 31, 2013
	(unaudited)	
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,799.9 and \$1,804.0, respectively)	\$ 1,840.4	\$ 1,830.1
Equity securities, available-for-sale, at fair value (cost \$210.4 and \$196.6, respectively)	274.6	265.3
Other invested assets, available-for-sale, at fair value (cost \$49.6 and \$49.5, respectively)	83.4	80.9
Other invested assets	5.0	5.0
Notes receivable from affiliate	70.0	70.0
Total investments	2,273.4	2,251.3
Cash and cash equivalents	78.3	80.3
Accrued investment income and other assets	35.1	33.6
Deferred policy acquisition costs	99.7	96.8
Reinsurance recoverable on losses and loss expenses payable	9.5	9.1
Prepaid reinsurance premiums	4.9	4.7
Current federal income taxes	—	0.3
Net deferred federal income taxes	7.7	11.9
Property and equipment, at cost	8.3	8.4
Total assets	\$ 2,516.9	\$ 2,496.4
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliates \$425.9 and \$438.0, respectively)	\$ 951.7	\$ 959.9
Unearned premiums (affiliates \$85.4 and \$78.4, respectively)	493.9	491.0
Notes payable (affiliates \$15.5 and \$15.5, respectively)	100.8	100.8
Postretirement and pension benefits	73.1	71.6
Due to affiliate	8.3	1.3
Current federal income taxes	0.4	—
Other liabilities	71.2	86.8
Total liabilities	1,699.4	1,711.4
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued	—	—
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued	—	—
Common stock, without par value. Authorized 100.0 shares; 47.6 and 47.5 shares issued, respectively, at stated value of \$2.50 per share	119.0	118.8
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	(116.0)	(115.9)
Additional paid-in capital	138.7	137.5
Accumulated other comprehensive income	89.1	80.8
Retained earnings	586.7	563.8
Total stockholders' equity	817.5	785.0
Total liabilities and stockholders' equity	\$ 2,516.9	\$ 2,496.4

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 March 31	
	2014	2013
Earned premiums (ceded to affiliates \$215.4 and \$210.7, respectively)	\$ 262.5	\$ 261.3
Net investment income (affiliate \$1.2 and \$1.2, respectively)	17.6	16.9
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	11.5	7.0
Total net realized gains on investments	10.7	6.7
Other income from affiliates	0.5	0.4
Total revenues	291.3	285.3
Losses and loss expenses (ceded to affiliates \$142.2 and \$131.8, respectively)	171.8	173.0
Acquisition and operating expenses	88.5	88.8
Interest expense (affiliates \$0.2 and \$0.2, respectively)	1.3	1.7
Other expenses	2.0	1.8
Total expenses	263.6	265.3
Income before federal income taxes	27.7	20.0
Federal income tax expense	0.6	0.3
Net income	\$ 27.1	\$ 19.7
Earnings per common share:		
Basic	\$ 0.67	\$ 0.49
Diluted	\$ 0.66	\$ 0.49
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)

Consolidated Statements of Comprehensive Income

(\$ in millions, except per share amounts)

(unaudited)

	Three months ended March 31	
	2014	2013
Net income	\$27.1	\$19.7
Other comprehensive income, net of tax:		
Net unrealized holding gains on investments:		
Unrealized holding gains arising during the period ended	23.0	19.4
Reclassification adjustments for gains realized in net income	(10.7	) (6.7
Income tax (expense) benefit	(4.2	) 0.3
Total net unrealized holding gains on investments	8.1	13.0
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Prior service benefits	(1.4	) (1.4
Net actuarial loss	1.6	2.3
Total net unrecognized benefit plan obligations	0.2	0.9
Other comprehensive income, net of tax	8.3	13.9
Comprehensive income, net of tax	\$35.4	\$33.6

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)	Three months ended March	
	2014	2013
(unaudited)		
Cash flows from operating activities:		
Net income	\$27.1	\$19.7
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	3.4	4.3
Share-based compensation	1.0	1.2
Net realized gains on investments	(10.7)	(6.7)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(2.9)	(2.8)
Accrued investment income and other assets	(1.5)	(3.4)
Postretirement and pension benefits	1.7	(1.7)
Other liabilities and due to/from affiliates, net	(10.6)	(9.0)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(0.6)	1.2
Losses and loss expenses payable	(8.2)	2.1
Unearned premiums	2.9	2.8
Federal income taxes	0.7	0.3
Net cash provided by operating activities	2.3	8.0
Cash flows from investing activities:		
Purchases of fixed maturities, available-for-sale	(137.2)	(81.7)
Purchases of equity securities, available-for-sale	(38.0)	(24.0)
Purchases of other invested assets	(0.4)	(0.2)
Maturities, calls and pay downs of fixed maturities, available-for-sale	68.9	40.2
Sales of fixed maturities, available-for-sale	71.3	38.5
Sales of equity securities, available-for-sale	34.6	28.1
Sales of other invested assets	0.2	0.2
Net additions of property and equipment	—	0.2
Net cash (used in) provided by investing activities	(0.6)	1.3
Cash flows from financing activities:		
Proceeds from issuance of common stock	0.6	0.1
Payments to acquire treasury stock	(0.1)	(0.1)
Payment of dividends	(4.2)	(4.0)
Net cash used in financing activities	(3.7)	(4.0)
Net (decrease) increase in cash and cash equivalents	(2.0)	5.3
Cash and cash equivalents at beginning of period	80.3	59.0
Cash and cash equivalents at end of period	\$78.3	\$64.3
Supplemental disclosures:		
Interest paid (affiliates \$0.2 and \$0.2, respectively)	\$1.3	\$0.2

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 month period ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. The balance sheet at December 31, 2013 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, 2013 (the “2013 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2013 Form 10-K.

Adoption of Accounting Pronouncements

None.

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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 March 31, 2014 and December 31, 2013:

(\$ millions)

March 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	\$ 314.3	\$ 15.8	\$ (5.0)	) \$ 325.1
Obligations of states and political subdivisions	691.4	24.8	(8.2)	) 708.0
Corporate securities	355.7	11.9	(4.9)	) 362.7
U.S. government agencies residential mortgage-backed securities	438.5	10.2	(4.1)	) 444.6
Total fixed maturities	1,799.9	62.7	(22.2)	) 1,840.4
Equity securities:				
Large-cap securities	163.0	44.9	—	207.9
Small-cap securities	47.4	19.3	—	66.7
Total equity securities	210.4	64.2	—	274.6
Other invested assets	49.6	33.8	—	83.4
Total available-for-sale securities	\$ 2,059.9	\$ 160.7	\$ (22.2)	) \$ 2,198.4

(\$ millions)

December 31, 2013	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	\$ 345.5	\$ 13.4	\$ (6.5)	) \$ 352.4
Obligations of states and political subdivisions	765.3	25.8	(16.9)	) 774.2
Corporate securities	345.0	11.4	(6.7)	) 349.7
U.S. government agencies residential mortgage-backed securities	348.2	9.7	(4.1)	) 353.8
Total fixed maturities	1,804.0	60.3	(34.2)	) 1,830.1
Equity securities:				
Large-cap securities	148.2	46.5	(0.3)	) 194.4
Small-cap securities	48.4	22.5	—	70.9
Total equity securities	196.6	69.0	(0.3)	) 265.3
Other invested assets	49.5	31.4	—	80.9
Total available-for-sale securities	\$ 2,050.1	\$ 160.7	\$ (34.5)) \$ 2,176.3

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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 March 31, 2014 and December 31, 2013:

(\$ millions, except # of positions) March 31, 2014	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
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$77.1	\$(5.0)	24	\$—	\$—	—	\$77.1	\$(5.0)	24
Obligations of states and political subdivisions	178.2	(5.0)	60	64.0	(3.2)	21	242.2	(8.2)	81
Corporate securities	91.0	(2.2)	18	42.6	(2.7)	9	133.6	(4.9)	27
U.S. government agencies residential mortgage-backed securities	187.4	(3.4)	37	14.6	(0.7)	8	202.0	(4.1)	45
Total fixed maturities	533.7	(15.6)	139	121.2	(6.6)	38	654.9	(22.2)	177
Total temporarily impaired securities	\$533.7	\$(15.6)	139	\$121.2	\$(6.6)	38	\$654.9	\$(22.2)	177

(\$ millions, except # of positions) December 31, 2013	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
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$109.6	\$(6.5)	29	\$—	\$—	—	\$109.6	\$(6.5)	29
Obligations of states and political subdivisions	206.4	(14.7)	76	25.6	(2.2)	7	232.0	(16.9)	83
Corporate securities	105.6	(3.2)	22	40.9	(3.5)	8	146.5	(6.7)	30
U.S. government agencies residential mortgage-backed securities	103.6	(3.3)	25	19.3	(0.8)	10	122.9	(4.1)	35
Total fixed maturities	525.2	(27.7)	152	85.8	(6.5)	25	611.0	(34.2)	177
Large-cap equity securities	5.3	(0.3)	2	—	—	—	5.3	(0.3)	2
Total temporarily impaired securities	\$530.5	\$(28.0)	154	\$85.8	\$(6.5)	25	\$616.3	\$(34.5)	179

The Company reviewed its investments at March 31, 2014, 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 months ended March 31, 2014 and 2013:

(\$ millions)	2014	2013
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Equity securities:

Large-cap securities	\$ (0.2)	\$ —)
Small-cap securities	(0.6)	(0.3)
Total other-than-temporary impairments	\$ (0.8)	\$ (0.3)

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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 March 31, 2014:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$ 54.8	\$ 55.5
Due after 1 year through 5 years	376.2	392.9
Due after 5 years through 10 years	359.7	376.4
Due after 10 years	570.7	571.0
U.S. government agencies residential mortgage-backed securities	438.5	444.6
Total	\$ 1,799.9	\$ 1,840.4

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 March 31, 2014, State Auto P&C had fixed maturity securities, with a carrying value of \$85.0 million, that were pledged as collateral for the FHLB Loan. In accordance with the terms of the FHLB Loan, State Auto P&C retains all rights regarding these securities, which are included in the "U.S. government agencies residential mortgage-backed securities" classification of the Company's fixed maturity securities portfolio.

Fixed maturities with fair values of \$8.7 million were on deposit with insurance regulators as required by law at March 31, 2014 and December 31, 2013, respectively. The Company retains all rights regarding these securities.

The following table sets forth the components of net investment income for the three months ended March 31, 2014 and 2013:

(\$ millions)	2014	2013
Fixed maturities	\$ 15.4	\$ 14.8
Equity securities	1.4	1.2
Cash and cash equivalents, and other	1.3	1.4

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Investment income	18.1	17.4
Investment expenses	0.5	0.5
Net investment income	\$ 17.6	\$ 16.9

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)

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three months ended March 31, 2014 and 2013:

(\$ millions)	2014	2013	
Realized gains:			
Fixed maturities	\$2.1	\$0.5	
Equity securities	9.4	6.6	
Other invested assets	0.1	—	
Total realized gains	11.6	7.1	
Realized losses:			
Equity securities:			
Sales	(0.1) (0.1)
OTTI	(0.8) (0.3)
Total realized losses	(0.9) (0.4)
Net realized gains on investments	\$10.7	\$6.7	
Change in unrealized holding gains (losses), net of tax:			
Fixed maturities	\$14.4	\$(9.2)
Equity securities	(4.5) 18.3	
Other invested assets	2.4	3.6	
Deferred federal income tax liability	(4.3) (4.5)
Valuation allowance	0.1	4.8	
Change in net unrealized holding gains, net of tax	\$8.1	\$13.0	

There was a deferred federal income tax liability, net of a valuation allowance, on the net unrealized holding gains at March 31, 2014 and December 31, 2013 of \$45.8 million and \$41.6 million, respectively.

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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)

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 March 31, 2014 and December 31, 2013, 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 months ended March 31, 2014 and 2013.

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. Regularly, a sample of security prices are referred back to the pricing service for more detailed explanation as to how the pricing service arrived at that particular price. The explanations are reviewed for reasonableness by the portfolio manager and investment officer. Additionally, the prices and assumptions are verified against an alternative pricing source for reasonableness and accuracy. 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 two securities discussed below), and U.S. government agencies residential 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 two fixed maturity corporate securities included in Level 3. The Company estimates the fair value of

one security using the present value of the future cash flows and the Company obtains a broker quote of the other security's fair value. Due to the limited amount of observable market information for both of these securities, the Company includes the fair value estimates in Level 3.

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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)

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 \$76.5 million and \$74.2 million at March 31, 2014 and December 31, 2013, 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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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 available-for-sale investments within the fair value hierarchy at March 31, 2014 and December 31, 2013:

(\$ millions)

March 31, 2014	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 325.1	\$ —	\$ 325.1	\$ —
Obligations of states and political subdivisions	708.0	—	708.0	—
Corporate securities	362.7	—	353.6	9.1
U.S. government agencies residential mortgage-backed securities	444.6	—	444.6	—
Total fixed maturities	1,840.4	—	1,831.3	9.1
Equity securities:				
Large-cap securities	207.9	207.9	—	—
Small-cap securities	66.7	66.7	—	—
Total equity securities	274.6	274.6	—	—
Other invested assets	83.4	6.9	76.5	—
Total available-for-sale investments	\$ 2,198.4	\$ 281.5	\$ 1,907.8	\$ 9.1

(\$ millions)

December 31, 2013	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 352.4	\$ —	\$ 352.4	\$ —
Obligations of states and political subdivisions	774.2	—	774.2	—
Corporate securities	349.7	—	340.8	8.9
U.S. government agencies residential mortgage-backed securities	353.8	—	353.8	—
Total fixed maturities	1,830.1	—	1,821.2	8.9
Equity securities:				
Large-cap securities	194.4	194.4	—	—
Small-cap securities	70.9	70.9	—	—
Total equity securities	265.3	265.3	—	—
Other invested assets	80.9	6.7	74.2	—
Total available-for-sale investments	\$ 2,176.3	\$ 272.0	\$ 1,895.4	\$ 8.9

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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)

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 months ended March 31, 2014 and the year ended December 31, 2013, separately for each major category of assets:

(\$ millions)	Fixed maturities
Balance at January 1, 2014	\$8.9
Total realized gains (losses) – included in earnings	—
Total unrealized gains – included in other comprehensive income	0.1
Purchases	0.1
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at March 31, 2014	\$9.1

(\$ millions)	Fixed maturities
Balance at January 1, 2013	\$8.5
Total realized (losses) gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	0.2
Purchases	0.2
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at December 31, 2013	\$8.9

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 March 31, 2014 was \$4.5 million and the fair value of the Trust Securities was \$0.5 million. Both investments have been placed in Level 3 of the fair value hierarchy.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Notes Receivable from Affiliate

In May 2009, the Company entered into two separate credit agreements with 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)	March 31, 2014			December 31, 2013		
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate
Notes receivable from affiliate	\$ 70.0	\$ 75.8	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)	March 31, 2014			December 31, 2013		
	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	\$ 86.5	5.03 %	\$ 85.3	\$ 85.7	5.03 %
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.44 %	15.5	15.5	4.44 %
Total notes payable	\$ 100.8	\$ 102.0		\$ 100.8	\$ 101.2	

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 Automobile Mutual Insurance Company (“State Auto Mutual”) and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin, Meridian Citizens Mutual Insurance Company, Meridian Security Insurance Company, Patrons Mutual Insurance Company of Connecticut, Rockhill Insurance Company (“RIC”), Plaza Insurance Company (“Plaza”), American Compensation Insurance Company (“American Compensation”) and Bloomington Compensation Insurance Company (“Bloomington Compensation”), (collectively referred to as the “Mutual Pooled Companies”).

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 months ended March 31, 2014 and 2013:

(\$ millions)	2014	2013
Premiums earned:		
Assumed from external insurers and reinsurers	\$ 1.0	\$ 0.4
Assumed under Pooling Arrangement	262.5	261.3
Ceded to external insurers and reinsurers	(6.0	) (5.5
Ceded under Pooling Arrangement	(215.4	) (210.7
Net assumed premiums earned	\$ 42.1	\$ 45.5
Losses and loss expenses incurred:		
Assumed from external insurers and reinsurers	\$ 0.7	\$ (0.2
Assumed under Pooling Arrangement ^(a)	171.8	173.0
Ceded to external insurers and reinsurers	(2.5	) (1.0
Ceded under Pooling Arrangement ^(a)	(142.2	) (131.8
Net assumed losses and loss expenses incurred	\$ 27.8	\$ 40.0

Includes adjustments for accounting differences between SAP and GAAP of

(a) \$0.8 million and \$0.7 million for the three months ended March 31, 2014 and 2013, respectively.

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 months ended March 31, 2014 and 2013:

(\$ millions)	2014	2013
Amount at statutory rate	\$ 9.7 35 %	\$ 7.0 35 %
Tax-exempt interest and dividends received deduction	(2.1) (8)	(2.3) (12)
Other, net	0.2 1	0.2 1
Valuation allowance	(7.2) (26)	(4.6) (23)
Federal income tax expense and effective rate	\$ 0.6 2 %	\$ 0.3 1 %

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities at March 31, 2014 and December 31, 2013:

(\$ millions)	March 31, 2014	December 31, 2013
Deferred tax assets:		
Unearned premiums not currently deductible	\$ 34.0	\$ 33.8
Losses and loss expenses payable discounting	21.4	21.6
Postretirement and pension benefits	25.4	24.9
Realized loss on other-than-temporary impairment	8.3	7.5
Other liabilities	15.7	17.3
Net operating loss carryforward	50.9	56.5
Tax credit carryforward	2.3	1.7
Other	8.3	9.2
Total deferred tax assets	166.3	172.5
Deferred tax liabilities:		
Deferral of policy acquisition costs	34.9	33.9
Net unrealized holding gains on investments	48.5	44.1
Total deferred tax liabilities	83.4	78.0
Total net deferred tax assets before valuation allowance	82.9	94.5
Less valuation allowance	75.2	82.6
Net deferred federal income taxes	\$ 7.7	\$ 11.9

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. In accordance with the Financial Accounting Standards Board's Accounting Standards Codification 740, Income Taxes (ASC 740), the Company periodically evaluates its deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including loss carryback potential, past operating results, existence of cumulative losses in the most recent years, projected performance of the business, future taxable income, including the ability to generate capital gains, and prudent and feasible tax planning strategies. In making such judgments, significant weight is given to evidence that can be objectively verified. At March 31, 2014 and December 31, 2013, the Company recorded a valuation allowance of \$75.2 million and \$82.6 million, respectively. The deferred income tax asset remaining after recognition of the valuation allowance represents deferred tax benefits on gross unrealized fixed maturity losses where management determined these benefits to be realizable due to management's assertion it has both the ability and intent to hold these securities through recovery or maturity. Based on ASC 740 intraperiod tax allocation guidelines, the following sets forth the change in valuation allowance attributable to continuing operations and other comprehensive income for the three months ended March 31, 2014 and 2013 is as follows:

(\$ millions)	2014	2013
Continuing operations	\$(7.2)	\$(4.6)
Other comprehensive income	(0.2)	(5.1)
Change in valuation allowance	\$(7.4)	\$(9.7)

In future periods the Company will re-assess its judgments and assumptions regarding the realization of its net deferred tax assets, but until such time the positive evidence exceeds the negative evidence the Company will maintain a valuation allowance against its net deferred tax assets.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 months ended March 31, 2014 and 2013:

(\$ millions)	Pension		Postretirement	
	2014	2013	2014	2013
Service cost	\$ 1.3	\$ 1.5	\$—	\$—
Interest cost	2.8	2.4	0.3	0.2
Expected return on plan assets	(3.2)	(3.0)	—	—
Amortization of:				
Prior service benefits	—	—	(1.4)	(1.4)
Net actuarial loss	1.4	2.0	0.2	0.3
Net periodic cost (benefit)	\$ 2.3	\$ 2.9	\$(0.9)	\$(0.9)

The Company's share of expected contributions to its pension plan during 2014 is \$13.1 million.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 months ended March 31, 2014 and 2013:

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Gains and Losses on Cash Flow Hedges	Total
Beginning balance at January 1, 2014	\$ 84.6	\$(3.8	) \$—	\$ 80.8
Other comprehensive income before reclassifications	18.8	—	—	18.8
Amounts reclassified from AOCI ^(a)	(10.7	) 0.2	—	(10.5
Net current period other comprehensive income	8.1	0.2	—	8.3
Ending balance at March 31, 2014	\$ 92.7	\$(3.6	) \$—	\$ 89.1
Beginning balance at January 1, 2013	\$ 124.0	\$(39.9	) \$0.1	\$ 84.2
Other comprehensive income before reclassifications	19.7	—	—	19.7
Amounts reclassified from AOCI ^(a)	(6.7	) 0.9	—	(5.8
Net current period other comprehensive income	13.0	0.9	—	13.9
Ending balance at March 31, 2013	\$ 137.0	\$(39.0	) \$0.1	\$ 98.1

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

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's consolidated statement of income for the three months ended March 31, 2014 and 2013:

(\$ millions)	Three months ended March 31		Affected line item in the Condensed Consolidated Statements of Income
Details about Accumulated Other Comprehensive Income Components	2014	2013	
Unrealized gains on available for sale securities	\$ 10.7	\$ 6.7	Realized gain on sale of securities
	10.7	6.7	Total before tax
	—	—	Tax benefit (expense)
	10.7	6.7	Net of tax
Amortization of benefit plan items			
Prior service benefits	1.4	1.4	(a)
Net actuarial loss	(1.6	) (2.3	) (a)
	(0.2	) (0.9	) Total before tax
	—	—	Tax benefit (expense)
	(0.2	) (0.9	) Net of tax
Total reclassifications for the period	\$ 10.5	\$ 5.8	

(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).

8. Net Earnings per Common Share

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The following table sets forth the compilation of basic and diluted earnings per common share for the three months ended March 31, 2014 and 2013:

(\$ and shares in millions, except per share amounts)	2014	2013
Numerator:		
Net income for basic earnings per common share	\$27.1	\$19.7
Denominator:		
Weighted average shares for basic net earnings per common share	40.8	40.5
Effect of dilutive share-based awards	0.5	0.2
Adjusted weighted average shares for diluted net earnings per common share	41.3	40.7
Basic net earnings per common share	\$0.67	\$0.49
Diluted net earnings per common share	\$0.66	\$0.49

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 months ended March 31, 2014 and 2013.

(millions)	2014	2013
Total number of antidilutive options and awards	1.7	3.2

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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 accounting for pension benefits also contributes to the difference between our GAAP loss and expense ratios and our SAP loss and expense ratios.

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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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth financial information regarding the Company's reportable segments for the three months ended March 31, 2014 and 2013:

(\$ millions)	Three months ended	
	March 31	
	2014	2013
Revenues from external sources:		
Insurance segments		
Personal insurance	\$ 114.3	\$ 114.7
Business insurance	93.5	88.5
Specialty insurance	54.7	58.1
Total insurance segments	262.5	261.3
Investment operations segment		
Net investment income	17.6	16.9
Net realized capital gains	10.7	6.7
Total investment operations segment	28.3	23.6
All other	0.5	0.4
Total revenues from external sources	291.3	285.3
Intersegment revenues:	1.3	1.3
Total revenues	292.6	286.6
Reconciling items:		
Eliminate intersegment revenues	(1.3	) (1.3
Total consolidated revenues	\$ 291.3	\$ 285.3
Segment income before federal income tax:		
Insurance segments SAP underwriting (loss) income		
Personal insurance	\$ 5.1	\$ 1.3
Business insurance	(8.5	) (5.3
Specialty insurance	(0.5	) (1.7
Total insurance segments	(3.9	) (5.7
Investment operations segment		
Net investment income	17.6	16.9
Net realized capital gains	10.7	6.7
Total investment operations segment	28.3	23.6
All other segments income	0.1	0.4
Total segment income before tax expense	24.5	18.3
Reconciling items:		
GAAP expense adjustments	5.4	4.5
Interest expense on corporate debt	(1.3	) (1.7
Corporate expenses	(0.9	) (1.1
Total reconciling items	3.2	1.7
Total consolidated income before federal income tax expense	\$ 27.7	\$ 20.0

Investable assets attributable to the Company's investment operations segment totaled \$2,351.7 million and \$2,331.6 million at March 31, 2014 and December 31, 2013, 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 State Auto Financial Corporation.

The following describes a pending legal proceeding, other than routine litigation incidental to our business, to which State Auto Financial or any of its subsidiaries is a party or to which any of its or their property is subject:

In April 2013, a putative class action lawsuit (Schumacher vs. State Automobile Mutual Insurance Company, et al.) was filed against State Auto Mutual, State Auto Financial and State Auto P&C in Federal District Court in Ohio. Plaintiffs claim that in connection with the homeowners policies of various State Auto companies, the coverage limits and premiums were improperly increased as a result of an insurance to value ("ITV") program and Plaintiffs allege that they purchased coverage in excess of that which was necessary to insure them in the event of loss. Plaintiffs' claims include breach of good faith and fair dealing, negligent misrepresentation and fraud, violation of the Ohio Deceptive Trade Practices Act, and fraudulent inducement. Plaintiffs are seeking class certification and compensatory and punitive damages to be determined by the court. The Company intends to deny any and all liability to plaintiffs or the alleged class and to vigorously defend this lawsuit.

The Company is involved in other lawsuits arising in the ordinary course of our business operations arising out of or otherwise related to our insurance policies. Additionally, from time to time the Company may be involved in lawsuits arising 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 or cash flow position.

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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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 “first quarter” as used below refers to the three months ended March 31, 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, 2013 (the “2013 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 March 31, 2014 and December 31, 2013, and for the consolidated statements of income for the three month periods ended March 31, 2014 and 2013. This discussion and analysis should be read together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in the 2013 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 2013 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 2013 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 2013 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2014 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 since January 1, 2012:

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	34.0	%
SA Wisconsin	—	
Meridian Security	—	
Meridian Citizens Mutual	0.5	
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 net income for the three months ended March 31, 2014 and 2013 was \$27.1 million and \$19.7 million, respectively. The improvement for the three months ended March 31, 2014 was due to the increased level of realized gains on investments, improved underwriting results and more net investment income when compared to the same 2013 period.

The following table sets forth certain key performance indicators we use to monitor our operations for the three months ended March 31, 2014 and 2013:

(\$ millions, except per share amounts)	Three months ended		
	March 31		
GAAP Basis:	2014	2013	
Total revenues	\$ 291.3	\$ 285.3	
Net income	\$ 27.1	\$ 19.7	
Basic earnings per share	\$ 0.67	\$ 0.49	
Diluted earnings per share	\$ 0.66	\$ 0.49	
Stockholders' equity	\$ 817.5	\$ 767.5	
Return on average equity (LTM)	8.6	% 4.3	%
Book value per share	\$ 20.05	\$ 18.96	
Debt to capital ratio	11.0	% 13.1	%
Cat loss and ALAE ratio	2.4	% 1.7	%
Non-cat loss and LAE ratio	63.1	% 64.5	%
Loss and LAE ratio	65.5	% 66.2	%
Expense ratio	33.7	% 34.0	%
Combined ratio	99.2	% 100.2	%
Premium written growth	0.6	% 0.2	%
Investment yield	3.3	% 3.1	%
SAP Basis :			
Cat loss and ALAE points	2.4	% 1.7	%
Non-cat loss and ALAE	57.3	% 58.4	%
ULAE	6.0	% 6.4	%
Loss and LAE ratio	65.7	% 66.5	%
Expense ratio	35.3	% 35.3	%
Combined ratio	101.0	% 101.8	%
	Twelve months ended		
	March 31		
	2014	2013	
Net premiums written to surplus	1.4	1.6	

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Homeowners Quota Share Arrangement

To reduce risk and volatility in our homeowners book of business, while at the same time providing us with 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 book 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 is in effect until 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 2013 Form 10-K for a discussion of the HO QS Arrangement.

The following tables set forth, on a GAAP and pro forma basis, certain of our key performance indicators before and after the impact of the HO QS Arrangement cession for the three months ended March 31, 2014 and 2013:

Reconciliation Table 1

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results			
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession	
Three months ended March 31, 2014				
Net written premiums	\$ 265.4	\$ 37.9	\$ 303.3	
Earned premiums	262.5	44.2	306.7	
Losses and LAE incurred:				
Cat loss and ALAE	6.3	2.4	8.7	
Non-cat loss and LAE	165.5	20.5	186.0	
Total Loss and LAE incurred	171.8	22.9	194.7	
Acquisition and operating expenses	88.5	12.8	101.3	
Net underwriting gain	\$ 2.2	\$ 8.5	\$ 10.7	
Cat loss and ALAE ratio	2.4	% 5.4	% 2.8	%
Non-cat loss and LAE ratio	63.1	% 46.3	% 60.7	%
Total Loss and LAE ratio	65.5	% 51.7	% 63.5	%
Expense ratio	33.7	% 29.0	% 33.0	%
Combined ratio	99.2	% 80.7	% 96.5	%

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Reconciliation Table 2

(\$ millions)

GAAP HO QS Arrangement Cession - Overall
Results