

Edgar Filing: State Auto Financial CORP - Form 10-Q

State Auto Financial CORP

Form 10-Q

May 03, 2017

false--12-31Q1201710-Q0000874977Accelerated FilerState Auto Financial

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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, 2017

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
(State or other jurisdiction of
incorporation or organization)

31-1324304
(I.R.S. Employer
Identification No.)

518 East Broad Street, Columbus, Ohio 43215-3976

(Address of principal executive offices) (Zip Code)

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

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

Yes 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 No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

On April 28, 2017, the Registrant had 42,002,494 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,	December
	2017	31, 2016
	(unaudited)	
Assets		
Fixed maturities, available-for-sale, at fair value (amortized cost \$2,104.7 and \$2,095.9, respectively)	\$ 2,123.5	\$2,109.3
Equity securities, available-for-sale, at fair value (cost \$321.3 and \$323.1, respectively)	395.6	382.8
Other invested assets, available-for-sale, at fair value (cost \$25.5 and \$25.5, respectively)	48.1	45.1
Other invested assets	5.4	5.4
Notes receivable from affiliate	70.0	70.0
<i>Total investments</i>	2,642.6	2,612.6
Cash and cash equivalents	44.8	51.1
Accrued investment income and other assets	46.6	40.0
Deferred policy acquisition costs (affiliated net assumed \$47.6 and \$50.7, respectively)	124.0	129.8
Reinsurance recoverable on losses and loss expenses payable	4.8	3.6
Prepaid reinsurance premiums	6.0	6.1
Due from affiliate	1.1	—
Current federal income taxes	6.8	6.7
Net deferred federal income taxes	94.9	102.1
Property and equipment, at cost	7.3	7.4
Total assets	\$ 2,978.9	\$2,959.4
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliated net assumed \$646.8 and \$630.9, respectively)	\$ 1,217.3	\$1,181.6
Unearned premiums (affiliated net assumed \$222.2 and \$220.9, respectively)	606.5	617.8
Notes payable (affiliates \$15.2 and \$15.2, respectively)	122.1	122.1
Postretirement and pension benefits (affiliated net ceded \$38.3 and \$40.1, respectively)	71.2	74.4
Due to affiliate	—	2.4
Other liabilities (affiliated net assumed \$16.5 and \$11.0, respectively)	60.7	69.8
Total liabilities	2,077.8	2,068.1
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; 48.8 and 48.6 shares issued, respectively, at stated value of \$2.50 per share	121.9	121.6
Treasury stock, 6.9 and 6.8 shares, respectively, at cost	(116.7)	(116.5)
Additional paid-in capital	162.6	159.9
Accumulated other comprehensive income (affiliated net ceded \$52.8 and \$53.7, respectively)	47.9	32.5
Retained earnings	685.4	693.8
Total stockholders' equity	901.1	891.3
Total liabilities and stockholders' equity	\$ 2,978.9	\$2,959.4

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)

	Three months ended March 31	
(unaudited)	2017	2016
Earned premiums (affiliated net assumed \$114.8 and \$113.4, respectively)	\$317.3	\$319.9
Net investment income (affiliates \$1.2 and \$1.2, respectively)	18.7	17.4
Net realized gains on investments:		
Total other-than-temporary impairment losses	(2.1)	(3.7)
Other net realized investment gains	9.9	5.0
Total net realized gains on investments	7.8	1.3
Other income from affiliates	0.5	0.6
Total revenues	344.3	339.2
Losses and loss expenses (affiliated net assumed \$86.2 and \$93.7, respectively)	234.0	225.0
Acquisition and operating expenses (affiliated net assumed \$80.3 and \$70.6, respectively)	112.2	107.5
Interest expense (affiliates \$0.2 and \$0.2, respectively)	1.4	1.3
Other expenses	1.9	1.6
Total expenses	349.5	335.4
(Loss) income before federal income taxes	(5.2)	3.8
Federal income tax (benefit) expense:		
Current	(0.1)	—
Deferred	(1.0)	0.8
Total federal income tax (benefit) expense	(1.1)	0.8
Net (loss) income	\$(4.1)	\$3.0
(Loss) earnings per common share:		
Basic	\$(0.10)	\$0.07
Diluted	\$(0.10)	\$0.07
Dividends paid per common share	\$0.10	\$0.10

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Consolidated Statements of Comprehensive Income

	Three months ended March 31	
	2017	2016
<i>(\$ in millions, except per share amounts)</i>		
(unaudited)		
Net (loss) income	\$(4.1)	\$3.0
Other comprehensive income, net of tax:		
Net unrealized holding gains on investments:		
Unrealized holding gains	30.8	37.0
Reclassification adjustments for gains realized in net income	(7.8)	(1.3)
Income tax expense	(8.0)	(12.5)
<i>Total net unrealized holding gains on investments</i>	15.0	23.2
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Negative prior service cost	(1.4)	(1.4)
Net actuarial loss	2.1	2.4
Income tax expense	(0.3)	(0.4)
<i>Total net unrecognized benefit plan obligations</i>	0.4	0.6
<i>Other comprehensive income</i>	15.4	23.8
Comprehensive income	\$11.3	\$26.8

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

	Three months ended March 31	
	2017	2016
<i>(\$ in millions)</i>		
(unaudited)		
Cash flows from operating activities:		
Net (loss) income	\$(4.1)	\$3.0
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization, net	3.1	4.4
Share-based compensation	1.7	1.4
Net realized gains on investments	(7.8)	(1.3)
Changes in operating assets and liabilities:		
Deferred policy acquisition benefits	5.8	1.6
Accrued investment income and other assets	(0.5)	(3.7)
Postretirement and pension benefits	(2.9)	(1.8)
Other liabilities and due to/from affiliates, net	(14.0)	4.9
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(1.1)	(0.1)
Losses and loss expenses payable	35.7	30.5
Unearned premiums	(11.3)	(15.5)
Federal income taxes	(0.9)	1.1
Net cash provided by operating activities	3.7	24.5
Cash flows from investing activities:		
Purchases of fixed maturities available-for-sale	(120.5)	(160.6)
Purchases of equity securities available-for-sale	(39.0)	(30.8)
Purchases of other invested assets	(0.2)	(0.4)
Maturities, calls and pay downs of fixed maturities available-for-sale	54.1	60.8
Sales of fixed maturities available-for-sale	50.7	75.8
Sales of equity securities available-for-sale	47.6	23.6
Sales of other invested assets available-for-sale	0.3	0.2
Net cash used in investing activities	(7.0)	(31.4)
Cash flows from financing activities:		
Proceeds from issuance of common stock	1.5	0.8
Payments to acquire treasury stock	(0.2)	(0.2)
Payment of dividends	(4.3)	(4.1)
Net cash used in financing activities	(3.0)	(3.5)
Net decrease in cash and cash equivalents	(6.3)	(10.4)
Cash and cash equivalents at beginning of period	51.1	58.1
Cash and cash equivalents at end of period	\$44.8	\$47.7
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.2 and \$0.2, respectively)	\$1.4	\$1.3

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

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, 2017, are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. The balance sheet at December 31, 2016, 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, 2016, (the “2016 Form 10-K”). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2016 Form 10-K.

Adoption of Recent Accounting Pronouncements

Improvements to Employee Share-Based Payment Accounting

The amendments in this guidance simplify the accounting for share-based payment award transactions including: income tax consequences, classification of awards as either equity or liabilities, classification of excess tax benefits, and classification on the statement of cash flows. The guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company adopted this guidance prospectively at January 1, 2017. Prior periods were not adjusted and it did not have a material impact on the condensed consolidated financial statements for the three month period ended March 31, 2017.

Pending Adoption of Recent Accounting Pronouncements

For information regarding accounting pronouncements that the Company has not yet adopted, see the “Pending Adoption of Recent Accounting Pronouncements” section of Note 1 of the Notes to Consolidated Financial Statements in the 2016 Form 10-K.

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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, 2017 and December 31, 2016:

(\$ millions)

March 31, 2017

Fixed maturities:

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
U.S. treasury securities and obligations of U.S. government agencies	\$441.3	\$9.9	\$(5.7)	\$445.5
Obligations of states and political subdivisions	607.3	14.1	(2.3)	619.1
Corporate securities	431.6	6.3	(1.7)	436.2
U.S. government agencies mortgage-backed securities	624.5	7.9	(9.7)	622.7
<i>Total fixed maturities</i>	2,104.7	38.2	(19.4)	2,123.5
Equity securities:				
Large-cap securities	97.4	39.3	(0.2)	136.5
Small-cap securities	56.0	20.5	—	76.5
Mutual and exchange traded funds	167.9	14.8	(0.1)	182.6
<i>Total equity securities</i>	321.3	74.6	(0.3)	395.6
Other invested assets	25.5	22.6	—	48.1
<i>Total available-for-sale securities</i>	\$2,451.5	\$135.4	\$(19.7)	\$2,567.2

(\$ millions)

December 31, 2016

Fixed maturities:

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
U.S. treasury securities and obligations of U.S. government agencies	\$401.9	\$8.9	\$(6.1)	\$404.7
Obligations of states and political subdivisions	634.6	12.3	(3.2)	643.7
Corporate securities	445.7	6.1	(2.2)	449.6
U.S. government agencies mortgage-backed securities	613.7	8.5	(10.9)	611.3
<i>Total fixed maturities</i>	2,095.9	35.8	(22.4)	2,109.3
Equity securities:				
Large-cap securities	108.9	32.7	(2.6)	139.0
Small-cap securities	57.2	21.9	—	79.1
Mutual and exchange traded funds	157.0	8.5	(0.8)	164.7
<i>Total equity securities</i>	323.1	63.1	(3.4)	382.8
Other invested assets	25.5	19.6	—	45.1
<i>Total available-for-sale securities</i>	\$2,444.5	\$118.5	\$(25.8)	\$2,537.2

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The 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, 2017 and December 31, 2016:

	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
March 31, 2017									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$257.0	\$(5.7)	35	\$—	\$—	—	\$257.0	\$(5.7)	35
Obligations of states and political subdivisions	126.6	(2.3)	17	—	—	—	126.6	(2.3)	17
Corporate securities	114.0	(1.3)	17	15.7	(0.4)	3	129.7	(1.7)	20
U.S. government agencies mortgage-backed securities	347.5	(8.9)	49	20.0	(0.8)	9	367.5	(9.7)	58
<i>Total fixed maturities</i>	845.1	(18.2)	118	35.7	(1.2)	12	880.8	(19.4)	130
Equity securities:									
Large-cap equity securities	1.3	—	2	4.6	(0.2)	2	5.9	(0.2)	4
Mutual and exchange traded funds	2.4	(0.1)	1	—	—	—	2.4	(0.1)	1
<i>Total equity securities</i>	3.7	(0.1)	3	4.6	(0.2)	2	8.3	(0.3)	5
<i>Total temporarily impaired securities</i>	\$848.8	\$(18.3)	121	\$40.3	\$(1.4)	14	\$889.1	\$(19.7)	135

	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
December 31, 2016									
Fixed maturities:									
U.S. treasury securities and obligations of U.S. government agencies	\$229.1	\$(6.1)	30	\$—	\$—	—	\$229.1	\$(6.1)	30
Obligations of states and political subdivisions	178.9	(3.2)	26	—	—	—	178.9	(3.2)	26
Corporate securities	102.9	(1.4)	16	29.4	(0.8)	4	132.3	(2.2)	20
U.S. government agencies mortgage-backed securities	341.7	(10.1)	43	20.5	(0.8)	11	362.2	(10.9)	54
<i>Total fixed maturities</i>	852.6	(20.8)	115	49.9	(1.6)	15	902.5	(22.4)	130
Equity securities:									
Large-cap equity securities	9.1	(0.9)	7	8.8	(1.7)	5	17.9	(2.6)	12
Mutual and exchange traded funds	29.9	(0.8)	2	—	—	—	29.9	(0.8)	2
<i>Total equity securities</i>	39.0	(1.7)	9	8.8	(1.7)	5	47.8	(3.4)	14
<i>Total temporarily impaired securities</i>	\$891.6	\$(22.5)	124	\$58.7	\$(3.3)	20	\$950.3	\$(25.8)	144

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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 reviewed its investments at March 31, 2017, 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, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Equity securities:		
Large-cap securities	\$(1.5)	\$(0.2)
Small-cap securities	(0.6)	(1.2)
Fixed maturities:	—	(2.3)
<i>Total other-than-temporary impairments</i>	\$(2.1)	\$(3.7)

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, 2017:

<i>(\$ millions)</i>	Amortized cost	Fair value
Due in 1 year or less	\$ 52.1	\$52.6
Due after 1 year through 5 years	540.6	546.7
Due after 5 years through 10 years	306.6	310.0
Due after 10 years	580.9	591.5
U.S. government agencies mortgage-backed securities	624.5	622.7
<i>Total</i>	\$ 2,104.7	\$ 2,123.5

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, 2017, State Auto P&C had U.S. government agencies mortgage-backed fixed maturity securities, with a carrying value of approximately \$106.5 million, that were pledged as collateral for the FHLB Loans (as defined in Note 3). In accordance with the terms of the FHLB Loans, State Auto P&C retains all rights regarding these pledged securities.

Fixed maturities with fair values of \$9.3 million and \$9.2 million were on deposit with insurance regulators as required by law at March 31, 2017, and December 31, 2016, respectively. The Company retains all rights regarding these securities.

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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 components of net investment income for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Fixed maturities	\$15.8	\$14.9
Equity securities	1.7	1.5
Cash and cash equivalents, and other	1.5	1.4
<i>Investment income</i>	19.0	17.8
Investment expenses	0.3	0.4
<i>Net investment income</i>	\$18.7	\$17.4

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

Proceeds on sales of available-for-sale securities were \$98.6 million and \$99.6 million for the three months ended March 31, 2017, and 2016, respectively.

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, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Realized gains:		
Fixed maturities	\$0.3	\$1.5
Equity securities	9.7	4.1
<i>Total realized gains</i>	10.0	5.6
Realized losses:		
Equity securities:		
Sales	(0.1)	(0.6)
OTTI	(2.1)	(1.4)
Fixed maturities:		
OTTI	—	(2.3)
<i>Total realized losses</i>	(2.2)	(4.3)
<i>Net realized gains on investments</i>	\$7.8	\$1.3
Change in unrealized holding gains (losses), net of tax:		
Fixed maturities	\$5.4	\$36.2
Equity securities	14.6	(1.0)
Other invested assets	3.0	0.5
Deferred federal income tax liability	(8.0)	(12.5)
<i>Change in net unrealized holding gains (losses), net of tax</i>	\$15.0	\$23.2

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

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, 2017, and December 31, 2016, 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, 2017, and 2016.

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

Fixed Maturities

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

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

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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 is one international fund (“the fund”) that invests in equity securities of foreign issuers and is managed by a third party investment manager. The fund had a fair value of \$38.4 million and \$35.7 million at March 31, 2017, and December 31, 2016, respectively, which was determined using the fund’s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the fund including obtaining and reviewing the fund’s audited financial statements. There are no unfunded commitments related to the fund. The Company may not sell its investment in the fund; however, the Company may redeem all or a portion of its investment in the fund at net asset value per share with the appropriate prior written notice. In accordance with Accounting Standard Codification 820-10, this investment is measured at fair value using the net asset value per share practical expedient and has not been classified in the fair value hierarchy. Fair values presented here are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the condensed consolidated balance sheets. 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, 2017 and December 31, 2016:

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
March 31, 2017				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$445.5	\$—	\$445.5	\$—
Obligations of states and political subdivisions	619.1	—	619.1	—
Corporate securities	436.2	—	432.6	3.6
U.S. government agencies mortgage-backed securities	622.7	—	622.7	—
<i>Total fixed maturities</i>	2,123.5	—	2,119.9	3.6
Equity securities:				
Large-cap securities	136.5	136.5	—	—
Small-cap securities	76.5	76.5	—	—
Mutual and exchange traded funds	182.6	182.6	—	—
<i>Total equity securities</i>	395.6	395.6	—	—
Other invested assets	9.7	9.7	—	—
<i>Total available-for-sale investments</i>	\$2,528.8	\$405.3	\$2,119.9	\$3.6

<i>(\$ millions)</i>	Total	Level 1	Level 2	Level 3
December 31, 2016				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$404.7	\$—	\$404.7	\$—
Obligations of states and political subdivisions	643.7	—	643.7	—
Corporate securities	449.6	—	446.1	3.5
U.S. government agencies mortgage-backed securities	611.3	—	611.3	—
<i>Total fixed maturities</i>	2,109.3	—	2,105.8	3.5
Equity securities:				
Large-cap securities	139.0	139.0	—	—
Small-cap securities	79.1	79.1	—	—
Mutual and exchange traded funds	164.7	164.7	—	—
<i>Total equity securities</i>	382.8	382.8	—	—
Other invested assets	9.4	9.4	—	—
<i>Total available-for-sale investments</i>	\$2,501.5	\$392.2	\$2,105.8	\$3.5

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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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, 2017, and the year ended December 31, 2016, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2017	\$ 3.5
Total realized gains – included in earnings	—
Total unrealized losses – included in other comprehensive income	—
Purchases	0.1
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at March 31, 2017	\$ 3.6

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2016	\$ 3.3
Total realized gains – included in earnings	—
Total unrealized gains – included in other comprehensive income	—
Purchases	0.2
Sales	—
Transfers into Level 3	—
Transfers out of Level 3	—
Balance at December 31, 2016	\$ 3.5

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 (the "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, 2017, was \$4.9 million and the fair value of the Trust Securities was \$0.5 million. The investments have been placed in Level 3 of the fair value hierarchy.

Notes Receivable from Affiliate

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

<i>(\$ millions, except interest rates)</i>	March 31, 2017			December 31, 2016		
	Carrying	fair	Interest	Carrying	fair	Interest
	value	value	rate	value	value	rate
Notes receivable from affiliate	\$70.0	\$74.3	7.00 %	\$70.0	\$75.7	7.00 %

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Notes Payable

Included in notes payable are the FHLB Loans and Subordinated Debentures. The Company estimates the fair value of the FHLB Loans by discounting cash flows using a borrowing rate currently available to the Company for loans with similar terms. The FHLB Loans have 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, 2017			December 31, 2016		
	Carrying value	Fair Value	Interest rate	Carrying value	Fair value	Interest rate
FHLB Loan due 2021: issued \$21.5, September 2016 with fixed interest	\$21.5	\$21.0	1.73 %	\$21.5	\$21.0	1.73 %
FHLB Loan due 2033: issued \$85.0, July 2013 with fixed interest	85.4	85.3	5.03 %	85.4	85.6	5.03 %
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.2	15.2	5.25 %	15.2	15.2	5.13 %
<i>Total notes payable</i>	\$122.1	\$121.5		\$122.1	\$121.8	

4. Losses and Loss Expenses Payable

The following table sets forth the activity in the liability for losses and loss expenses for the three months ended March 31, 2017 and 2016:

(\$ millions)

	2017	2016
Losses and loss expenses payable, at beginning of period	\$1,181.6	\$1,053.0
Less: reinsurance recoverable on losses and loss expenses payable	3.6	5.9
<i>Net balance at beginning of period</i>	1,178.0	1,047.1
Incurred related to:		
Current year	243.7	215.4
Prior years	(9.7)) 9.6
<i>Total incurred</i>	234.0	225.0
Paid related to:		
Current year	60.1	52.3
Prior years	139.4	142.8
<i>Total paid</i>	199.5	195.1
<i>Net balance at end of period</i>	1,212.5	1,077.0
Plus: reinsurance recoverable on losses and loss expenses payable	4.8	6.5
<i>Losses and loss expenses payable, at end of period</i>	\$1,217.3	\$1,083.5

The Company recorded favorable development related to prior years' loss and loss expense reserves for the three months ended March 31, 2017, of \$9.7 million compared to adverse development of \$9.6 million for the same 2016 period. Favorable development of prior years' unallocated loss adjustment expenses and catastrophe reserves were approximately \$2.7 million and \$2.2 million, respectively, of the 2017 development. Favorable development of prior accident years' non-catastrophe loss and ALAE reserves was primarily driven by the commercial insurance segment. The commercial insurance segment non-catastrophe loss and ALAE reserves contributed \$7.6 million of favorable development in 2017, driven by other commercial, small commercial package and workers' compensation of \$3.2 million, \$2.0 million and \$1.9 million, respectively. Favorable development in these lines was driven by lower than

anticipated severity emerging from multiple accident years. Slightly offsetting the favorable development was adverse development in the personal insurance segment of \$2.3 million , driven by homeowners' which contributed \$2.8 million of adverse development, primarily from accident year 2016, which included three large losses that occurred in late 2016.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Favorable development of catastrophe reserves was approximately \$0.7 million for the three months ended March 31, 2016, and adverse development of unallocated loss adjustment expenses was \$1.6 million for the same 2016 period. The specialty insurance segment non-catastrophe loss and ALAE reserves accounted for \$4.9 million of adverse development, which was driven by programs with adverse development of \$3.9 million. Adverse development in programs was primarily due to two programs with commercial auto exposures, both of which are in run-off. The personal insurance segment contributed \$3.4 million of the adverse development, driven by personal auto which developed unfavorably by \$3.2 million, primarily due to higher than anticipated bodily injury severity from the prior two accident years.

5. Reinsurance

The insurance subsidiaries of State Auto Financial, including State Auto P&C, Milbank and SA Ohio (collectively referred to as the “STFC Pooled Companies”) participate in a quota share reinsurance pooling arrangement (“the Pooling Arrangement”) with State Auto Mutual and its subsidiaries and affiliates (collectively referred to as the “Mutual Pooled Companies”).

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, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Premiums earned:		
Assumed from external insurers and reinsurers	\$1.1	\$1.4
Assumed under Pooling Arrangement	317.3	319.9
Ceded to external insurers and reinsurers	(6.1)	(6.8)
Ceded under Pooling Arrangement	(202.5)	(206.5)
<i>Net assumed premiums earned</i>	\$109.8	\$108.0
Losses and loss expenses incurred:		
Assumed from external insurers and reinsurers	\$1.6	\$1.1
Assumed under Pooling Arrangement	234.4	225.4
Ceded to external insurers and reinsurers	(2.0)	(1.9)
Ceded under Pooling Arrangement	(148.2)	(131.7)
<i>Net assumed losses and loss expenses incurred</i>	\$85.8	\$92.9

6. Income Taxes

The following table sets forth the reconciliation between actual federal income tax (benefit) expense and the amount computed at the indicated statutory rate for the three months ended March 31, 2017 and 2016:

<i>(\$ millions)</i>	2017		2016	
Amount at statutory rate	\$(1.8)	35.0	%	\$1.3 35.0 %
Tax-exempt interest and dividends received deduction	(1.5)	29.1	(2.0)	(52.8)
Other, net	2.2	(42.4)	1.5	37.8
<i>Federal income tax (benefit) expense and effective rate</i>	\$(1.1)	21.7	%	\$0.8 20.0 %

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

7. 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, 2017 and 2016:

(\$ millions)	Pension		Postretirement	
	2017	2016	2017	2016
Service cost	\$1.7	\$1.6	\$—	\$—
Interest cost	2.9	2.9	0.2	0.2
Expected return on plan assets	(4.2)	(3.7)	—	—
Amortization of:				
Negative prior service cost	—	—	(1.4)	(1.4)
Net actuarial loss	2.0	2.3	0.1	0.1
<i>Net periodic cost (benefit)</i>	\$2.4	\$3.1	\$(1.1)	\$(1.1)

The Company contributed \$3.3 million to its pension plan for the three months ended March 31, 2017, and expects to contribute an additional \$6.5 million in 2017.

8. 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, 2017 and 2016:

(\$ millions)	Unrealized Gains and Losses on Available-for-Sale Securities	Benefit Plan Items	Total
	Beginning balance at January 1, 2017	\$ 62.8	\$(30.3)
Other comprehensive income before reclassifications Amounts reclassified from AOCI (a)	—	—	20.1
Net current period other comprehensive	5.1	0.4	(4.7)
	15.0	0.4	15.4

income
*Ending
 balance*
 at \$ 77.8 \$(29.9) \$47.9
March
 31,
 2017

Beginning
 balance
 at \$ 68.5 \$(30.9) \$37.6
 January
 1,
 2016

Other
 comprehensive
 loss 24.0 — 24.0
 before
 reclassifications
 Amounts
 reclassified
 from 0.8) 0.6 (0.2)
 AOCI
 (a)

Net
 current
 period 23.2 0.6 23.8
 other
 comprehensive
 income
*Ending
 balance*
 at \$ 91.7 \$(30.3) \$61.4
March
 31,
 2016

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

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the reclassifications out of accumulated other comprehensive income, by component, to the Company's condensed consolidated statement of income for the three months ended March 31, 2017 and 2016:

(\$

millions)

Three months ended March 31	Three months ended March 31	Affected Other Component	Item in the Condensed Consolidated Statements of Income Components
2017	2016		
			Unrealized gains on available securities
7.8	1.3		Total before tax
(2.7)	(0.5)		Tax expense
5.1	0.8		Net of tax
			Amortization of benefit plan items
			Negative prior service cost
1.4	1.4	(b)	
			Net actuarial loss
(0.7)	(1.0)		Total before tax
0.3	0.4		Tax benefit
(0.4)	(0.6)		Net of tax
<i>Total reclassifications for the period</i>			
\$4.7	\$0.2		

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

9. Net (Loss) 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, 2017 and 2016:

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

	2017	2016
Numerator:		
Net (loss) income for basic (loss) earnings per common share	\$(4.1)	\$3.0
Denominator:		
Weighted average shares for basic net (loss) earnings per common share	41.9	41.4
Effect of dilutive share-based awards	—	0.4
<i>Adjusted weighted average shares for diluted net (loss) earnings per common share</i>	41.9	41.8
Basic net (loss) earnings per common share	\$(0.10)	\$0.07
Diluted net (loss) earnings per common share	\$(0.10)	\$0.07

The following table sets forth common stock options, stock awards and restricted share units ("RSU award") 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, 2017 and 2016:

(shares in millions)

2017 2016

Total number of antidilutive options and awards **0.6** 1.7

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

10. Segment Information

The Company has four reportable segments: personal insurance, commercial 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 investment operations segment, managed by Stateco, provides investment services.

Effective January 1, 2017, the Company completed the transition of its internal decision-making process to a product management structure. Under this structure, the Company's principal operating decision makers assess performance based on the underwriting results of individual products. The products within each insurance segment, are as follows:

- *Personal Insurance Segment* - personal auto, homeowners, farm & ranch and other personal
- *Commercial Insurance Segment* - commercial auto, small commercial package, middle market commercial, workers' compensation and other commercial
- *Specialty Insurance Segment* - E&S property, E&S casualty and programs

Certain amounts previously reported within the commercial insurance segment due to immateriality and convenience, are now reported in the personal insurance segment. Prior reporting periods have been restated to conform to the new presentation.

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

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

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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, 2017 and 2016:

<i>(\$ millions)</i>	2017	2016
Revenue from external sources:		
Insurance segments		
Personal insurance	\$152.7	\$153.5
Commercial insurance	103.6	111.4
Specialty insurance	61.0	55.0
<i>Total insurance segments</i>	317.3	319.9
Investment operations segment		
Net investment income	18.7	17.4
Net realized capital gains	7.8	1.3
<i>Total investment operations segment</i>	26.5	18.7
All other	0.5	0.6
<i>Total revenue from external sources</i>	344.3	339.2
Intersegment revenue	1.5	1.4
<i>Total revenue</i>	345.8	340.6
Reconciling items:		
Eliminate intersegment revenue	(1.5)	(1.4)
<i>Total consolidated revenues</i>	\$344.3	\$339.2
Segment income before federal income tax:		
Insurance segments SAP underwriting (loss) gain		
Personal insurance	\$(10.6)	\$4.4
Commercial insurance	(4.9)	(7.4)
Specialty insurance	(8.6)	(8.7)
<i>Total insurance segments (loss) gain</i>	(24.1)	(11.7)
Investment operations segment		
Net investment income	18.7	17.4
Net realized capital gains	7.8	1.3
<i>Total investment operations segment</i>	26.5	18.7
All other	0.1	0.1
<i>Total segment income before tax expense</i>	2.5	7.1
Reconciling items:		
GAAP expense adjustments	(5.4)	(1.2)
Interest expense on corporate debt	(1.4)	(1.3)
Corporate expenses	(0.9)	(0.8)
<i>Total reconciling items</i>	(7.7)	(3.3)
<i>Total consolidated (loss) income before federal income tax expense</i>	\$(5.2)	\$3.8

Investable assets attributable to the Company's investment operations segment totaled \$2,687.4 million and \$2,663.7 million at March 31, 2017, and December 31, 2016, respectively.

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Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

11. Contingencies and Litigation

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

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

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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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, 2016 (the “2016 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, 2017 and December 31, 2016, and for the consolidated statements of income for the three month periods ended March 31, 2017 and 2016. This discussion and analysis should be read together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in the 2016 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 2016 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 2016 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.

We have four reportable segments: personal insurance, commercial insurance, specialty insurance and investment operations. As of January 1, 2017, we completed the transition of our internal decision-making process to a product management structure under which our principal operating decision makers assess performance based on the underwriting results of individual products. The products within each insurance segment are as follows:

- *Personal Insurance Segment* - personal auto, homeowners, farm & ranch and other personal
- *Commercial Insurance Segment* - commercial auto, small commercial package, middle market commercial, workers’ compensation and other commercial
- *Specialty Insurance Segment* - E&S property, E&S casualty and programs

Certain amounts previously reported within the commercial insurance segment due to immateriality and convenience, are now reported in the personal insurance segment. Prior reporting periods have been restated to conform to the new presentation.

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 investment operations segment, managed by Stateco, provides investment services. See “Personal and Business Insurance” and “Specialty Insurance” in Item 1 of the 2016 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2017 is set forth in Note 10 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

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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.

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

STFC

Pooled

Companies:

State	
Auto	1.0 %
P&C	
Milwaukee	
SA	
Ohio	
Total	
STFC	65.0 %
Pooled	
Companies	

State

Auto

Mutual

Pooled

Companies:

State	
Auto	4.5 %
Mutual	
SA	
Wisconsin	
Meridian	
Security	
Patrons	
Mutual	0.5 %
RIC	
Plaza	
American	
Compensation	
Bloomington	
Compensation	
Total	
State	
Auto	35.0 %
Mutual	
Pooled	
Companies	

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RESULTS OF OPERATIONS

Our pre-tax loss for the three months ended March 31, 2017 was \$5.2 million compared to pre-tax income of \$3.8 million in 2016. The decrease was primarily due to an increase in catastrophe losses and acquisition and operating expenses when compared to the same 2016 period. While the number of weather events classified as catastrophes for the three months ended March 31, 2017 was flat compared to the same period of 2016, the 2017 events were more severe than those experienced in 2016. During the first quarter 2017, widespread storms impacted the Ohio Valley region, South Carolina, Texas, Mississippi and Georgia. The month of March was particularly severe as it accounted for nearly 80% of our catastrophe losses. Slightly more than half of the catastrophe losses for the quarter were in the homeowners line of business.

The following table sets forth certain key performance indicators we use to monitor our operations for the three months ended March 31, 2017 and 2016:

<i>(\$ millions, except per share amounts)</i>	2017	2016	
<u>GAAP Basis:</u>			
Total revenues	\$344.3	\$339.2	
(Loss) income before federal income taxes	\$(5.2)	\$3.8	
Net (loss) income	\$(4.1)	\$3.0	
Basic (loss) earnings per share	\$(0.10)	\$0.07	
Diluted (loss) earnings per share	\$(0.10)	\$0.07	
Stockholders' equity	\$901.1	\$908.9	
Return on average equity (LTM)	1.5 %	3.3	%
Book value per share	\$21.50	\$21.95	
Debt to capital ratio	11.9 %	10.0	%
Cat loss and ALAE ratio	10.8 %	4.7	%
Non-cat loss and LAE ratio	63.0 %	65.6	%
Loss and LAE ratio	73.8 %	70.3	%
Expense ratio	35.4 %	33.6	%
Combined ratio	109.2 %	103.9	%
Premium written growth	0.4 %	(0.7)	%
Investment yield	3.0 %	2.9	%

SAP Basis:

Cat loss and ALAE ratio	10.8 %	4.7	%
Non-cat loss and ALAE ratio	57.2 %	59.2	%
ULAE ratio	5.9 %	6.6	%
Loss and LAE ratio	73.9 %	70.5	%
Expense ratio	34.9 %	34.8	%
Combined ratio	108.8 %	105.3	%

(\$ millions)

Twelve
months
ended
March 31
20172016

Net premiums written to surplus **1.5** 1.6

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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

Insurance Segments

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

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

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see “Critical Accounting Policies – Deferred Acquisition Costs” section included in Item 7 of our 2016 Form 10-K.

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

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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The following tables set forth our insurance segments' SAP underwriting gain (loss) and SAP combined ratios for the three months ended March 31, 2017 and 2016:

(\$ in millions)

March 31, 2017	Personal	Commercial	Specialty	Total	
Net written premiums	\$141.6	\$ 100.2	\$ 64.3	\$306.1	
Net earned premiums	152.7	103.6	61.0	317.3	
Losses and LAE incurred:					
Cat loss and ALAE	24.6	7.5	2.2	34.3	
Non-cat loss and ALAE	83.8	55.2	42.5	181.5	
<i>Total Loss and ALAE</i>	108.4	62.7	44.7	215.8	
ULAE	10.6	6.0	2.0	18.6	
<i>Total Loss and LAE</i>	119.0	68.7	46.7	234.4	
Underwriting expenses	44.3	39.8	22.9	107.0	
<i>Net underwriting loss</i>	\$(10.6)	\$(4.9)	\$(8.6)	\$(24.1)	
Cat loss and ALAE ratio	16.1	% 7.3	% 3.6	% 10.8	%
Non-cat loss and ALAE ratio	54.9	% 53.2	% 69.6	% 57.2	%
<i>Total Loss and ALAE ratio</i>	71.0	% 60.5	% 73.2	% 68.0	%
ULAE ratio	6.9	% 5.8	% 3.5	% 5.9	%
<i>Total Loss and LAE ratio</i>	77.9	% 66.3	% 76.7	% 73.9	%
Expense ratio	31.3	% 39.6	% 35.5	% 34.9	%
<i>Combined ratio</i>	109.2	% 105.9	% 112.2	% 108.8	%

(\$ in millions)

March 31, 2016	Personal	Commercial	Specialty	Total	
Net written premiums	\$142.3	\$ 102.1	\$ 60.4	\$304.8	
Net earned premiums	153.5	111.4	55.0	319.9	
Losses and LAE incurred:					
Cat loss and ALAE	12.5	2.0	0.5	15.0	
Non-cat loss and ALAE	81.2	70.5	37.8	189.5	
<i>Total Loss and ALAE</i>	93.7	72.5	38.3	204.5	
ULAE	11.5	7.0	2.4	20.9	
<i>Total Loss and LAE</i>	105.2	79.5	40.7	225.4	
Underwriting expenses	43.9	39.3	23.0	106.2	
<i>Net underwriting gain (loss)</i>	\$4.4	\$(7.4)	\$(8.7)	\$(11.7)	
Cat loss and ALAE ratio	8.1	% 1.8	% 0.9	% 4.7	%
Non-cat loss and ALAE ratio	52.9	% 63.2	% 68.9	% 59.2	%
<i>Total Loss and ALAE ratio</i>	61.0	% 65.0	% 69.8	% 63.9	%
ULAE ratio	7.5	% 6.2	% 4.6	% 6.6	%
<i>Total Loss and LAE ratio</i>	68.5	% 71.2	% 74.4	% 70.5	%
Expense ratio	30.8	% 38.5	% 38.0	% 34.8	%
<i>Combined ratio</i>	99.3	% 109.7	% 112.4	% 105.3	%

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

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Personal Insurance Segment

The following tables set forth the SAP underwriting gain (loss) and SAP combined ratios by major product line for our personal insurance segment for the three months ended March 31, 2017 and 2016:

Table 1

(\$ in millions)

March 31, 2017	Personal Auto	Homeowners	Farm & Ranch	Other Personal	Total
Net written premiums	\$ 82.3	\$ 45.2	\$ 9.9	\$ 4.2	\$141.6
Net earned premiums	82.9	55.5	9.4	4.9	152.7
Losses and LAE incurred:					
Cat loss and ALAE	3.2	18.0	2.4	1.0	24.6
Non-cat loss and ALAE					