

National Interstate CORP
Form 10-Q
August 07, 2007

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

Form 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2007**

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 000-51130**

National Interstate Corporation

(Exact name of registrant as specified in its charter)

Ohio

*(State or other jurisdiction of
incorporation or organization)*

34-1607394

*(I.R.S. Employer
Identification No.)*

**3250 Interstate Drive
Richfield, Ohio 44286-9000
(330) 659-8900**

(Address and telephone number of principal executive offices)

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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check One):
Large Accelerated Filer Accelerated Filer 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
The number of shares outstanding of the registrant's sole class of common shares as of August 1, 2007 was 19,219,797.

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. Financial Statements**

National Interstate Corporation and Subsidiaries
Consolidated Balance Sheets
(In thousands, except per share data)

| | June 30, 2007 (Unaudited) | December 31, 2006 |
|---|--|----------------------------------|
| ASSETS | | |
| Investments: | | |
| Fixed maturities available-for-sale, at fair value (amortized cost \$350,631 and \$332,552, respectively) | \$ 344,021 | \$ 327,449 |
| Equity securities available-for-sale, at fair value (cost \$48,673 and \$33,476, respectively) | 48,868 | 34,095 |
| Short-term investments, at cost which approximates fair value | 23,280 | 22,744 |
| | | |
| Total investments | 416,169 | 384,288 |
| Cash and cash equivalents | 23,972 | 22,166 |
| Securities lending collateral | 153,715 | 158,928 |
| Accrued investment income | 4,492 | 4,321 |
| Premiums receivable, net of allowance for doubtful accounts of \$583 and \$522, respectively | 119,663 | 77,076 |
| Reinsurance recoverables on paid and unpaid losses | 107,419 | 90,070 |
| Prepaid reinsurance premiums | 36,781 | 21,272 |
| Deferred policy acquisition costs | 19,764 | 15,035 |
| Deferred federal income taxes | 11,295 | 10,731 |
| Property and equipment, net | 19,055 | 18,586 |
| Funds held by reinsurer | 2,003 | 2,340 |
| Other assets | 2,092 | 1,435 |
| | | |
| Total assets | \$ 916,420 | \$ 806,248 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses | \$ 299,693 | \$ 265,966 |
| Unearned premiums and service fees | 173,649 | 127,723 |
| Long-term debt | 15,464 | 15,464 |
| Amounts withheld or retained for account of others | 30,735 | 27,885 |
| Reinsurance balances payable | 16,484 | 7,156 |
| Securities lending obligation | 153,715 | 158,928 |
| Accounts payable and other liabilities | 19,821 | 19,676 |
| Commissions payable | 8,728 | 6,347 |
| Assessments and fees payable | 4,198 | 3,340 |
| | | |
| Total liabilities | 722,487 | 632,485 |
| Shareholders' equity: | | |
| Preferred shares - no par value | | |

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| | | |
|---|------------|------------|
| Authorized 10,000 shares | | |
| Issued 0 shares | | |
| Common stock \$0.01 par value | | |
| Authorized 50,000 shares | | |
| Issued 23,350 shares, including 4,153 and 4,191 shares, respectively, in treasury | 234 | 234 |
| Additional paid-in capital | 44,896 | 43,921 |
| Retained earnings | 158,847 | 138,450 |
| Accumulated other comprehensive loss | (4,170) | (2,915) |
| Treasury shares | (5,874) | (5,927) |
| Total shareholders equity | 193,933 | 173,763 |
| Total liabilities and shareholders equity | \$ 916,420 | \$ 806,248 |

See notes to consolidated financial statements.

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Income
(Unaudited)
(In thousands, except per share data)

| | Three Months Ended June | | Six Months Ended June | |
|---|-------------------------|-------------|-----------------------|-------------|
| | 2007 | 30, 2006 | 2007 | 30, 2006 |
| Revenue: | | | | |
| Premiums earned | \$ 63,265 | \$ 52,429 | \$ 123,555 | \$ 102,744 |
| Net investment income | 5,586 | 4,276 | 10,731 | 8,175 |
| Realized gains on investments | 207 | 145 | 272 | 515 |
| Other | 955 | 540 | 1,820 | 1,017 |
| Total revenues | 70,013 | 57,390 | 136,378 | 112,451 |
| Expenses: | | | | |
| Losses and loss adjustment expenses | 37,187 | 30,438 | 72,720 | 60,334 |
| Commissions and other underwriting expense | 11,144 | 9,934 | 22,545 | 18,699 |
| Other operating and general expenses | 4,048 | 3,306 | 7,839 | 6,099 |
| Interest expense | 385 | 379 | 767 | 743 |
| Total expenses | 52,764 | 44,057 | 103,871 | 85,875 |
| Income before federal income taxes | 17,249 | 13,333 | 32,507 | 26,576 |
| Provision for federal income taxes | 5,391 | 4,330 | 10,182 | 8,847 |
| Net income | \$ 11,858 | \$ 9,003 | \$ 22,325 | \$ 17,729 |
| Net income per common share basic | \$ 0.62 | \$ 0.47 | \$ 1.16 | \$ 0.93 |
| Net income per common share diluted | \$ 0.61 | \$ 0.47 | \$ 1.15 | \$ 0.92 |
| Weighted average of common shares outstanding basic | 19,192 | 19,136 | 19,183 | 19,119 |
| Weighted average of common shares outstanding diluted | 19,374 | 19,279 | 19,355 | 19,271 |
| Cash dividends per common share | \$ 0.05 | \$ 0.04 | \$ 0.10 | \$ 0.08 |

See notes to consolidated financial statements .

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Shareholders Equity
(Unaudited)
(Dollars in thousands)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|---|-------------------------|---|------------------------------|---|---------------------------|--------------|
| Balance at January 1, 2007 | \$ 234 | \$ 43,921 | \$ 138,450 | \$ (2,915) | \$ (5,927) | \$ 173,763 |
| Net income | | | 22,325 | | | 22,325 |
| Unrealized depreciation of investment securities, net of tax benefit of \$676 | | | | (1,255) | | (1,255) |
| Comprehensive income | | | | | | 21,070 |
| Dividends on common stock | | | (1,928) | | | (1,928) |
| Issuance of 37,906 treasury shares upon exercise of options and stock award grants | | 274 | | | 53 | 327 |
| Tax benefit realized from exercise of stock options | | 178 | | | | 178 |
| Stock compensation expense | | 523 | | | | 523 |
| Balance at June 30, 2007 | \$ 234 | \$ 44,896 | \$ 158,847 | \$ (4,170) | \$ (5,874) | \$ 193,933 |
| Balance at January 1, 2006 | \$ 234 | \$ 42,257 | \$ 105,826 | \$ (2,712) | \$ (6,072) | \$ 139,533 |
| Net income | | | 17,729 | | | 17,729 |
| Unrealized depreciation of investment securities, net of tax benefit of \$2,412 | | | | (4,479) | | (4,479) |
| Comprehensive income | | | | | | 13,250 |
| Dividends on common stock | | | (1,539) | | | (1,539) |
| Issuance of 90,000 treasury shares upon exercise of stock options | | 171 | | | 125 | 296 |
| Tax benefit realized from exercise of stock options | | 523 | | | | 523 |
| Stock compensation expense | | 399 | | | | 399 |

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| | | | | | | |
|--------------------------|--------|-----------|------------|------------|------------|------------|
| Balance at June 30, 2006 | \$ 234 | \$ 43,350 | \$ 122,016 | \$ (7,191) | \$ (5,947) | \$ 152,462 |
|--------------------------|--------|-----------|------------|------------|------------|------------|

See notes to consolidated financial statements.

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

| | Six Months Ended June 30, | |
|--|----------------------------------|-------------|
| | 2007 | 2006 |
| Operating activities | | |
| Net income | \$ 22,325 | \$ 17,729 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of bond premiums and discounts | 142 | 107 |
| Provision for depreciation and amortization | 625 | 579 |
| Net realized gains on investment securities | (272) | (515) |
| Deferred federal income taxes | 112 | (542) |
| Stock compensation expense | 523 | 399 |
| Increase in deferred policy acquisition costs, net | (4,729) | (4,202) |
| Increase in reserves for losses and loss adjustment expenses | 33,727 | 24,143 |
| Increase in premiums receivable | (42,587) | (44,126) |
| Increase in unearned premiums and service fees | 45,926 | 49,719 |
| (Increase) decrease in interest receivable and other assets | (536) | 3,218 |
| Increase in prepaid reinsurance premiums | (15,509) | (13,544) |
| Increase in accounts payable and other liabilities, commissions payable and assessments and fees payable | 3,384 | 3,640 |
| Increase in amounts withheld or retained for account of others | 2,850 | 3,201 |
| Increase in reinsurance recoverable | (17,349) | (9,707) |
| Increase in reinsurance balances payable | 9,328 | 10,608 |
| Other | 50 | |
| Net cash provided by operating activities | 38,010 | 40,707 |
| Investing activities | | |
| Purchases of fixed maturities | (103,821) | (48,337) |
| Purchases of equity securities | (22,373) | (30,635) |
| Proceeds from sale of fixed maturities | | 997 |
| Proceeds from sale of equity securities | 6,873 | 17,739 |
| Proceeds from maturity of investments | 85,639 | 20,670 |
| Additional cash paid for purchase of subsidiary | | (1,246) |
| Cash and cash equivalents of business acquired | | 5,585 |
| Capital expenditures | (1,099) | (579) |
| Net cash used in investing activities | (34,781) | (35,806) |
| Financing activities | | |
| Repayment of long-term debt | | (625) |
| Decrease in securities lending collateral | 5,213 | |
| Decrease in securities lending obligation | (5,213) | |
| Tax benefit realized from exercise of stock options | 178 | 523 |
| Issuance of common shares from treasury upon exercise of stock options | 327 | 296 |
| Cash dividends paid on common shares | (1,928) | (1,539) |

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| | | |
|--|-----------|-----------|
| Net cash used in financing activities | (1,423) | (1,345) |
| Net increase in cash and cash equivalents | 1,806 | 3,556 |
| Cash and cash equivalents at beginning of period | 22,166 | 7,461 |
| Cash and cash equivalents at end of period | \$ 23,972 | \$ 11,017 |

See notes to consolidated financial statements.

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**NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

The consolidated financial statements include the accounts of the Company and its subsidiaries, National Interstate Insurance Company (NIIC), Hudson Indemnity, Ltd. (HIL), National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI), Triumpe Casualty Company (TCC), National Interstate Insurance Agency, Inc. (NIIA), Hudson Management Group, Ltd. (HMG), American Highways Insurance Agency, Inc., Safety, Claims, and Litigation Services, Inc., Explorer RV Insurance Agency, Inc. and Safety, Claims, Litigation Services, LLC. Significant intercompany transactions have been eliminated.

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature.

Operating results for the three and six month period ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates. Certain reclassifications have been made to financial information presented for prior years to conform to the current year's presentation.

2. Recent Accounting Pronouncements

The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to elect to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159, an entity may elect the fair value option for eligible items that exist at the adoption date. Subsequent to the initial adoption, the election of the fair value option should only be made at the initial recognition of the asset or liability or upon a re-measurement event that gives rise to the new-basis of accounting. All subsequent changes in fair value for that instrument are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be recorded at fair value nor does it eliminate disclosure requirements included in other accounting standards. SFAS No. 159 is effective as of January 1, 2008. The Company is currently evaluating the impact, if any, that the adoption of SFAS No. 159 will have on its result of operations, financial condition and liquidity.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company has not yet determined the impact SFAS No. 157 will have on its financial statements, but expects the impact, if any, to be immaterial.

Accounting for Uncertainty in Income Taxes

In June 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes* an interpretation of SFAS No. 109. FIN 48 clarifies the recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN 48 on

January 1, 2007. There is no impact of this interpretation on the Company's results of operations, financial condition and liquidity for the three and six months ended June 30, 2007.

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The Company recognized no liability for unrecognized tax benefits at January 1, 2007. In addition, the Company has not accrued for interest and penalties related to unrecognized tax benefits. However, if interest and penalties would need to be accrued related to unrecognized tax benefits, such amounts would be recognized as a component of the provision for federal income taxes.

The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company is no longer subject to U.S. federal income tax examination by tax authorities for years before 2003. The Company is no longer subject to state income tax examination for years before 2003. There are no ongoing examinations of income tax returns by federal or state tax authorities.

3. Shareholders Equity

The Company grants options and other awards to officers of the Company under the Long Term Incentive Plan (LTIP). At June 30, 2007, there were 998,794 of the Company's common shares reserved for issuance upon exercise of stock options or other awards under the LTIP and options for 662,800 shares were outstanding. In March 2007, the Company granted a restricted stock award and stock bonus award under the LTIP. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Company may accelerate vesting and exercisability of options. The Compensation Committee of the Board of Directors must approve all grants.

On January 1, 2006, the Company adopted SFAS No. 123(R) (revised version of SFAS No. 123), *Accounting for Stock-Based Compensation*, which requires measurement of compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the requisite service period of stock-based awards. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company's valuation methodology used for all options granted since the Company's initial public offering in 2005 for purposes of its footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method for awards issued subsequent to the Company's initial public offering, which provides for no retroactive application to prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards, as the required services are rendered. The Company has adopted SFAS No. 123(R) using the prospective method for awards issued prior to the Company's initial public offering. Awards issued prior to the initial public offering were valued for disclosure purposes using the minimum value method. No compensation cost will be recognized for future vesting of these awards.

For both the three months ended June 30, 2007 and 2006, the Company recognized stock compensation expense related to SFAS 123(R) of \$0.2 million and related income tax benefits of approximately \$30,000. For both the six months ended June 30, 2007 and 2006, the Company recognized stock compensation expense related to SFAS 123(R) of \$0.4 million and related income tax benefits of approximately \$0.1 million. The Company also recognized compensation expense of \$0.3 million related to the stock bonus award and restricted stock award in the first six months of 2007. Stock compensation expense is included in the "Other operating and general expenses" line item of the Company's Consolidated Statements of Income.

The Company paid dividends of \$0.05 and \$0.04, and \$0.10 and \$0.08 per common share for the three and six months ended June 30, 2007 and 2006, respectively.

4. Transactions with Related Parties

The Company's principal insurance subsidiary, NIIC, is involved in both the cession and assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA, a wholly-owned subsidiary of the Company, is a party to an underwriting management agreement with Great American Insurance Company ("Great American"). As of June 30, 2007, Great American owned 53.1% of the outstanding shares of the Company. Great American is a wholly-owned subsidiary of American Financial Group, Inc. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American's net premiums written for public transportation and recreational vehicle risks. NIIA provides administrative services to Great American in connection with Great American's underwriting of these risks. The Company also cedes premiums through reinsurance agreements with Great American to reduce exposure in certain of its property-casualty insurance programs.

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The table below summarizes the reinsurance balance and activity with Great American:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|------------------------------------|-------------|----------------------------------|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Written premiums assumed | \$ 1,941 | \$ 1,237 | \$3,613 | \$2,348 |
| Assumed premiums earned | 1,390 | 1,008 | 2,593 | 1,981 |
| Assumed losses and loss adjustment expense incurred | 1,452 | 378 | 2,458 | 1,515 |
| Ceded premiums written | 1,004 | 1,047 | 2,752 | 2,525 |
| Ceded premiums earned | 986 | 945 | 1,953 | 2,048 |
| Ceded losses and loss adjustment expense recoveries | 110 | 285 | 1,040 | 1,248 |
| Payable to Great American as of quarter end | 844 | 1,738 | 844 | 1,738 |

Great American or its parent, American Financial Group, Inc., performs certain services for the Company without charge including, without limitation, actuarial services and on a consultative basis, as needed, internal audit, legal, accounting and other support services. If Great American no longer controlled a majority of the Company's common shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to us. This could impact our personnel resources, require us to hire additional professional staff and generally increase our operating expenses. Management believes, based on discussions with Great American, that these services will continue to be provided by the affiliated entity in future periods and the relative impact on operating results is not material.

In addition, NIIC is party to a reinsurance agreement with Validus Reinsurance, Ltd. The total amount ceded under this agreement was \$0.1 million for the six months ended 2007 and 2006, respectively. The contract terms were negotiated on an arms-length basis. Validus Reinsurance, Ltd. is a subsidiary of Validus Holdings, Ltd., whose chief financial officer Mr. Joseph E. (Jeff) Consolino is one of the Company's directors and Audit Committee Chairman.

5. Reinsurance

Premiums and reinsurance activity consisted of the following:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|-------------|------------------------------------|---------------|----------------|---------------|----------------------------------|---------------|----------------|---------------|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| | Written | Earned | Written | Earned | Written | Earned | Written | Earned |
| | (Dollars in thousands) | | | | | | | |
| Direct | \$ 79,547 | \$ 78,142 | \$ 68,576 | \$ 63,451 | \$ 197,759 | \$ 152,013 | \$ 174,707 | \$ 124,955 |
| Assumed | 2,336 | 2,325 | 4,152 | 3,469 | 5,054 | 5,074 | 7,559 | 6,640 |
| Ceded | (15,349) | (17,202) | (13,206) | (14,491) | (49,051) | (33,532) | (43,337) | (28,851) |
| Net Premium | \$ 66,534 | \$ 63,265 | \$ 59,522 | \$ 52,429 | \$ 153,762 | \$ 123,555 | \$ 138,929 | \$ 102,744 |

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property-casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the three months ended June 30, 2007 and 2006 were \$9.7 million and \$7.4 million, respectively, and were \$16.7 million and \$15.8 million for the six months ended June 30, 2007 and 2006, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company and regularly evaluates the financial condition of its reinsurers.

6. Commitments and Contingencies

The Company and its subsidiaries are subject at times to various claims, lawsuits and legal proceedings arising in the ordinary course of business. All legal actions relating to claims made under insurance policies are considered in the establishment of our loss and loss adjustment expense reserves. In addition, regulatory bodies, such as state insurance departments, the Securities and Exchange Commission, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning our compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended.

The Company's insurance companies also have lawsuits pending in which the plaintiff seeks extra-contractual damages from us in addition to damages claimed, or in excess of the available limits under an insurance policy. These lawsuits, which are in various stages

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of development, generally mirror similar lawsuits filed against other carriers in the industry. Although the Company is vigorously defending these lawsuits, the outcomes of these cases cannot be determined at this time. The Company has established loss and loss adjustment expense reserves for lawsuits as to which it has been determined that a loss is both probable and estimable. In addition to these case reserves, we also establish reserves for claims incurred but not reported to cover unknown exposures and adverse development on known exposures. Based on currently available information, the Company believes that the reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on its financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by the Company for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on its financial condition, cash flows and results of operations.

On August 3, 2007 the Company was informed that the jury in a case pending in the Superior Court of the State of California for the County of Los Angeles, had issued, on August 2, 2007, a special verdict adverse to the Company's interests in a pending lawsuit with one of the Company's insurance companies. This special verdict is advisory in nature, so a formal judgment must still be entered by the court. Although the judge will likely render a judgment sometime in the near future, the Company does not have any certainty of timing. The current estimated net exposure to the Company for this anticipated judgment approximates \$9.0 million. However, the Company believes that it has a strong appellate case and strategy, and intends to vigorously pursue the appellate process. Upon appeal, the Company believes the matter will be resolved in a manner that will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows. As of June 30, 2007, the Company had not established a case reserve for this claim but has and will continue to closely monitor this case with counsel. The Company has consistently established litigation expense reserves to account for the cost to vigorously defend the Company's position which it will continue to reserve for throughout the appeal process.

As a direct writer of insurance, the Company receives assessments by state funds to cover losses to policyholders of insolvent or rehabilitated companies and other authorized fees. These mandatory assessments may be partially recovered through a reduction in future premium taxes in some states. At June 30, 2007 and December 31, 2006, the liability for such assessments was \$4.2 million and \$3.3 million, respectively, and will be paid over several years as assessed by the various state funds.

7. Earnings Per Common Share

The following table sets forth the computation of basic and diluted net income per share:

| | Three Months Ended June | | Six Months Ended June 30, | |
|---|---|-------------|---|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| | (In thousands, except per share) | | (In thousands, except per share) | |
| Net income | \$ 11,858 | \$ 9,003 | \$ 22,325 | \$ 17,729 |
| Weighted average shares outstanding during period | 19,192 | 19,136 | 19,183 | 19,119 |
| Additional shares issuable under employee common stock option plans using treasury stock method | 182 | 143 | 172 | 152 |
| Weighted average shares outstanding assuming exercise of stock options | 19,374 | 19,279 | 19,355 | 19,271 |
| Net income per share: | | | | |
| Basic | \$ 0.62 | \$ 0.47 | \$ 1.16 | \$ 0.93 |
| Diluted | \$ 0.61 | \$ 0.47 | \$ 1.15 | \$ 0.92 |

There were 195,265 outstanding options excluded from diluted earnings per share because they were anti-dilutive for both the three and six months ended June 30, 2007. For both the three and six months ended June 30, 2006 there were 315,000 outstanding options excluded from dilutive earnings per share because they were anti-dilutive.

8. Segment Information

The Company operates its business as one segment, property and casualty insurance. The Company manages this segment through a product management structure. The following table shows revenues summarized by the broader business component description. These business components were determined based primarily on similar economic characteristics, products and services:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Revenue: | | | | |
| Premiums earned: | | | | |
| Alternate Risk Transfer | \$ 25,851 | \$ 17,354 | \$ 49,696 | \$ 33,282 |
| Transportation | 18,651 | 17,800 | 36,715 | 35,660 |
| Specialty Personal Lines | 12,631 | 11,436 | 24,734 | 22,264 |
| Hawaii and Alaska | 4,189 | 4,017 | 8,237 | 7,237 |
| Other | 1,943 | 1,822 | 4,173 | 4,301 |
| Total premiums earned | 63,265 | 52,429 | 123,555 | 102,744 |
| Net investment income | 5,586 | 4,276 | 10,731 | 8,175 |
| Realized gains on investments | 207 | 145 | 272 | 515 |
| Other | 955 | 540 | 1,820 | 1,017 |
| Total revenues | \$ 70,013 | \$ 57,390 | \$ 136,378 | \$ 112,451 |

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9. Securities Lending

In August 2006, the Company entered into a securities lending program whereby certain fixed maturity and equity securities from the Company's investment portfolio are loaned to other institutions for short periods of time. The Company requires collateral equal to 102% of the market value of the loaned securities plus accrued interest. The collateral is invested by the lending agent, in accordance with the Company's guidelines, generating investment income, net of applicable fees. The Company is not permitted to sell or repledge the collateral on the securities lending program. The Company accounts for this program as a secured borrowing and records the collateral held and corresponding liability to return the collateral on the Company's Consolidated Balance Sheets. At June 30, 2007, the fair value of collateral held was \$153.7 million and the fair value of securities lent plus accrued interest was \$150.9 million. The securities loaned remain a recorded asset of the Company.

10. Comprehensive Income

Comprehensive income includes the Company's net income plus the changes in the unrealized gains or losses (net of income taxes) on the Company's available-for-sale securities. Total comprehensive income was \$9.8 million and \$6.5 million for the three months ended June 30, 2007 and 2006, respectively and \$21.1 million and \$13.3 million for the six months ended June 30, 2007 and 2006, respectively.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This document, including information incorporated by reference, contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995). All statements, trend analyses and other information contained in this Form 10-Q relative to markets for our products and trends in our operations or financial results, as well as other statements including words such as may, target, anticipate, believe, plan, estimate, intend, project, and other similar expressions, constitute forward-looking statements. We made these statements based on our plans and current analyses of our business and the insurance industry as a whole. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Factors that could contribute to these differences include, among other things:

- general economic conditions and other factors, including prevailing interest rate levels and stock and credit market performance which may affect (among other things) our ability to sell our products, our ability to access capital resources and the costs associated with such access to capital and the market value of our investments;

- customer response to new products and marketing initiatives;

- tax law changes;

- increasing competition in the sale of our insurance products and services and the retention of existing customers;

- changes in legal environment;

- regulatory changes or actions, including those relating to regulation of the sale, underwriting and pricing of insurance products and services and capital requirements;

- levels of natural catastrophes, terrorist events, incidents of war and other major losses;

- adequacy of insurance reserves; and

- availability of reinsurance and ability of reinsurers to pay their obligations.

The forward-looking statements herein are made only as of the date of this report. We assume no obligation to publicly update any forward-looking statements.

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General

We underwrite and sell traditional and alternative risk transfer property and casualty insurance products to the passenger transportation industry and the trucking industry, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles, commercial vehicles and watercraft throughout the United States.

As of June 30, 2007, Great American Insurance Company (Great American) owned 53.1% of our outstanding common shares. Great American is a wholly-owned subsidiary of American Financial Group, Inc. We have four property and casualty insurance subsidiaries, National Interstate Insurance Company (NIIC), Hudson Indemnity, Ltd. (HIL), National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI) and Triumphe Casualty Company (TCC) and six other agency and service subsidiaries. NIIC is licensed in all 50 states and the District of Columbia. HIL is domiciled in the Cayman Islands and conducts insurance business outside the United States. We write our insurance policies on a direct basis through NIIC, NIIC-HI and TCC. We also assume a portion of premiums written by other affiliated companies whose passenger transportation insurance business we manage. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, affiliated agencies and agent internet initiatives. We use our six other agency and service subsidiaries to sell and service our insurance business.

Results of Operations

Overview

Through the operations of our subsidiaries, we are engaged in property and casualty insurance operations. We generate underwriting profits by providing specialized insurance products, services and programs not generally available in the marketplace. We focus on niche insurance markets where we offer insurance products designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry. We derive our revenues primarily from premiums generated by our insurance policies and income from our investment portfolio. Our expenses consist primarily of losses and loss adjustment expenses (LAE), commissions and other underwriting expenses, and other operating and general expenses.

Our net earnings for the second quarter of 2007 increased \$2.9 million, or 31.7%, to \$11.9 million or \$0.61 per share (diluted), compared to \$9.0 million or \$0.47 per share (diluted) for the second quarter of 2006. The increase in net earnings is attributable to the continued growth in earned premium of \$10.8 million and a reduction in the combined ratio of 1.0 percentage points, due to a slightly lower expense ratio experienced during the second quarter of 2007 compared to 2006. Also contributing to the growth in net earnings is an increase in net investment income of \$1.3 million and a reduction in our effective tax rate of 1.2 percentage points during the second quarter of 2007 compared to the same period in 2006.

Our net earnings for the first half of 2007 increased \$4.6 million, or 25.9%, to \$22.3 million or \$1.15 per share (diluted), compared to \$17.7 million or \$0.92 per share (diluted) for the first half of 2006. The increase in our net earnings is evidence of our continued solid underwriting results. Several factors contributed to the increase in net earnings, including a continued growth in earned premium of \$20.8 million, an increase in net investment income of \$2.6 million and the continued reduction in our effective tax rate of 2.0 percentage points during the first half of 2007 compared to the same period in 2006.

Table of Contents**Gross Premiums Written**

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following table sets forth an analysis of gross premiums written by business component during the periods indicated:

| | Three Months Ended June 30, | | 2006 | |
|---------------------------|-----------------------------|---------|-----------|---------|
| | 2007 | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Alternative Risk Transfer | \$ 33,721 | 41.2% | \$ 25,228 | 34.7% |
| Transportation | 25,238 | 30.8% | 24,741 | 34.0% |
| Specialty Personal Lines | 16,037 | 19.6% | 15,056 | 20.7% |
| Hawaii and Alaska | 5,933 | 7.2% | 5,921 | 8.1% |
| Other | 954 | 1.2% | 1,782 | 2.5% |
| Gross premiums written | \$ 81,883 | 100.00% | \$ 72,728 | 100.0% |

| | Six Months Ended June 30, | | 2006 | |
|---------------------------|---------------------------|---------|------------|---------|
| | 2007 | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Alternative Risk Transfer | \$ 110,431 | 54.4% | \$ 95,292 | 52.3% |
| Transportation | 47,113 | 23.2% | 43,260 | 23.7% |
| Specialty Personal Lines | 30,973 | 15.3% | 28,829 | 15.8% |
| Hawaii and Alaska | 12,087 | 6.0% | 11,664 | 6.4% |
| Other | 2,209 | 1.1% | 3,221 | 1.8% |
| Gross premiums written | \$ 202,813 | 100.0% | \$ 182,266 | 100.0% |

Gross premium written includes both direct premium and assumed premium. During the second quarter of 2007, as a percent of total gross premiums written, the alternative risk transfer component of the business had the largest dollar increase of \$8.5 million, or 33.7%, compared to the same period in 2006. The growth in this business component, which accounts for approximately 93% of the growth in our gross premiums written growth, is primarily attributable to growth from new captive programs launched in 2006 and new members in several of our group captive programs. For the six months ended June 30, 2007, the alternative risk transfer component increased \$15.1 million, or 15.9%, as compared to the same period in 2006. The growth in this component for the first half of 2007 is attributable to both the addition of new members to our existing group captive programs and the addition of a large transportation captive in the first quarter of 2007.

The group captive programs, which focus on specialty or niche insurance businesses, provide various services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with providing various types of property and casualty insurance coverage. Insurance coverage is provided primarily to associations or similar groups of members and to specified classes of business of our agent partners.

As part of our captive programs, we have analyzed, on a quarterly basis, captive members' loss performance on a policy year basis to determine if there would be a premium assessment to participants, or if there would be a return of premium to participants as a result of less than expected losses. Assessment premium and return of premium are recorded as adjustments to written premium (assessments increase written premium; returns of premium reduce

written premium). For the second quarter of 2007 and 2006, we recorded no return on premium and \$0.9 million return of premium, respectively. For the first half of 2007 and 2006, we recorded a return of premium of \$1.3 million and \$1.9 million, respectively.

In addition to the alternative risk transfer component, the transportation and specialty personal lines business components also contributed to the increase in gross premiums written in the first half of 2007. The transportation component had a \$3.9 million, or 8.9%, increase for the six months ended June 30, 2007 over the same period in 2006. The growth in this component is primarily due to an increase in the number of policies in force in our truck products. The specialty personal lines component increased \$2.1 million, or 7.4%, compared to the same period in 2006. The increase in the specialty personal lines component is primarily related to additional policies in force for the recreational vehicle product generated through new distribution channels. Offsetting the growth in gross premiums written during the first half of 2007 was a decrease in our Other component of \$1.0 million. Our Other component is mainly comprised of assigned risk policies that we receive from involuntary state insurance plans and over which we have no control.

Table of Contents**Premiums Earned**

Three months ended June 30, 2007 compared to June 30, 2006. The following table shows premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Three Months Ended June 30, | | Change | |
|---------------------------|--------------------------------|-----------|-----------|---------|
| | 2007 | 2006 | Amount | Percent |
| | (Dollars in thousands) | | | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$ 25,851 | \$ 17,354 | \$ 8,497 | 49.0% |
| Transportation | 18,651 | 17,800 | 851 | 4.8% |
| Specialty Personal Lines | 12,631 | 11,436 | 1,195 | 10.4% |
| Hawaii and Alaska | 4,189 | 4,017 | 172 | 4.3% |
| Other | 1,943 | 1,822 | 121 | 6.6% |
| Total premiums earned | \$ 63,265 | \$ 52,429 | \$ 10,836 | 20.7% |

Our net premiums earned increased \$10.8 million, or 20.7%, to \$63.3 million during the three months ended June 30, 2007 compared to \$52.4 million for the same period in 2006, primarily attributable to the alternative risk transfer component, which accounts for approximately 78% of the overall total premiums earned growth. The \$8.5 million increase in this component is mainly due to the addition of new captive programs the last half of 2006 and the addition of a large captive in the January of 2007, as well new participants in our existing group captive programs. Due to an increase in the number of policies in force primarily from expanded distribution, our specialty personal lines component increased \$1.2 million, or 10.4%, in the second quarter of 2007 compared to the same period in 2006. The transportation component increased \$0.9 million, or 4.8%, during the second quarter of 2007 over 2006 primarily due to an increase in the number of policies in force primarily from our truck products.

Six months ended June 30, 2007 compared to June 30, 2006. The following table shows premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Six Months Ended June 30, | | Change | |
|---------------------------|------------------------------|------------|-----------|---------|
| | 2007 | 2006 | Amount | Percent |
| | (Dollars in thousands) | | | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$ 49,696 | \$ 33,282 | \$ 16,414 | 49.3% |
| Transportation | 36,715 | 35,660 | 1,055 | 3.0% |
| Specialty Personal Lines | 24,734 | 22,264 | 2,470 | 11.1% |
| Hawaii and Alaska | 8,237 | 7,237 | 1,000 | 13.8% |
| Other | 4,173 | 4,301 | (128) | (3.0%) |
| Total premiums earned | \$ 123,555 | \$ 102,744 | \$ 20,811 | 20.3% |

Our net premiums earned increased \$20.8 million, or 20.3%, to \$123.6 million during the six months ended June 30, 2007 compared to \$102.7 million for the same period in 2006, primarily attributable to the alternative risk transfer component. Our alternative risk transfer component increased \$16.4 million, or 49.3%, during the first six months of 2007 compared to the same period in 2006, primarily due to new captive programs that were introduced in the last half of 2006, new participants in existing group captive programs and the addition of a large captive in January of 2007.

Due to an increase in the number of policies in force primarily from expanded distribution in 2006 and the first half of 2007, our specialty personal lines component increased \$2.5 million, or 11.1%, in the first six months of 2007 compared to the same period in 2006. The Hawaii and Alaska and transportation components increased \$1.0 million and \$1.1 million, respectively, both due to an increase in the number of policies in force during the first six months of 2007.

Underwriting and Loss Ratio Analysis

Underwriting profitability, as opposed to overall profitability or net earnings, is measured by the combined ratio. The combined ratio is the sum of the losses and LAE ratio and the underwriting expense ratio. A combined ratio under 100% is indicative of an underwriting profit. Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. For the three and six months ended June 30, 2007, we maintained relatively flat to slightly down rate levels on renewal business.

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The table below presents our net earned premiums and combined ratios for the periods indicated:

| | Three Months Ended June | | Six Months Ended June | |
|---|-------------------------|-----------|------------------------|------------|
| | 30, | 30, | 30, | 30, |
| | 2007 | 2006 | 2007 | 2006 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Gross premiums written | \$ 81,883 | \$ 72,728 | \$ 202,813 | \$ 182,266 |
| Ceded reinsurance | (15,349) | (13,206) | (49,051) | (43,337) |
| Net premiums written | 66,534 | 59,522 | 153,762 | 138,929 |
| Change in unearned premiums, net of ceded | (3,269) | (7,093) | (30,207) | (36,185) |
| Net premiums earned | \$ 63,265 | \$ 52,429 | \$ 123,555 | \$ 102,744 |
| Combined Ratios: | | | | |
| Loss and LAE ratio ⁽¹⁾ | 58.8% | 58.1% | 58.9% | 58.7% |
| Underwriting expense ratio ⁽²⁾ | 22.5% | 24.2% | 23.1% | 23.1% |
| Combined ratio | 81.3% | 82.3% | 82.0% | 81.8% |

(1) The ratio of losses and LAE to premiums earned.

(2) The ratio of the sum of commissions and other underwriting expenses, other operating expenses less other income to premiums earned.

Three months ended June 30, 2007 compared to June 30, 2006. Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to accurately estimate losses and LAE at the time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period. The loss and LAE ratio for the second quarter of 2007 increased 0.7 percentage points to 58.8% compared to 58.1% in the same period in 2006. There was a slight increase in loss severity in the second quarter of 2007 compared to the same period in 2006. These ratios include reductions for favorable development of losses from prior years of \$3.0 million, or 4.7 percentage points, and \$3.6 million, or 6.8 percentage points, respectively. The loss and LAE ratio is in a range consistent with prior year.

Our underwriting expense ratio includes commissions and other underwriting expenses and other operating and general expenses, offset by other income. Commissions and other underwriting expenses consist principally of

brokerage and agent commissions that represent a percentage of the premiums on insurance policies and reinsurance contracts written, and vary depending upon the amount and types of contracts written, and ceding commissions paid to ceding insurers and excise taxes. The underwriting expense ratio for the second quarter of 2007 decreased 1.7 points to 22.5% compared to 24.2% for the same period in 2006. The decrease in the underwriting expense ratio is primarily due to a lower commission expense incurred during the second quarter of 2007 compared to same period in 2006. *Six months ended June 30, 2007 compared to June 30, 2006.* The loss and LAE ratio for the six months ended June 30, 2007 remained relatively constant at 58.9% compared to 58.7% for the same period in 2006. These ratios include a reduction for favorable development of losses from prior years of \$4.6 million or 3.7 percentage points and \$2.1 million or 2.0 percentage points, in the first six months of 2007 and 2006, respectively. The loss ratio is in a range consistent with prior year. The underwriting expense ratio for the six months ended June 30, 2007 remained constant at 23.1% compared to the same period in 2006.

Investment Income

2007 compared to 2006. Net investment income increased \$1.3 million, or 30.6%, to \$5.6 million for the three months ended June 30, 2007 compared to \$4.3 million in the same period in 2006. For the six months ended June 30, 2007 compared to the same period in 2006, net investment income increased \$2.6 million, or 31.3%, to \$10.7 million. The increase is primarily related to a growth in average cash and invested assets over the prior year and a higher yield on the fixed income and short term investment portfolio. The growth in cash and invested assets is due to positive cash flow from operations and the reinvestment of earnings.

Table of Contents***Realized Gains on Investments***

2007 compared to 2006. Net realized gains were \$0.2 million for second quarter of 2007 compared to net realized gains of \$0.1 million for the second quarter of 2006. Net realized gains were \$0.3 million and \$0.5 million for first six months ending 2007 and 2006, respectively. Realized gains are taken when opportunities arise. The realized gains in 2007 and 2006 were primarily generated from sales of equity holdings. While designated as available for sale, we generally intend to hold our fixed maturities to maturity unless we identify an opportunity for economic gain. When evaluating sales opportunities, we do not have any specific thresholds that would cause us to sell these securities prior to maturity. We consider multiple factors, such as reinvestment alternatives and specific circumstances of the investment currently held. Credit quality, portfolio allocation and other-than-temporary impairment are other factors that may encourage us to sell a security prior to maturity at a gain or loss. Historically, we have not had the need to sell our investments to generate liquidity.

Other Income

2007 compared to 2006. Other income increased \$0.4 million or 77% to \$1.0 million for the second quarter of 2007 compared to \$0.5 million in 2006. For the six months ended June 30, 2007 and 2006, other income was \$1.8 million and \$1.0 million, respectively, representing a \$0.8 million, or 79%, increase. This increase is primarily attributable to increase rental income associated with two tenants who occupy a portion of the building we acquired in October 2006, which is adjacent to our corporate headquarters.

Commissions and Other Underwriting Expenses

2007 compared to 2006. Commissions and other underwriting expenses for the second quarter of 2007 increased \$1.2 million to \$11.1 million from \$9.9 million in the comparable period in 2006. For the six months ended June 30, 2007 and 2006, commissions and other underwriting expenses were \$22.5 million and \$18.7 million, respectively, increasing \$3.8 million, or 20.6%. Both the quarter and year to date increases are a direct result of our written premium growth.

Other Operating and General Expenses

2007 compared to 2006. For the three and six months ended June 30, 2007, other operating and general expenses were \$4.0 million and \$7.8 million, respectively, as compared to \$3.3 million and \$6.1 million in the 2006 periods. The \$0.7 million increase in other operating and general expenses during the second quarter of 2007 is primarily related to an increase in employee related expenses due to a higher personnel headcount during the second quarter of 2007 compared to 2006.

The \$1.7 million or 28.5% increase in other operating and general expenses during the six months ended June 30, 2007 as compared to the same period in 2006 was due to several employee related expenses, including an increase of \$0.6 million related to our annual bonuses paid in March 2007, a one-time stock bonus award of \$0.2 million and an increase in employee headcount.

In addition, a portion of the increase in the other operating and general expenses during both the three months and six months ended June 30, 2007 over 2006 is related to an increase in facilities expenses from office space that we lease to others; however, this increase is partially offset by an increase in rental income during the same period.

Income Taxes

2007 compared to 2006. The effective tax rate was 31.3% and 32.5% for the three-month period ended June 30, 2007 and 2006, respectively. The year-to-date effective tax rate was 31.3% in 2007 and 33.3% for the same period during 2006. The 2.0% decrease in the effective tax rate is primarily the result of the low tax rate on profits generated by Hudson Management Group, Ltd., our United States Virgin Island subsidiary.

Financial Condition***Investments***

At June 30, 2007, our investment portfolio contained \$344.0 million in fixed maturity securities and \$48.9 million in equity securities, all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At June 30, 2007, we had pretax net unrealized losses of \$6.6 million on fixed maturities and pretax net unrealized gains of \$0.2 million on equity securities.

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At June 30, 2007, 98.9% of the fixed maturities in our portfolio were rated investment grade (credit rating of AAA to BBB) by Standard & Poor's Corporation. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or non-investment grade.

Summary information for securities with unrealized gains or losses at June 30, 2007 follows:

| | Securities with Unrealized Gains (Dollars in thousands) | Securities with Unrealized Losses (Dollars in thousands) |
|---|--|---|
| Fixed Maturities: | | |
| Fair value of securities | \$40,758 | \$ 303,263 |
| Amortized cost of securities | \$40,237 | \$ 310,394 |
| Gross unrealized gain or (loss) | \$ 521 | \$ (7,131) |
| Fair value as a percent of amortized cost | 101.3% | 97.7% |
| Number of security positions held | 96 | 342 |
| Number individually exceeding \$50,000 gain or (loss) | 2 | 35 |
| Concentration of gains or losses by type or industry: | | |
| US Government and government agencies | \$ 131 | \$ (3,863) |
| State, municipalities, and political subdivisions | 58 | (1,037) |
| Banks, insurance, and brokers | 328 | (1,972) |
| Industrial and other | 4 | (259) |
| Percentage rated investment grade ⁽¹⁾ | 94.6% | 99.5% |
| Equity Securities: | | |
| Fair value of securities | \$28,469 | \$ 20,399 |
| Cost of securities | \$27,502 | \$ 21,171 |
| Gross unrealized gain or (loss) | \$ 967 | \$ (772) |
| Fair value as percent of cost | 103.5% | 96.4% |
| Number individually exceeding \$50,000 gain or (loss) | 6 | |

(1) Investment grade of AAA to BBB by Standard & Poor's Corporation.

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at June 30, 2007, based on their fair values. Asset-backed securities are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Securities with Unrealized Gains | Securities with Unrealized Losses |
|------------------------------------|---|--|
| Maturity: | | |
| One year or less | 11.6% | 9.4% |
| After one year through five years | 54.4% | 42.5% |
| After five years through ten years | 28.0% | 42.5% |
| After ten years | 6.0% | 5.6% |

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The table below summarizes the unrealized gains and losses on fixed maturities and equity securities by dollar amount:

| | June 30, 2007 | | Fair Value |
|---|-------------------------------|---|---------------------------|
| | Aggregate Fair Value | Aggregate Unrealized Gain (Loss) | as % of Cost Basis |
| | (Dollars in thousands) | | |
| Fixed Maturities: | | | |
| Securities with unrealized gains: | | | |
| Exceeding \$50,000 and for: | | | |
| Less than one year (2 issues) | \$ 1,600 | \$ 280 | 121.2% |
| More than one year (0 issues) | | | |
| Less than \$50,000 (94 issues) | 39,158 | 241 | 100.6% |
| | \$ 40,758 | \$ 521 | |
| Securities with unrealized losses: | | | |
| Exceeding \$50,000 and for: | | | |
| Less than one year (17 issues) | \$ 30,867 | \$ (1,093) | 96.6% |
| More than one year (18 issues) | 32,240 | (3,006) | 91.5% |
| Less than \$50,000 (307 issues) | 240,156 | (3,032) | 98.8% |
| | \$ 303,263 | \$ (7,131) | |
| Equity Securities: | | | |
| Securities with unrealized gains: | | | |
| Exceeding \$50,000 and for: | | | |
| Less than one year (6 issues) | \$ 7,003 | \$ 506 | 107.8% |
| More than one year (0 issues) | | | |
| Less than \$50,000 (43 issues) | 21,466 | 461 | 102.2% |
| | \$ 28,469 | \$ 967 | |
| Securities with unrealized losses: | | | |
| Exceeding \$50,000 and for: | | | |
| Less than one year (0 issues) | \$ | \$ | |
| More than one year (0 issues) | | | |
| Less than \$50,000 (56 issues) | 20,399 | (772) | 96.4% |
| | \$ 20,399 | \$ (772) | |

When a decline in the value of a specific investment is considered to be other than temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are other than temporary requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include those discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Other-Than-Temporary Impairment.

Premiums and Reinsurance

In the alternative risk transfer component, under most captive programs, all members of the group share a common renewal date. These common renewal dates are scheduled throughout the year. However, we have several large captives that renew during the first six months of a given fiscal year, including a new passenger transportation group captive that was added in the first quarter of 2007. The captive renewals in the first six months result in a large increase in premiums receivable, unearned premiums, prepaid reinsurance premiums and reinsurance balances payable during the first six months of a given fiscal year.

Premiums receivable increased \$42.6 million, or 55.3%, from December 31, 2006 to June 30, 2007 and unearned premiums increased \$45.9 million, or 36.0%, from December 31, 2006 to June 30, 2007. The increase in premiums receivable and unearned premiums is primarily due to an increase in direct written premiums in our alternative risk transfer component; these increases gradually decrease throughout the year.

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Prepaid reinsurance premiums increased \$15.5 million, or 72.9%, from December 31, 2006 to June 30, 2007 and reinsurance balances payable increased \$9.3 million, or 130.4%, from December 31, 2006 to June 30, 2007. The increase in prepaid reinsurance premiums and reinsurance balances payable is primarily due to an increase in ceded written premiums in the alternative risk transfer component.

Liquidity and Capital Resources

The liquidity requirements of our insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and payments of dividends and taxes to us from insurance subsidiaries. Historically and during the first six months of 2007, cash flows from underwriting, investments and maturing investments have provided more than sufficient funds to meet these requirements without requiring the sale of investments. If our cash flows change dramatically from historical patterns, for example as a result of a decrease in premiums or an increase in claims paid or operating expenses, we may be required to sell securities before their maturity and possibly at a loss. Our insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments to meet their liquidity needs. Funds received in excess of cash requirements are generally invested in additional marketable securities. Our historic pattern of using receipts from current premium writings for the payment of liabilities incurred in prior periods has enabled us to extend slightly the maturities of our investment portfolio beyond the estimated settlement date of our loss reserves.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

Our principal sources of liquidity are our existing cash, cash equivalents and short-term investments. Cash, cash equivalents and short-term investments were consistent as of June 30, 2007 and December 31, 2006 at \$47.3 million and \$44.9 million, respectively.

Net cash provided by operating activities was \$38.0 million during the six-month period ended June 30, 2007 compared to \$40.7 million during the comparable period in 2006. This decrease of \$2.7 million is attributable to various fluctuations within our operating activities, the primary drivers being an increase in reinsurance recoverables associated with the increase in premium and a decrease in unearned premium due to timing of our premium writings. Net cash used in investing activities was \$34.8 million and \$35.8 million for the six months ended June 30, 2007 and 2006, respectively. The \$1.0 million decrease in cash used in investing activities was primarily related to a \$47.2 million increase in the purchase of investments in the first quarter of 2007, offset by a \$53.1 million increase in the proceeds from sales and maturities of investments as compared to the same period in 2006. Also increasing the cash used in investing activities in the first six months of 2006 was an additional payment of \$1.2 million made on January 3, 2006 for the remaining balance of the purchase price associated with the acquisition of TCC. As part of this acquisition in 2006, we acquired \$5.6 million in cash and cash equivalents.

We utilized net cash from financing activities of \$1.4 million and \$1.3 million, respectively, for the six months ended June 30, 2007 and 2006. Our financing activities primarily include those related to stock option activity and dividends paid on our common shares. There have been no material changes to the cash used in financing activities during the six months ended June 30, 2007 compared to the same period in 2006.

We will have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends and taxes. Funds to meet these obligations will come primarily from parent company cash, dividend and other payments from our insurance company subsidiaries and from our line of credit.

In 2003, we purchased the outstanding common equity of a business trust that issued mandatorily redeemable preferred capital securities. The trust used the proceeds from the issuance of its capital securities and common equity to buy \$15.5 million of debentures issued by us. These debentures are the trust's only assets and mature in 2033. The interest rate is equal to the three-month LIBOR, which is determined during the respective quarter, plus 420 basis points with interest payments due quarterly. The selected three-month LIBOR rate at June 30, 2007 and December 31, 2006 was 5.36% and 5.37%, respectively. Payments from the debentures finance the distributions paid on the capital securities. We have the right to redeem the debentures, in whole or in part, on or after May 23, 2008.

We also have a \$2.0 million line of credit (unused at June 30, 2007) that bears interest at the lending institution's prime rate (8.25% at June 30, 2007 and December 31, 2006) less 50 basis points. In accordance with the terms of the line of

credit agreement, interest payments are due monthly and the principal balance is due upon demand. The line of credit renews annually on September 1st of a given year. The line of credit is available currently, and has been used in the past, for general corporate purposes, including the capitalization of our insurance company subsidiaries in order to support the growth of their written premiums.

We believe that funds generated from operations, including dividends from insurance subsidiaries, parent company cash and funds available under our line of credit will provide sufficient resources to meet our liquidity requirements for at least the next 12 months.

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However, if these funds are insufficient to meet fixed charges in any period, we would be required to generate cash through additional borrowings, sale of assets, sale of portfolio securities or similar transactions. If we were required to sell portfolio securities early for liquidity purposes rather than holding them to maturity, we would recognize gains or losses on those securities earlier than anticipated. If we were forced to borrow additional funds in order to meet liquidity needs, we would incur additional interest expense, which could have a negative impact on our earnings. Since our ability to meet our obligations in the long term (beyond a 12-month period) is dependent upon factors such as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our operating needs.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of losses and loss adjustment expense reserves and the determination of other-than-temporary impairment on investments are the two areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical. For a more detailed discussion of these policies, see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2006.

Losses and Loss Adjustment Expense Reserves

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of that loss to us and our final payment of that loss, and its related LAE. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. At June 30, 2007 and December 31, 2006, we had \$299.7 million and \$266.0 million, respectively, of gross loss and LAE reserves, representing management's best estimate of the ultimate loss. Management records on a monthly and quarterly basis its best estimate of loss reserves. For purposes of computing the recorded reserves, management utilizes various data inputs, including analysis that is derived from a review of prior quarter results performed by actuaries employed by Great American. In addition, on an annual basis, actuaries from Great American review the recorded reserves for NIIC, NIIC-HI and TCC utilizing current period data and provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by these U.S. insurance subsidiaries. The actuarial analysis of NIIC's, NIIC-HI's and TCC's net reserves for the year ending December 31, 2006 reflected point estimates that were within 1% of management's recorded net reserves as of such date. Using this actuarial data along with its other data inputs, management concluded that the recorded reserves appropriately reflect management's best estimates of the liability as of June 30, 2007 and December 31, 2006.

The quarterly reviews of unpaid loss and LAE reserves by Great American actuaries are prepared using standard actuarial techniques. These may include (but may not be limited to):

the Case Incurred Development Method;

the Paid Development Method;

the Bornhuetter-Ferguson Method; and

the Incremental Paid LAE to Paid Loss Methods.

The period of time from the occurrence of a loss through the settlement of the liability is referred to as the tail. Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to settle particular claims. For short-tail lines, management tends to give more weight to the Case Incurred and Paid Development methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved, and more weight may be given to the Bornhuetter-Ferguson method. Liability claims for long-tail lines are more susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to

a higher degree of variability.

Supplementary statistical information is reviewed to determine which methods are most appropriate and whether adjustments are needed to particular methods. This information includes:

open and closed claim counts;

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average case reserves and average incurred on open claims;

closure rates and statistics related to closed and open claim percentages;

average closed claim severity;

ultimate claim severity;

reported loss ratios;

projected ultimate loss ratios; and

loss payment patterns.

Other-Than-Temporary Impairment

Our principal investments are in fixed maturities, all of which are exposed to at least one of three primary sources of investment risk: credit, interest rate and market valuation risks. The financial statement risks are those associated with the recognition of impairments and income, as well as the determination of fair values. Recognition of income ceases when a bond goes into default. We evaluate whether other-than-temporary impairments have occurred on a case-by-case basis. Management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause and amount of decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations we use in the impairment evaluation process include, but are not limited to:

the length of time and the extent to which the market value has been below amortized cost;

whether the issuer is experiencing significant financial difficulties;

economic stability of an entire industry sector or subsection;

whether the issuer, series of issuers or industry has a catastrophic type of loss;

the extent to which the unrealized loss is credit-driven or a result of changes in market interest rates;

historical operating, balance sheet and cash flow data;

internally generated financial models and forecasts;

our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value; and

other subjective factors, including concentrations and information obtained from regulators and rating agencies.

When an investment is determined to have other-than-temporary impairment, in most cases we will dispose of the investment. This approach allows us to realize the loss for tax purposes and to reinvest the proceeds in what we view as more productive investments. For those investments we choose to retain, we record an adjustment for impairment. We recorded a \$0.1 million impairment adjustment for the six months ended June 30, 2007 and no impairment adjustments in the first half of 2006. Because total unrealized losses are a component of shareholders' equity, any recognition of other-than-temporary impairment losses has no effect on our comprehensive income or consolidated financial position. See Management's Discussions and Analysis of Financial Condition and Results of Operations Investments.

Contractual Obligations/Off-Balance Sheet Arrangements

During the first half of 2007, our contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2006.

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We do not currently have any relationships with unconsolidated entities of financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

As of June 30, 2007, there were no material changes to the information provided in our Annual Report on Form 10-K for the year ended December 31, 2006 under Item 7A Quantitative and Qualitative Disclosures About Market Risk.

ITEM 4. Controls and Procedures

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Our management, with participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of June 30, 2007. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2007 in alerting them on a timely basis to material information relating to the Company (including our consolidated subsidiaries) required to be included in our periodic filings under the Exchange Act.

There have been no significant changes in our internal controls over financial reporting or in other factors that have occurred during the fiscal quarter ended June 30, 2007 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

On August 3, 2007 we were informed that the jury in a case pending in the Superior Court of the State of California for the County of Los Angeles, had issued, on August 2, 2007, a special verdict adverse to our interests in a pending lawsuit with one of our insurance companies. This special verdict is advisory in nature, so a formal judgment must still be entered by the court. Although the judge will likely render a judgment sometime in the near future, we do not have any certainty of timing. The current estimated net exposure to us for this anticipated judgment approximates \$9.0 million. However, we believe that we have a strong appellate case and strategy, and intend to vigorously pursue the appellate process. Upon appeal, we believe the matter will be resolved in a manner that will not have a material adverse effect on our consolidated financial position, results of operations or cash flows. As of June 30, 2007, we had not established a case reserve for this claim but have and will continue to closely monitor this case with counsel. We have consistently established litigation expense reserves to account for the cost to vigorously defend our position which we will continue to reserve for throughout the appeal process.

There are no other material changes from the legal proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2006, other than the case noted in the preceding paragraph. For more information regarding such legal matters please refer to Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2006, Note 15 to the Consolidated Financial Statements included therein and Note 6 to the Consolidated Financial Statements contained in this quarterly report.

ITEM 1A. Risk Factors.

There are no material changes to the risk factors previously reported in our Annual Report on Form 10-K for the year ended December 31, 2006. For more information regarding such risk factors, please refer to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 3. Defaults Upon Senior Securities

None.

Table of Contents**ITEM 4. Submission of Matters to a Vote of Security Holders**

Our Annual Meeting of Shareholders was held on May 18, 2007. There were two proposals voted upon: Proposal No. 1, election of four directors and Proposal No. 2, ratifying the appointment of Ernst & Young LLP as our independent registered public accounting firm.

The votes cast for, against, withheld and the number of abstentions as to each matter voted upon at the 2007 Annual Meeting is set forth below:

| Name | Term Expires | For | Against | Withheld | Abstain | Broker Non-Votes |
|--------------------------|---------------------|------------|----------------|-----------------|----------------|-------------------------|
| Proposal 1: | | | | | | |
| Joseph E. Consolino | 2009 | 18,338,739 | N/A | 599,816 | N/A | N/A |
| Theodore H. Elliott, Jr. | 2009 | 18,300,317 | N/A | 638,238 | N/A | N/A |
| Gary J. Gruber | 2009 | 16,621,930 | N/A | 2,316,625 | N/A | N/A |
| Donald D. Larson | 2009 | 16,622,230 | N/A | 2,316,325 | N/A | N/A |
| Proposal 2 | | 18,885,078 | 46,793 | N/A | 6,684 | N/A |

N/A Not Applicable

The following are the directors whose terms continued after the meeting:

| Name | Term Expires |
|------------------|---------------------|
| Keith A. Jensen | 2008 |
| James C. Kennedy | 2008 |
| Joel Schiavone | 2008 |
| Alan R. Spachman | 2008 |

ITEM 5. Other Information

None.

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ITEM 6. Exhibits

| Exhibit No. | Exhibit Description |
|--------------------|--|
| 3.1 | Amended and Restated Articles of Incorporation (1) |
| 3.2 | Amended and Restated Code of Regulations (1) |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(1) These exhibits are incorporated by reference to our Registration Statement on Form S-1, as amended (Registration No. 333-119270) filed on November 12, 2004.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL INTERSTATE
CORPORATION

Date: August 7, 2007

/s/ Alan R. Spachman
Alan R. Spachman
Chairman of the Board and Chief
Executive Officer
(Duly Authorized Officer and Principal
Executive Officer)

Date: August 7, 2007

/s/ Julie A. McGraw
Julie A. McGraw
Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal
Financial Officer)