

RLI CORP  
Form 10-Q  
July 28, 2014

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2014

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-09463

**RLI Corp.**

(Exact name of registrant as specified in its charter)

Edgar Filing: RLI CORP - Form 10-Q

**ILLINOIS**

(State or other jurisdiction of  
incorporation or organization)

**37-0889946**

(I.R.S. Employer  
Identification Number)

**9025 North Lindbergh Drive, Peoria, IL**

(Address of principal executive offices)

**61615**

(Zip Code)

**(309) 692-1000**

(Registrant's telephone number, including area code)

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 or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

As of July 11, 2014, the number of shares outstanding of the registrant's Common Stock was 43,023,504.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## RLI Corp. and Subsidiaries

## Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	For the Three-Month Periods Ended June 30,	
	2014	2013
Net premiums earned	\$ 168,604	\$ 154,553
Net investment income	13,982	12,847
Net realized investment gains	10,431	3,742
Consolidated revenue	\$ 193,017	\$ 171,142
Losses and settlement expenses	73,345	65,607
Policy acquisition costs	55,156	51,502
Insurance operating expenses	13,534	11,885
Interest expense on debt	1,874	1,513
General corporate expenses	2,549	1,692
Total expenses	\$ 146,458	\$ 132,199
Equity in earnings of unconsolidated investees	5,864	4,633
Earnings before income taxes	\$ 52,423	\$ 43,576
Income tax expense	16,698	13,674
Net earnings	\$ 35,725	\$ 29,902
Other comprehensive earnings (loss), net of tax	19,934	(33,481)
Comprehensive earnings (loss)	\$ 55,659	\$ (3,579)
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 0.83	\$ 0.70
Basic comprehensive earnings (loss) per share	\$ 1.29	\$ (0.08)
Diluted:		
Diluted net earnings per share	\$ 0.82	\$ 0.69
Diluted comprehensive earnings (loss) per share	\$ 1.27	\$ (0.08)
Weighted average number of common shares outstanding		
Basic	43,001	42,628
Diluted	43,688	43,341
Cash dividends paid per common share	\$ 0.18	\$ 0.17

See accompanying notes to the unaudited condensed consolidated interim financial statements.



Edgar Filing: RLI CORP - Form 10-Q

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	For the Six-Month Periods Ended June 30,	
	2014	2013
Net premiums earned	\$ 329,736	\$ 298,704
Net investment income	27,564	25,733
Net realized investment gains	16,932	7,426
Consolidated revenue	\$ 374,232	\$ 331,863
Losses and settlement expenses	144,361	127,055
Policy acquisition costs	110,207	101,838
Insurance operating expenses	26,067	24,454
Interest expense on debt	3,725	3,025
General corporate expenses	4,747	4,078
Total expenses	\$ 289,107	\$ 260,450
Equity in earnings of unconsolidated investees	9,289	8,132
Earnings before income taxes	\$ 94,414	\$ 79,545
Income tax expense	29,720	24,796
Net earnings	\$ 64,694	\$ 54,749
Other comprehensive earnings (loss), net of tax	37,671	(15,928)
Comprehensive earnings	\$ 102,365	\$ 38,821
Earnings per share:		
Basic:		
Basic net earnings per share	\$ 1.50	\$ 1.29
Basic comprehensive earnings per share	\$ 2.38	\$ 0.91
Diluted:		
Diluted net earnings per share	\$ 1.48	\$ 1.27
Diluted comprehensive earnings per share	\$ 2.34	\$ 0.90
Weighted average number of common shares outstanding		
Basic	42,993	42,587
Diluted	43,669	43,268
Cash dividends paid per common share	\$ 0.35	\$ 0.33

See accompanying notes to the unaudited condensed consolidated interim financial statements.

Edgar Filing: RLI CORP - Form 10-Q

RLI Corp. and Subsidiaries

Condensed Consolidated Balance Sheets

(Unaudited)

(in thousands, except share data)	June 30, 2014	December 31, 2013
<b>ASSETS</b>		
Investments		
Fixed income		
Available-for-sale, at fair value	\$ 1,534,622	\$ 1,440,052
Held-to-maturity, at amortized cost	650	651
Equity securities, at fair value	436,462	418,654
Short-term investments, at cost	18,489	23,232
Cash	27,234	39,469
Total investments and cash	\$ 2,017,457	\$ 1,922,058
Accrued investment income	15,229	15,710
Premiums and reinsurance balances receivable	203,499	152,509
Ceded unearned premium	72,396	60,407
Reinsurance balances recoverable on unpaid losses	339,104	354,924
Deferred policy acquisition costs	68,190	61,508
Property and equipment	42,935	40,261
Investment in unconsolidated investees	64,487	49,793
Goodwill and intangibles	74,407	74,876
Other assets	11,292	8,264
<b>TOTAL ASSETS</b>	<b>\$ 2,908,996</b>	<b>\$ 2,740,310</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Unpaid losses and settlement expenses	\$ 1,127,073	\$ 1,129,433
Unearned premiums	444,453	392,081
Reinsurance balances payable	62,402	47,334
Funds held	59,398	61,656
Income taxes-deferred	81,963	57,801
Bonds payable, long-term debt	149,604	149,582
Accrued expenses	40,199	59,596
Other liabilities	24,509	13,861
<b>TOTAL LIABILITIES</b>	<b>\$ 1,989,601</b>	<b>\$ 1,911,344</b>
Shareholders Equity		
Common stock (\$1 par value, 100,000,000 shares authorized) (65,953,718 shares issued, 43,023,504 shares outstanding at 6/30/14) (65,912,638 shares issued, 42,982,424 shares outstanding at 12/31/13)	\$ 65,954	\$ 65,913
Paid-in capital	211,774	208,705
Accumulated other comprehensive earnings	173,698	136,027
Retained earnings	860,968	811,320
Deferred compensation	11,626	11,562
Less: Treasury shares at cost (22,930,214 shares at 6/30/14 and 12/31/13)	(404,625)	(404,561)
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>\$ 919,395</b>	<b>\$ 828,966</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 2,908,996</b>	<b>\$ 2,740,310</b>

See accompanying notes to the unaudited condensed consolidated interim financial statements.



## RLI Corp. and Subsidiaries

## Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	For the Six-Month Periods Ended June 30,	
	2014	2013
Net cash provided by operating activities	\$ 38,528	\$ 26,781
Cash Flows from Investing Activities		
Investments purchased	\$ (311,402)	\$ (295,508)
Investments sold	217,403	145,314
Investments called or matured	49,932	77,436
Net change in short-term investments	15,462	33,134
Net property and equipment purchased	(4,921)	(8,167)
Investment in equity method investee	(5,301)	
Net cash used in investing activities	\$ (38,827)	\$ (47,791)
Cash Flows from Financing Activities		
Cash dividends paid	\$ (15,046)	\$ (14,062)
Stock plan share issuance	2,760	1,545
Excess tax benefit from exercise of stock options	350	1,970
Net cash used in financing activities	\$ (11,936)	\$ (10,547)
Net decrease in cash	\$ (12,235)	\$ (31,557)
Cash at the beginning of the period	\$ 39,469	\$ 44,314
Cash at June 30	\$ 27,234	\$ 12,757

See accompanying notes to the unaudited condensed consolidated interim financial statements.



**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. BASIS OF PRESENTATION**

The unaudited condensed consolidated interim financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2013 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at June 30, 2014 and the results of operations of RLI Corp. and subsidiaries for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

The preparation of the unaudited condensed consolidated interim financial statements requires management to make estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated interim financial statements, and the reported amounts of revenue and expenses during the period. These estimates are inherently subject to change and actual results could differ significantly from these estimates.

**B. ADOPTED ACCOUNTING STANDARDS**

We have not adopted any new accounting standards as there have been no accounting standard updates which would impact our financial statements.

**C. PROSPECTIVE ACCOUNTING STANDARDS**

There are no prospective accounting standards which would impact our financial statements as of June 30, 2014.

**D. INTANGIBLE ASSETS**

In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and intangibles totaled \$74.4 million at June 30, 2014.

Goodwill resulting from acquisitions completed prior to 2011 totaled \$26.2 million and is attributable to our surety segment. Goodwill and intangible assets resulting from the Contractors Bonding and Insurance Company (CBIC) acquisition in April 2011 totaled \$32.2 million. The CBIC-related assets include goodwill attributable to our casualty and surety segments of \$5.3 million and \$15.1 million, respectively, and an indefinite-lived intangible asset in the amount of \$8.8 million. Annual impairment testing was performed on each of these goodwill and indefinite-lived intangible assets during the

## Edgar Filing: RLI CORP - Form 10-Q

second quarter of 2014. Based upon these reviews, none of the assets were impaired. In addition, as of June 30, 2014, there were no triggering events that occurred that would suggest an updated review was necessary. Definite-lived intangible assets related to the CBIC acquisition totaled \$3.0 million, net of amortization, as of June 30, 2014.

The remaining \$16.0 million of goodwill and intangibles relates to our purchase of Rockbridge Underwriting Agency (Rockbridge) in November 2012. Of this amount, \$12.4 million is recorded as goodwill attributable to our casualty segment. The remaining \$3.6 million relates to definite-lived intangible assets, net of amortization, as of June 30, 2014. Annual impairment testing was performed on this goodwill asset in the fourth quarter of 2013. Based upon this review, the asset was not impaired. In addition, as of June 30, 2014, there were no triggering events that occurred that would suggest an updated review was necessary.

The aforementioned definite-lived intangible assets are amortized against future operating results based on their estimated useful lives. Amortization of intangible assets resulting from the acquisitions of CBIC and Rockbridge was \$0.3 for the second quarter of 2014, and \$0.5 million for the six months ended June 30, 2014.

### E. EARNINGS PER SHARE

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is anti-dilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents.

The following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the unaudited condensed consolidated interim financial statements.

(in thousands, except per share data)	For the Three-Month Period Ended June 30, 2014			For the Three-Month Period Ended June 30, 2013		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic EPS</b>						
Income available to common shareholders	\$ 35,725	43,001	\$ 0.83	\$ 29,902	42,628	\$ 0.70
<b>Effect of Dilutive Securities</b>						
Stock options		687			713	
<b>Diluted EPS</b>						
Income available to common shareholders	\$ 35,725	43,688	\$ 0.82	\$ 29,902	43,341	\$ 0.69

Edgar Filing: RLI CORP - Form 10-Q

(in thousands, except per share data)	For the Six-Month Period Ended June 30, 2014			For the Six-Month Period Ended June 30, 2013		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic EPS</b>						
Income available to common shareholders	\$ 64,694	42,993	\$ 1.50	\$ 54,749	42,587	\$ 1.29
<b>Effect of Dilutive Securities</b>						
Stock options		676			681	
<b>Diluted EPS</b>						
Income available to common shareholders	\$ 64,694	43,669	\$ 1.48	\$ 54,749	43,268	\$ 1.27

F. COMPREHENSIVE EARNINGS

Our comprehensive earnings include net earnings plus unrealized gains/losses on our available-for-sale investment securities, net of tax. In reporting comprehensive earnings on a net basis in the statement of earnings, we used the federal statutory tax rate of 35 percent. The following table illustrates the changes in the balance of each component of accumulated other comprehensive earnings for each period presented in the unaudited condensed consolidated interim financial statements.

(in thousands)	For the Three-Month Periods Ended June 30,		For the Six - Month Periods Ended June 30,	
	2014	2013	2014	2013
<b>Unrealized Gains/Losses on Available-for-Sale Securities</b>				
Beginning balance	\$ 153,764	\$ 160,723	\$ 136,027	\$ 143,170
Other comprehensive earnings before reclassifications	26,714	(30,824)	48,674	(10,557)
Amounts reclassified from accumulated other comprehensive earnings	(6,780)	(2,657)	(11,003)	(5,371)
Net current-period other comprehensive earnings	\$ 19,934	\$ (33,481)	\$ 37,671	\$ (15,928)
Ending balance	\$ 173,698	\$ 127,242	\$ 173,698	\$ 127,242

The sale or other-than-temporary impairment of an available-for-sale security results in amounts being reclassified from accumulated other comprehensive earnings to current period net earnings. The effects of reclassifications out of accumulated other comprehensive earnings by the respective line items of net earnings are presented in the following table.

Edgar Filing: RLI CORP - Form 10-Q

(in thousands) Component of Accumulated Other Comprehensive Earnings	Amount Reclassified from Accumulated Other Comprehensive Earnings				Affected line item in the Statement of Earnings
	For the Three-Month Periods Ended June 30, 2014		For the Six-Month Periods Ended June 30, 2013		
Unrealized gains and losses on available-for-sale securities	\$ 10,431	\$ 4,087	\$ 16,928	\$ 8,263	Net realized investment gains Other-than-temporary impairment (OTTI) losses on investments
	\$ 10,431	\$ 4,087	\$ 16,928	\$ 8,263	Earnings before income taxes
	(3,651)	(1,430)	(5,925)	(2,892)	Income tax expense
	\$ 6,780	\$ 2,657	\$ 11,003	\$ 5,371	Net earnings

## 2. INVESTMENTS

Our investments include fixed income debt securities and common stock equity securities. As disclosed in our 2013 Annual Report on Form 10-K, we present our investments in these classes as available-for-sale and held-to-maturity. When available, we obtain quoted market prices to determine fair value for our investments. If a quoted market price is not available, fair value is estimated using a secondary pricing source or using quoted market prices of similar securities. We have no investment securities for which fair value is determined using Level 3 inputs as defined in note 3 to the unaudited condensed consolidated interim financial statements, Fair Value Measurements.

The following tables show the amortized cost, unrealized gains/losses, fair value and contractual maturities for our available-for-sale and held-to-maturity securities.

### *Available-for-Sale Securities*

The amortized cost and fair value of available-for-sale securities at June 30, 2014 and December 31, 2013 were as follows:

### Available-for-sale

(in thousands)

Asset Class	Cost or Amortized Cost	6/30/2014		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
U.S. agency	\$ 3,883	\$ 99	\$ (1)	\$ 3,981
Corporate	550,687	28,919	(797)	578,809
Mtge/ABS/CMBS*	375,116	11,242	(2,918)	383,440
Non-U.S. govt. & agency	13,853	1,064		14,917
U.S. government	31,571	168	(10)	31,729

Edgar Filing: RLI CORP - Form 10-Q

Municipal		510,516		13,111		(1,881)		521,746
<b>Total Fixed Income</b>	<b>\$</b>	<b>1,485,626</b>	<b>\$</b>	<b>54,603</b>	<b>\$</b>	<b>(5,607)</b>	<b>\$</b>	<b>1,534,622</b>
<b>Equity</b>	<b>\$</b>	<b>218,797</b>	<b>\$</b>	<b>217,731</b>	<b>\$</b>	<b>(66)</b>	<b>\$</b>	<b>436,462</b>

**Available-for-sale**

(in thousands)

Asset Class	12/31/2013			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. agency	\$ 10,513	\$ 22	\$ (237)	\$ 10,298
Corporate	511,748	22,302	(8,012)	526,038
Mtge/ABS/CMBS*	350,187	8,188	(7,650)	350,725
Non-U.S. govt. & agency	13,306	437	(65)	13,678
U.S. government	17,086	217		17,303
Municipal	528,209	6,495	(12,694)	522,010
<b>Total Fixed Income</b>	<b>\$ 1,431,049</b>	<b>\$ 37,661</b>	<b>\$ (28,658)</b>	<b>\$ 1,440,052</b>
<b>Equity</b>	<b>\$ 218,848</b>	<b>\$ 200,081</b>	<b>\$ (275)</b>	<b>\$ 418,654</b>

---

\*Mortgage-backed, asset-backed and commercial mortgage-backed

The following table presents the amortized cost and fair value of available-for-sale debt securities by contractual maturity dates as of June 30, 2014:

AFS (in thousands)	6/30/2014	
	Amortized Cost	Fair Value
Due in one year or less	\$ 11,557	\$ 11,628
Due after one year through five years	211,437	221,664
Due after five years through 10 years	618,409	642,994
Due after 10 years	269,107	274,896
Mtge/ABS/CMBS*	375,116	383,440
Total available-for-sale	\$ 1,485,626	\$ 1,534,622

---

\*Mortgage-backed, asset-backed & commercial mortgage-backed

*Held-to-Maturity Debt Securities*

The carrying value and fair value of held-to-maturity securities was \$0.7 million at June 30, 2014 and December 31, 2013. Held-to-maturity securities are carried on the unaudited condensed consolidated balance sheets at amortized cost and changes in the fair value of these securities, other than impairment charges, are not reported on the financial statements. Unrecognized gains on our held-to-maturity securities were less than \$0.1 million at June 30, 2014 and December 31, 2013. As of June 30, 2014, the carrying value and fair value of all debt securities held-to-maturity had a contractual maturity date of one year or less.

*Unrealized Losses*

We conduct and document periodic reviews of all securities with unrealized losses to evaluate whether the impairment is other-than-temporary. The following tables are used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of June 30, 2014 and December 31, 2013. The tables segregate the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position. As of June 30, 2014 unrealized losses, as shown in the following tables, were 0.3 percent of total invested assets. Unrealized



Edgar Filing: RLI CORP - Form 10-Q

losses decreased in 2014, as interest rates declined during the first half of the year.

(in thousands)	June 30, 2014			December 31, 2013		
	< 12 Mos.	12 Mos. & Greater	Total	< 12 Mos.	12 Mos. & Greater	Total
<b>U.S. Government</b>						
Fair value	\$ 4,423	\$	\$ 4,423	\$	\$	\$
Cost or amortized cost	4,433		4,433			
Unrealized Loss	\$ (10)	\$	\$ (10)	\$	\$	\$
<b>U.S. Agency</b>						
Fair value	\$ 1,883	\$	\$ 1,883	\$ 5,760	\$	\$ 5,760
Cost or amortized cost	1,884		1,884	5,997		5,997
Unrealized Loss	\$ (1)	\$	\$ (1)	\$ (237)	\$	\$ (237)
<b>Non-U.S. Government</b>						
Fair value	\$	\$	\$	\$ 1,825	\$	\$ 1,825
Cost or amortized cost				1,890		1,890
Unrealized Loss	\$	\$	\$	\$ (65)	\$	\$ (65)
<b>Mortgage-backed</b>						
Fair value	\$ 7,349	\$ 79,004	\$ 86,353	\$ 118,283	\$	\$ 118,283
Cost or amortized cost	7,392	81,396	88,788	124,034		124,034
Unrealized Loss	\$ (43)	\$ (2,392)	\$ (2,435)	\$ (5,751)	\$	\$ (5,751)
<b>ABS/CMBS*</b>						
Fair value	\$ 16,557	\$ 16,457	\$ 33,014	\$ 54,115	\$	\$ 54,115
Cost or amortized cost	16,659	16,838	33,497	56,014		56,014
Unrealized Loss	\$ (102)	\$ (381)	\$ (483)	\$ (1,899)	\$	\$ (1,899)
<b>Corporate</b>						
Fair value	\$ 51,213	\$ 32,233	\$ 83,446	\$ 190,470	\$ 2,245	\$ 192,715
Cost or amortized cost	51,414	32,829	84,243	198,250	2,477	200,727
Unrealized Loss	\$ (201)	\$ (596)	\$ (797)	\$ (7,780)	\$ (232)	\$ (8,012)
<b>Municipal</b>						
Fair value	\$ 22,079	\$ 117,639	\$ 139,718	\$ 309,407	\$ 943	\$ 310,350
Cost or amortized cost	22,132	119,467	141,599	322,095	949	323,044
Unrealized Loss	\$ (53)	\$ (1,828)	\$ (1,881)	\$ (12,688)	\$ (6)	\$ (12,694)
<b>Subtotal, fixed income</b>						
Fair value	\$ 103,504	\$ 245,333	\$ 348,837	\$ 679,860	\$ 3,188	\$ 683,048
Cost or amortized cost	103,914	250,530	354,444	708,280	3,426	711,706
Unrealized Loss	\$ (410)	\$ (5,197)	\$ (5,607)	\$ (28,420)	\$ (238)	\$ (28,658)
<b>Equity securities</b>						
Fair value	\$ 9,372	\$	\$ 9,372	\$ 2,394	\$	\$ 2,394
Cost or amortized cost	9,438		9,438	2,669		2,669
Unrealized Loss	\$ (66)	\$	\$ (66)	\$ (275)	\$	\$ (275)
<b>Total</b>						
Fair value	\$ 112,876	\$ 245,333	\$ 358,209	\$ 682,254	\$ 3,188	\$ 685,442
Cost or amortized cost	113,352	250,530	363,882	710,949	3,426	714,375

Edgar Filing: RLI CORP - Form 10-Q

Unrealized Loss	\$	(476)	\$	(5,197)	\$	(5,673)	\$	(28,695)	\$	(238)	\$	(28,933)
-----------------	----	-------	----	---------	----	---------	----	----------	----	-------	----	----------

---

\*Asset-backed & commercial mortgage-backed

## Edgar Filing: RLI CORP - Form 10-Q

The following table shows the composition of the fixed income securities in unrealized loss positions at June 30, 2014 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent Standard & Poor's (S&P) and Moody's ratings. The vast majority of the securities are rated by S&P and/or Moody's.

NAIC Rating	Equivalent S&P Rating	Equivalent Moody's Rating	(dollars in thousands)			
			Amortized Cost	Fair Value	Unrealized Loss	Percent to Total
1	AAA/AA/A	Aaa/Aa/A	\$ 321,030	\$ 315,595	\$ (5,435)	96.9%
2	BBB	Baa	9,251	9,226	(25)	0.4%
3	BB	Ba	15,137	15,048	(89)	1.6%
4	B	B	8,371	8,316	(55)	1.0%
5	CCC or lower	Caa or lower	655	652	(3)	0.1%
6						
		Total	\$ 354,444	\$ 348,837	\$ (5,607)	100.0%

### *Cash and Short-term Investments*

Cash consists of uninvested balances in bank accounts. We had a cash balance of \$27.2 million at the end of the second quarter of 2014, compared to \$39.5 million at the end of 2013. Short-term investments are carried at cost, which approximates fair value. The balance at June 30, 2014 was \$18.5 million compared to \$23.2 million at December 31, 2013.

### *Evaluating Investments for OTTI*

The fixed income portfolio contained 205 securities in an unrealized loss position as of June 30, 2014. The \$5.6 million in associated unrealized losses for these 205 securities represents 0.4 percent of the fixed income portfolio's cost basis. Of these 205 securities, 111 have been in an unrealized loss position for 12 consecutive months or longer. All fixed income securities in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities. Any credit-related impairment related to fixed income securities we do not plan to sell and for which we are not more likely than not to be required to sell is recognized in net earnings, with the non-credit related impairment recognized in comprehensive earnings. Based on our analysis, our fixed income portfolio is of high credit quality and we believe we will recover the amortized cost basis of our fixed income securities. We continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. There were no other-than-temporary impairment (OTTI) losses recognized in net earnings or other comprehensive earnings in the periods presented on the fixed income portfolio.

As of June 30, 2014, we held two common stock securities that were in an unrealized loss position. The unrealized loss on these securities was less than \$0.1 million. Based on our analysis, we believe each security will recover in a reasonable period of time and we have the intent and ability to hold them until recovery. No equity securities have been in an unrealized loss position for 12 consecutive months or longer. There were no OTTI losses recognized in the periods presented on the equity portfolio.

### 3. FAIR VALUE MEASUREMENTS

#### *Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

Fair value is defined as the price in the principal market that would be received for an asset to facilitate an orderly transaction between market participants on the measurement date.

We determined the fair value of certain financial instruments based on their underlying characteristics and relevant transactions in the marketplace. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

Financial assets are classified based upon the lowest level of significant input that is used to determine fair value. The following are the levels of the fair value hierarchy and a brief description of the type of valuation inputs that are used to establish each level:

**Pricing Level 1** is applied to valuations based on readily available, unadjusted quoted prices in active markets for identical assets. These valuations are based on quoted prices that are readily and regularly available in an active market.

**Pricing Level 2** is applied to valuations based upon quoted prices for similar assets in active markets, quoted prices for identical or similar assets in inactive markets; or valuations based on models where the significant inputs are observable (e.g. interest rates, yield curves, prepayment speeds, default rates, loss severities) or can be corroborated by observable market data.

**Pricing Level 3** is applied to valuations that are derived from techniques in which one or more of the significant inputs are unobservable.

As a part of management's process to determine fair value, we utilize widely recognized, third-party pricing sources to determine our fair values. We have obtained an understanding of the third-party pricing sources' valuation methodologies and inputs. The following is a description of the valuation techniques used for financial assets that are measured at fair value, including the general classification of such assets pursuant to the fair value hierarchy.

**Corporate, Agencies, Government and Municipal Bonds:** The pricing vendor employs a multi-dimensional model which uses standard inputs including (listed in order of priority for use) benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, market bids/offers and other reference data. The pricing vendor also monitors market indicators, as well as industry and economic events. All bonds valued using these techniques are classified as Level 2. All corporate, agency, government and municipal securities were deemed Level 2.



**Mortgage-backed Securities (MBS)/Commercial Mortgage-backed Securities (CMBS) and Asset-backed Securities (ABS):** The pricing vendor evaluation methodology includes principally interest rate movements and new issue data. Evaluation of the tranches (non-volatile, volatile or credit sensitivity) is based on the pricing vendors' interpretation of accepted modeling and pricing conventions. This information is then used to determine the cash flows for each tranche, benchmark yields, prepayment assumptions and to incorporate collateral performance. To evaluate MBS and CMBS volatility, an option adjusted spread model is used in combination with models that simulate interest rate paths to determine market price information. This process allows the pricing vendor to obtain evaluations of a broad universe of securities in a way that reflects changes in yield curve, index rates, implied volatility, mortgage rates and recent trade activity. MBS/CMBS and ABS with corroborated, observable inputs are classified as Level 2. All of our MBS/CMBS and ABS are deemed Level 2.

**Common Stock:** Exchange traded equities have readily observable price levels and are classified as Level 1 (fair value based on quoted market prices). All of our common stock holdings are deemed Level 1.

For the Level 2 securities, as described above, we periodically conduct a review to assess the reasonableness of the fair values provided by our pricing services. Our review consists of a two pronged approach. First, we compare prices provided by our pricing services to those provided by an additional source. Second, we obtain prices from securities brokers and compare them to the prices provided by our pricing services. In both comparisons, when discrepancies are found, we compare our prices to actual reported trade data for like securities. Based on this assessment, we determined that the fair values of our Level 2 securities provided by our pricing services are reasonable.

For common stock, we receive prices from a nationally recognized pricing service. Prices are based on observable inputs in an active market and are therefore disclosed as Level 1. Based on this assessment, we determined that the fair values of our Level 1 securities provided by our pricing service are reasonable.

Due to the relatively short-term nature of cash, short-term investments, accounts receivable and accounts payable, their carrying amounts are reasonable estimates of fair value.

Assets measured at fair value in the accompanying unaudited condensed consolidated interim financial statements on a recurring basis are summarized below:

Edgar Filing: RLI CORP - Form 10-Q

(in thousands)	As of June 30, 2014				Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Total trading securities	\$	\$	\$	\$	
Available-for-sale securities					
U.S. agency	\$	\$	3,981	\$	\$ 3,981
Corporate			578,809		578,809
Mortgage-backed			268,726		268,726
ABS/CMBS*			114,714		114,714
Non-U.S. govt. & agency			14,917		14,917
U.S. government			31,729		31,729
Municipal			521,746		521,746
Equity	436,462				436,462
Total available-for-sale securities	\$	\$	1,534,622	\$	\$ 1,971,084
Total	\$	\$	1,534,622	\$	\$ 1,971,084

\*Asset-backed & commercial mortgage-backed

(in thousands)	As of December 31, 2013				Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Total trading securities	\$	\$	\$	\$	
Available-for-sale securities					
U.S. agency	\$	\$	10,298	\$	\$ 10,298
Corporate			526,038		526,038
Mortgage-backed			244,416		244,416
ABS/CMBS*			106,309		106,309
Non-U.S. govt. & agency			13,678		13,678
U.S. government			17,303		17,303
Municipal			522,010		522,010
Equity	418,654				418,654
Total available-for-sale securities	\$	\$	1,440,052	\$	\$ 1,858,706
Total	\$	\$	1,440,052	\$	\$ 1,858,706

\*Asset-backed & commercial mortgage-backed

As noted in the above table, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period. Additionally, there were no securities transferred in or out of levels 1 or 2 during the six-month period ended June 30, 2014.

#### 4. STOCK BASED COMPENSATION

Our RLI Corp. Omnibus Stock Plan (omnibus plan) was in place from 2005 to 2010. The omnibus plan provided for grants of up to 3,000,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we granted 2,457,644 stock options under this plan, including incentive stock options (ISOs), which were adjusted as part of the special dividends paid in 2013 and prior years.

During the second quarter of 2010, our shareholders approved the RLI Corp. Long-Term Incentive Plan (LTIP), which replaced the omnibus plan. In conjunction with the adoption of the LTIP, effective May 6, 2010, options were no longer granted under the omnibus plan. Awards under the LTIP may be in the form of restricted stock, stock options (non-qualified only), stock appreciation rights, performance units, as well as other stock-based awards. Eligibility under the LTIP is limited to employees or directors of the company or any affiliate. The granting of awards under the LTIP is solely at the discretion of the board of directors. The total number of shares of common stock available for distribution under the LTIP may not exceed 4,000,000 shares (subject to adjustment for changes in our capitalization). Since 2010, we have granted 2,732,500 stock options under the LTIP, including 420,000 thus far in 2014.

Under the LTIP, as under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period and expire eight years after grant.

In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

The following tables summarize option activity for the periods ended June 30, 2014 and 2013:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2014	2,595,084	\$ 26.04		
Options granted	420,000	\$ 42.88		
Options exercised	(43,872)	\$ 18.31		\$ 1,139
Options canceled/forfeited	(740)	\$ 16.51		
Outstanding options at June 30, 2014	2,970,472	\$ 28.53	5.47	\$ 51,232
Exercisable options at June 30, 2014	1,300,292	\$ 22.02	4.21	\$ 30,894



Edgar Filing: RLI CORP - Form 10-Q

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2013	2,945,204	\$ 22.23		
Options granted	531,700	\$ 35.79		
Options exercised	(306,524)	\$ 16.98		\$ 5,942
Options canceled/forfeited	(41,520)	\$ 25.47		
Outstanding options at June 30, 2013	3,128,860	\$ 25.00	5.59	\$ 41,315
Exercisable options at June 30, 2013	1,474,360	\$ 19.83	4.38	\$ 27,095

The majority of our options are granted annually at our regular board meeting in May. In addition, options are approved at the May meeting for quarterly grants to certain retirement eligible employees. Since grants to retirement eligible employees are fully expensed when issued, the approach allows for a more even expense distribution throughout the year.

Thus far in 2014, 420,000 options were granted with a weighted average exercise price of \$42.88 and a weighted average fair value of \$7.76. We recognized \$1.2 million of expense in the second quarter of 2014, and \$2.1 million in the first six months of 2014, related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.4 million in the second quarter of 2014, and \$0.7 million in the first six months of 2014, related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$5.9 million, which will be recognized over the remainder of the vesting period. Comparatively, we recognized \$1.0 million of expense in the second quarter of 2013, and \$1.8 million of expense in the first six months of 2013. We recorded a tax benefit of \$0.3 million in the second quarter of 2013, and \$0.6 million in the first six months of 2013, related to this compensation expense.

The fair value of options was estimated using a Black-Scholes based option pricing model with the following weighted average grant-date assumptions and weighted average fair values as of June 30:

	2014	2013
Weighted-average fair value of grants	\$ 7.76	\$ 6.49
Risk-free interest rates	1.70%	0.74%
Dividend yield	1.94%	2.00%
Expected volatility	23.22%	25.41%
Expected option life	5.18 years	5.23 years

The risk-free rate was determined based on U.S. treasury yields that most closely approximated the option's expected life. The dividend yield was calculated based on the average annualized dividends paid during the most recent five-year period. It excluded the special dividends paid in the fourth quarters of 2013 and prior years. The expected volatility was calculated based on the median of the rolling volatilities for the expected life of the

options. In previous years, expected volatility was calculated based on the mean reversion of RLI's stock. The expected option life was determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

In 2013 and 2014, each outside director received \$10,000 worth of restricted common shares as part of annual director compensation. The shares were issued annually from the LTIP during the first quarter of each year. The shares were directly owned by each director on the date of issuance and included a one-year restriction on the sale or transfer of such shares. In the first quarter of 2014, we issued a total of 2,097 restricted shares and recognized \$0.1 million of compensation expense. This restricted share program has been terminated and no further restricted shares will be issued going forward.

**5. OPERATING SEGMENT INFORMATION** - Selected information by operating segment is presented in the table below. Additionally, the table reconciles segment totals to total earnings and total revenues.

SEGMENT DATA (in thousands)

	For the Three-Month Periods Ended June 30, REVENUES		For the Six-Month Periods Ended June 30, REVENUES	
	2014	2013	2014	2013
Net premiums earned:				
Casualty	\$ 94,360	\$ 78,372	\$ 185,337	\$ 151,341
Property	48,791	49,619	92,109	94,600
Surety	25,453	26,562	52,290	52,763
Segment totals before income taxes	\$ 168,604	\$ 154,553	\$ 329,736	\$ 298,704
Net investment income	13,982	12,847	27,564	25,733
Net realized gains	10,431	3,742	16,932	7,426
Total consolidated revenue	\$ 193,017	\$ 171,142	\$ 374,232	\$ 331,863
	NET EARNINGS		NET EARNINGS	
	2014	2013	2014	2013
Casualty	\$ 16,467	\$ 14,614	\$ 22,545	\$ 18,718
Property	2,293	2,222	11,971	13,146
Surety	7,809	8,723	14,585	13,493
Net underwriting income	\$ 26,569	\$ 25,559	\$ 49,101	\$ 45,357
Net investment income	13,982	12,847	27,564	25,733
Net realized gains	10,431	3,742	16,932	7,426
General corporate expense and interest on debt	(4,423)	(3,205)	(8,472)	(7,103)
Equity in earnings of unconsolidated investees	5,864	4,633	9,289	8,132
Total earnings before income taxes	\$ 52,423	\$ 43,576	\$ 94,414	\$ 79,545
Income tax expense	16,698	13,674	29,720	24,796
Total net earnings	\$ 35,725	\$ 29,902	\$ 64,694	\$ 54,749

## Edgar Filing: RLI CORP - Form 10-Q

The following table further summarizes revenues (net premiums earned) by major product type within each operating segment:

(in thousands)	For the Three-Month Periods Ended June 30,		For the Six-Month Periods Ended June 30,	
	2014	2013	2014	2013
<b>Casualty</b>				
Commercial and personal umbrella	\$ 25,024	\$ 20,606	\$ 49,780	\$ 39,556
General liability	20,523	20,020	40,455	40,797
Commercial transportation	15,005	12,197	29,516	22,131
Professional services	13,839	10,062	26,700	19,071
P&C package business	8,495	7,607	16,778	15,028
Executive products	4,721	4,651	9,405	9,367
Medical professional liability	3,724	1,712	7,424	2,462
Other casualty	3,029	1,517	5,279	2,929
<b>Total</b>	<b>\$ 94,360</b>	<b>\$ 78,372</b>	<b>\$ 185,337</b>	<b>\$ 151,341</b>
<b>Property</b>				
Commercial property	\$ 20,054	\$ 19,259	\$ 40,487	\$ 38,875
Marine	12,962	15,042	25,163	29,656
Crop reinsurance	5,683	6,388	6,869	7,655
Property reinsurance	3,387	4,383	6,748	9,655
Other property	6,705	4,547	12,842	8,759
<b>Total</b>	<b>\$ 48,791</b>	<b>\$ 49,619</b>	<b>\$ 92,109</b>	<b>\$ 94,600</b>
<b>Surety</b>				
Miscellaneous	\$ 9,598	\$ 9,488	\$ 19,080	\$ 18,969
Contract	6,256	6,653	13,017	13,112
Commercial	6,313	5,717	12,447	11,428
Oil and Gas	3,286	4,704	7,746	9,254
<b>Total</b>	<b>\$ 25,453</b>	<b>\$ 26,562</b>	<b>\$ 52,290</b>	<b>\$ 52,763</b>
<b>Grand Total</b>	<b>\$ 168,604</b>	<b>\$ 154,553</b>	<b>\$ 329,736</b>	<b>\$ 298,704</b>

### 6. ACQUISITION

On February 5, 2014, we invested \$5.3 million for a 20 percent equity ownership interest in Prime Holdings Insurance Services, Inc. (Prime), an Illinois domiciled insurance carrier based in Salt Lake City, Utah. Prime is a privately-held excess and surplus lines insurance company operating in 49 states through a network of wholesale brokers and specializing in hard-to-place risks. The investment in Prime is reflected on our balance sheet as an investment in unconsolidated investee. Under the equity method of accounting we recognize our proportionate share of Prime's income as equity in earnings of unconsolidated investees. Our share of Prime's earnings amounted to \$0.2 million in the second quarter of 2014 and \$0.3 million in the first six months of 2014.

Additionally, we entered into a 25 percent quota share reinsurance treaty with Prime, effective January 1, 2014. We assumed gross premiums of \$2.5 million related to this quota share agreement in the second quarter of 2014 and \$5.0 million in the first six months of 2014.



**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995:** This discussion and analysis may contain 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 that are not historical facts, and involve risks and uncertainties that could cause actual results to differ materially from those expected and projected. Various risk factors that could affect future results are listed in our filings with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the year ended December 31, 2013.

**OVERVIEW**

We underwrite selected property and casualty insurance through major subsidiaries collectively known as RLI Insurance Group (the Group). We conduct operations principally through four insurance companies. These companies are organized in a vertical structure beneath RLI Corp. with RLI Insurance Company (RLI Ins.) as the first-level, or principal, insurance subsidiary. RLI Ins. writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company (Mt. Hawley), a subsidiary of RLI Ins., writes excess and surplus lines insurance on a non-admitted basis in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley, has authority to write multiple lines of insurance on an admitted basis in 48 states and the District of Columbia. Contractors Bonding and Insurance Company (CBIC), a subsidiary of RLI Ins., has authority to write multiple lines of insurance on an admitted basis in all 50 states and the District of Columbia. Each of our insurance companies is domiciled in Illinois, with the exception of CBIC, which is domiciled in Washington. We are an Illinois corporation that was organized in 1965.

As a specialty company with a niche focus, we offer insurance coverages in both the specialty admitted and excess and surplus markets. Coverages in the specialty admitted market, such as our oil and gas surety bonds, are for risks that are unique or hard-to-place in the standard market, but must remain with an admitted insurance company for regulatory or marketing reasons. In addition, our coverages in the specialty admitted market may be designed to meet specific insurance needs of targeted insured groups, such as our professional liability and package coverages for design professionals and our stand-alone personal umbrella policy. The specialty admitted market is subject to more state regulation than the excess and surplus market, particularly with regard to rate and form filing requirements, restrictions on the ability to exit lines of business, premium tax payments and membership in various state associations, such as state guaranty funds and assigned risk plans. We also underwrite coverages in the excess and surplus market. The excess and surplus market, unlike the standard admitted market, is less regulated and more flexible in terms of policy forms and premium rates. This market provides an alternative for customers with risks or loss exposures that generally cannot be written in the standard admitted market. This typically results in coverages that are more restrictive and more expensive than coverages in the standard admitted market. When we underwrite within the excess and surplus market, we are selective in the lines of business and type of risks we choose

to write. Using our non-admitted status in this market allows us to tailor terms and conditions to manage these exposures effectively. Often, the development of these coverages is generated through proposals brought to us by an agent or broker seeking coverage for a specific group of clients or loss exposures. Once a proposal is submitted, our underwriters determine whether it would be a viable product based on our business objectives.

The foundation of our overall business strategy is to underwrite for profit in all market conditions and we achieved this for 18 consecutive years, averaging an 87.6 combined ratio over that period of time. This foundation drives our ability to provide shareholder returns in three different ways: the underwriting income itself, net investment income from our investment portfolio and long-term appreciation in our equity portfolio. Our investment strategy is based on preservation of capital as the first priority, with a secondary focus on generating total return. The fixed income portfolio consists primarily of highly-rated, diversified, liquid investment-grade securities. Consistent underwriting income allows a portion of our shareholders' equity to be invested in equity securities. Our equity portfolio consists of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Our minority equity ownership in Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality sunglasses, has also enhanced overall returns. We have a diversified investment portfolio and monitor our investment risks. Despite periodic fluctuations in market value, our equity portfolio is part of a long-term asset allocation strategy and has contributed significantly to our historic growth in book value.

We measure the results of our insurance operations by monitoring certain measures of growth and profitability across three distinct business segments: casualty, property and surety. Growth is measured in terms of gross premiums written, and profitability is analyzed through combined ratios, which are further subdivided into their respective loss and expense components.

The property and casualty insurance business is cyclical and influenced by many factors, including price competition, economic conditions, natural or man-made disasters (for example, earthquakes, hurricanes and terrorism), interest rates, state regulations, court decisions and changes in the law.

One of the unique and challenging features of the property and casualty insurance business is that coverages must be priced before costs have fully developed, because premiums are charged before claims are incurred. This requires that liabilities be estimated and recorded in recognition of future loss and settlement obligations. Due to the inherent uncertainty in estimating these liabilities, there can be no assurance that actual liabilities will not be more or less than recorded amounts; if actual liabilities differ from recorded amounts, there will be an adverse or favorable effect on net earnings. In evaluating the objective performance measures previously mentioned, it is important to consider the following individual characteristics of each major insurance segment.

The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products and commercial umbrella coverages, as well as package business and other specialty coverages, such as professional liability and workers compensation for office-based professionals. We offer fidelity and crime coverage for commercial insureds and select financial institutions and recently expanded our casualty offerings

to include medical professional liability coverage in the excess and surplus market. We also assume select casualty business written by Prime under a reinsurance treaty. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment is also subject to inflation risk and may be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment is comprised primarily of commercial fire, earthquake, difference in conditions, marine, and facultative and treaty reinsurance including crop. We also offer select personal lines policies, such as recreational vehicle and Hawaii homeowners coverages. While our marine and facultative reinsurance coverages are predominantly domestic risks, these portfolios do contain a relatively small portion of foreign risks. Property insurance and reinsurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coast, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by minimizing the total policy limits written in a particular region, purchasing reinsurance and maintaining policy terms and conditions throughout market cycles. We also use computer-assisted modeling techniques to provide estimates that help us carefully manage the concentration of risks exposed to catastrophic events. Our assumed multi-peril crop and hail treaty reinsurance business covers revenue shortfalls or production losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects and disease. Significant aggregation of these losses is mitigated by the U.S. Federal Government reinsurance program that provides stop loss protection inuring to our benefit.

The surety segment specializes in writing small-to-large commercial and contract surety coverages, as well as those for the energy, petrochemical and refining industries. We offer miscellaneous bonds including license and permit, notary and court bonds. Often, our surety coverages involve a statutory requirement for bonds. While these bonds typically maintain a relatively low loss ratio, losses may fluctuate due to adverse economic conditions affecting the financial viability of our insureds. The contract surety product guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to the deterioration of a contractor's financial condition. This line has historically produced marginally higher loss ratios than other surety lines during economic downturns.

Rates increased moderately on most coverages through 2013, a year in which abnormally low catastrophe activity led to improved financial results across the industry. This led to softer reinsurance pricing in the first half of 2014, which will likely impact primary rates for the remainder of the year. As a result, the insurance marketplace remains intensely competitive. Despite these competitive pressures, we believe that our business model is built to create underwriting income by focusing on sound risk selection and discipline. Our primary focus will continue to be on underwriting profitability, with a secondary focus on premium growth where we believe underwriting profit exists, as opposed to general premium growth or market share measurements.



*GAAP and non-GAAP Financial Performance Metrics*

Throughout this quarterly report, we present our operations in the way we believe will be most meaningful, useful and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP presentation of net income, we show certain statutory reporting information and other non-GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are underwriting income, combined ratios and net unpaid loss and settlement expenses.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures and explanations of their importance to our operations.

*Underwriting Income*

Underwriting income or profit represents one measure of the pretax profitability of our insurance operations and is derived by subtracting losses and settlement expenses, policy acquisition costs and insurance operating expenses from net premiums earned. Each of these captions is presented in the statements of earnings, but not subtotaled. However, this information is available in total and by segment in note 11 to the consolidated financial statements on our 2013 Annual Report on Form 10-K, regarding operating segment information. The nearest comparable GAAP measure is earnings before income taxes which, in addition to underwriting income, includes net investment income, net realized gains/losses on investments, general corporate expenses, debt costs and unconsolidated investee earnings.

*Combined Ratio*

This ratio is a common industry measure of profitability for any underwriting operation and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, divided by net premiums earned. All items included in these components of the combined ratio are presented in our GAAP financial statements. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every \$100 of premium we earn, we record \$15 of underwriting income.

*Net Unpaid Loss and Settlement Expenses*

Unpaid losses and settlement expenses, as shown in the liabilities section of our balance sheets, represents the total obligations to claimants for both estimates of known claims and estimates for incurred but not reported (IBNR) claims. The related asset item, reinsurance balances recoverable on unpaid losses and settlement expense, is the estimate of known claims and estimates of IBNR that we expect to recover from reinsurers. The net of these two items is generally referred to as net unpaid loss and settlement expenses and is commonly used in our disclosures regarding the process of establishing these various estimated amounts.



### Critical Accounting Policies

In preparing the unaudited condensed consolidated interim financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ significantly from those estimates.

The most critical accounting policies involve significant estimates and include those used in determining the liability for unpaid losses and settlement expenses, investment valuation and OTTI, recoverability of reinsurance balances, deferred policy acquisition costs and deferred taxes. For a detailed discussion of each of these policies, refer to our 2013 Annual Report on Form 10-K. There have been no significant changes to any of these policies during the current year.

### SIX MONTHS ENDED JUNE 30, 2014 COMPARED TO SIX MONTHS ENDED JUNE 30, 2013

Consolidated revenues, as displayed in the table that follows, totaled \$374.2 million for the first six months of 2014 compared to \$331.9 million for the same period in 2013.

	For the Six-Month Periods Ended June 30,	
	2014	2013
<b>Consolidated revenues</b> (in thousands)		
Net premiums earned	\$ 329,736	\$ 298,704
Net investment income	27,564	25,733
Net realized investment gains	16,932	7,426
<b>Total consolidated revenue</b>	<b>\$ 374,232</b>	<b>\$ 331,863</b>

Consolidated revenue for the first six months of 2014 increased \$42.4 million, or 13 percent, from the same period in 2013. Net premiums earned for the Group increased 10 percent, led by growth in our casualty segment which was up 22 percent. Net premiums earned from our surety and property segments declined slightly from the prior year. Net investment income increased 7 percent to \$27.6 million due to a larger invested asset base and reinvestment rates that remain near the average yield of the portfolio. We realized net investment gains of \$16.9 million in the first six months of 2014, compared to \$7.4 million during the same period of 2013.

Net after-tax earnings for the first six months of 2014 totaled \$64.7 million, \$1.48 per diluted share, compared to \$54.7 million, \$1.27 per diluted share, for the same period in 2013. In 2014, favorable development on prior years' loss and catastrophe reserves resulted in additional pretax earnings of \$42.3 million. Partially offsetting this favorable development was \$1.3 million of reinsurance reinstatement premium related to unfavorable development on prior years' surety reserves. From a comparative standpoint, results for 2013 included favorable development on prior years' loss and catastrophe reserves which resulted in additional pretax earnings of \$40.0 million. In addition, losses from spring storms impacted results for both periods, with losses totaling \$8.0 million in the first half of 2014 compared to \$10.0 million for the same period last year. Bonus and profit sharing-related expenses



associated with these specific items totaled \$4.5 million in 2014, compared to \$3.6 million in 2013. These performance-related expenses affected policy acquisition, insurance operating and general corporate expenses. Bonus and profit-sharing amounts earned by executives, managers and associates are predominately influenced by corporate performance including operating earnings, combined ratio and return on capital.

During the first six months of 2014, equity in earnings of unconsolidated investees totaled \$9.3 million. This amount includes \$9.0 million from Maui Jim and \$0.3 million from Prime Holdings Insurance Services, Inc. (Prime). Refer to Note 6, Acquisitions, for more information regarding our February 2014 investment in Prime. Comparatively, the first six months of 2013 reflected \$8.1 million of Maui Jim earnings.

Comprehensive earnings, which include net earnings plus other comprehensive earnings (primarily the change in unrealized gains/losses, net of tax), was \$102.4 million, \$2.34 per diluted share, for the first half of 2014, compared to \$38.8 million, \$0.90 per diluted share, for the same period last year. Unrealized gains, net of tax, for the first six months of 2014 were \$37.7 million, compared to unrealized losses, net of tax, of \$15.9 million for the same period in 2013. Unrealized gains in the current year were largely from the fixed income portfolio, as interest rates declined during the first half of 2014.

## **RLI INSURANCE GROUP**

As reflected in the table below, gross premiums written for the Group increased 3 percent to \$461.6 million for the first six months of 2014. Our casualty and surety segments each showed growth, up 8 percent and 2 percent, respectively, which offset a 4 percent decline from the property segment. Expansion efforts and new product initiatives have contributed to the overall growth in premiums, as production has increased despite heightened competition in the marketplace. From a pricing standpoint, trends seen during the current year have varied across our product portfolio. The positive pricing momentum seen within our casualty segment during the prior year has largely slowed, while rates on most surety products and property coverages have remained flat or declined. Net premiums written advanced 5 percent in the first six months of 2014, and outpaced growth in gross premiums written due largely to cost savings realized on our 2014 reinsurance renewals. During the first half of 2014, we renewed all material reinsurance treaties which resulted in over \$16.0 million of annual savings. Reinsurance structures are largely unchanged with the exception of surety, where we purchased additional limit, and professional liability for office-based professionals, where we increased our retention. On a net premiums earned basis, premiums increased \$31.0 million, or 10 percent, due to overall growth experienced in recent periods and increased retentions in 2013 on certain casualty products. The casualty segment has contributed significantly to this growth, with net premiums written up 11 percent, and net premiums earned up 23 percent from the first half of last year. Underwriting income for the Group totaled \$49.1 million for the first six months of 2014, compared to \$45.4 million in 2013. Both periods benefited from similar amounts of favorable development on prior years' loss and catastrophe reserves. Spring storm losses also impacted results for each period, though to a lesser extent in 2014. Compared to 2013, results for 2014 included \$2.0 million less in spring storm losses. The GAAP combined ratio totaled 85.1 in 2014, compared to 84.8 in 2013. The Group's loss ratio increased to 43.8, from 42.5, while the Group's expense ratio improved one point to 41.3.