National Interstate CORP
Form 10-Q
May 01, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2015
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	34-1607394
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3250 Interstate Drive, Richfield, OH	44286-9000
(Address of principal executives offices)	(Zip Code)

(330) 659-8900
(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. þ 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). þ 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 þ
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 þ No
The number of shares outstanding of the registrant's sole class of common shares as of April 30, 2015 was 19,839,228.

Table of Contents

National Interstate Corporation
Table of Contents

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)

	March 31, 2015 (Unaudited)	December 31, 2014
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost – $973,296 and $945,956, respectively)	$1,006,288	$974,746
Equity securities available-for-sale, at fair value (amortized cost – $79,565 and $76,352, respectively)	88,701	85,228
Other invested assets	47,055	46,786
Total investments	1,142,044	1,106,760
Cash and cash equivalents	64,526	53,583
Accrued investment income	8,441	8,724
Premiums receivable, net of allowance for doubtful accounts of $2,558 and $2,627, respectively	259,915	271,336
Reinsurance recoverable on paid and unpaid losses	190,089	180,332
Prepaid reinsurance premiums	49,673	47,013
Deferred policy acquisition costs	22,456	22,654
Deferred federal income taxes	20,723	23,150
Property and equipment, net	24,425	24,538
Funds held by reinsurer	3,027	4,335
Intangible assets, net	7,721	7,791
Prepaid expenses and other assets	3,561	4,517
Total assets	$1,796,601	$1,754,733
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	$907,812	$883,078
Unearned premiums and service fees	300,125	311,255
Long-term debt	12,000	12,000
Amounts withheld or retained for accounts of others	103,944	101,799
Reinsurance balances payable	34,948	31,069
Accounts payable and other liabilities	49,014	33,402
Commissions payable	14,375	15,392
Assessments and fees payable	4,340	4,649
Total liabilities	1,426,558	1,392,644
Shareholders' equity:		
Preferred shares – no par value		
Authorized – 10,000 shares		
Issued – 0 shares	—	—
Common shares – $0.01 par value		
Authorized – 50,000 shares		
Issued – 23,350 shares, including 3,512 and 3,557 shares, respectively, in treasury	234	234
Additional paid-in capital	59,857	59,386
Retained earnings	287,552	283,031

Accumulated other comprehensive income	27,383	24,483
Treasury shares	(4,983)	(5,045)
Total shareholders’ equity	370,043	362,089
Total liabilities and shareholders’ equity	$1,796,601	$1,754,733

See notes to consolidated financial statements.

Table of Contents

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

	Three Months Ended March 31,	
	2015	2014
Revenues:		
Premiums earned	$137,823	$133,503
Net investment income	9,656	8,702
Net realized gains on investments (*)	1,069	2,605
Other	830	760
Total revenues	149,378	145,570
Expenses:		
Losses and loss adjustment expenses	108,781	102,580
Commissions and other underwriting expenses	22,983	22,538
Other operating and general expenses	6,243	5,460
Transaction expenses	—	2,010
Expense on amounts withheld	1,501	1,555
Interest expense	47	74
Total expenses	139,555	134,217
Income before income taxes	9,823	11,353
Provision for income taxes	2,714	3,298
Net income	$7,109	$8,055
Net income per share – basic	$0.36	$0.41
Net income per share – diluted	$0.36	$0.41
Weighted average of common shares outstanding – basic	19,834	19,693
Weighted average of common shares outstanding – diluted	19,881	19,771
Cash dividends per common share	$0.13	$0.12

(*) Consists of the following:		
Net realized gains before impairment losses	$1,084	$2,839
Total losses on securities with impairment charges	—	(45)
Non-credit portion recognized in other comprehensive income	(15)	(189)
Net impairment charges recognized in earnings	(15)	(234)
Net realized gains on investments	$1,069	$2,605

See notes to consolidated financial statements.

Table of Contents

National Interstate Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income
(Unaudited)
(Dollars in thousands)

	Three Months Ended March 31,	
	2015	2014
Net income	$7,109	$8,055
Other comprehensive income, before tax:		
Net unrealized holding gains on available-for-sale securities:		
Net unrealized holding gains on securities arising during the period	5,025	9,608
Reclassification adjustment for net realized gains included in net income	(563)	(609)
Total other comprehensive income, before tax	4,462	8,999
Deferred income tax expense on other comprehensive income	1,562	3,149
Other comprehensive income, net of tax	2,900	5,850
Total comprehensive income	$10,009	$13,905

See notes to consolidated financial statements.

Table of Contents

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 Income	Treasury Stock	Total
Balance at January 1, 2015	$234	$59,386	$283,031	$ 24,483	$(5,045)	$362,089
Net income			7,109			7,109
Other comprehensive income, net of tax				2,900		2,900
Dividends on common stock			(2,588)			(2,588)
Issuance of 44,371 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		298			62	360
Net tax effect from exercise/vesting of stock compensation		(39)				(39)
Stock-based compensation expense		212				212
Balance at March 31, 2015	$234	$59,857	$287,552	$ 27,383	$(4,983)	$370,043
Balance at January 1, 2014	$234	$56,481	$281,518	$ 19,281	$(5,230)	$352,284
Net income			8,055			8,055
Other comprehensive income, net of tax				5,850		5,850
Dividends on common stock			(2,370)			(2,370)
Issuance of 94,287 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		1,663			131	1,794
Net tax effect from exercise/vesting of stock compensation		(21)				(21)
Stock-based compensation expense		229				229
Balance at March 31, 2014	$234	$58,352	$287,203	$ 25,131	$(5,099)	$365,821

See notes to consolidated financial statements.

Table of Contents

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

	Three Months Ended March 31,	
	2015	2014
Operating activities		
Net income	$7,109	$8,055
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of bond premiums and discounts	699	1,143
Provision for depreciation and amortization	1,392	968
Net realized gains on investment securities	(1,069)	(2,605)
Deferred federal income taxes	865	1,394
Stock-based compensation expense	212	229
Decrease (increase) in deferred policy acquisition costs, net	198	(1,223)
Increase in reserves for losses and loss adjustment expenses	24,734	11,010
Decrease in premiums receivable	11,421	1,202
(Decrease) increase in unearned premiums and service fees	(11,130)	6,540
Decrease in interest receivable and other assets	2,547	1,058
Increase in prepaid reinsurance premiums	(2,660)	(6,628)
Decrease in accounts payable, commissions and other liabilities and assessments and fees payable	(65)	(5,560)
Increase in amounts withheld or retained for accounts of others	2,145	4,423
(Increase) decrease in reinsurance recoverable	(9,757)	2,243
Increase in reinsurance balances payable	3,879	3,020
Other	(13)	9
Net cash provided by operating activities	30,507	25,278
Investing activities		
Purchases of fixed maturities	(59,048)	(34,016)
Purchases of equity securities	(4,371)	(8,140)
Proceeds from sale of fixed maturities	2,925	7,794
Proceeds from sale of equity securities	1,857	1,369
Proceeds from maturities and redemptions of investments	42,411	24,229
Change in other invested assets, net	125	(614)
Capital expenditures	(1,196)	(1,270)
Net cash used in investing activities	(17,297)	(10,648)
Financing activities		
Net tax effect from exercise/vesting of stock-based compensation	(39)	(21)
Proceeds from the issuance of common shares from treasury	360	1,794
Cash dividends paid on common shares	(2,588)	(2,370)
Net cash used in financing activities	(2,267)	(597)
Net increase in cash and cash equivalents	10,943	14,033
Cash and cash equivalents at beginning of period	53,583	35,684
Cash and cash equivalents at end of period	$64,526	$49,717

See notes to consolidated financial statements.

Table of Contents

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 U.S. generally accepted accounting principles (“GAAP”) and the instructions to Form 10-Q.

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

These interim unaudited 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, 2014. 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 month period ended March 31, 2015 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2015.

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.

2. Recent Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis ("ASU 2015-02"). The FASB issued ASU 2015-02 to simplify consolidation accounting by reducing the number of consolidation models and to provide more useful information to stakeholders. The ASU affects reporting entities that are required to evaluate whether they should consolidate certain entities. The main provisions affect limited partnerships and similar legal entities as variable interest entities or voting interest entities; the evaluation of fees paid to a decision maker as a variable interest; the effect of fee arrangements on the primary beneficiary determination; and a scope exception for certain investment funds. The updated guidance is effective for annual and interim periods beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. The adoption of this guidance is not expected to have a material effect on the Company's results of operations or financial position.

3. Fair Value Measurements

The Company must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value.

Table of Contents

Pricing services use a variety of observable inputs to estimate the fair value of fixed maturities that do not trade on a daily basis. These inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data and measures of volatility. Included in the pricing of mortgage-backed securities are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Inputs from brokers and independent financial institutions include, but are not limited to, yields or spreads of comparable investments which have recent trading activity, credit quality, duration, credit enhancements, collateral value and estimated cash flows based on inputs including delinquency rates, estimated defaults and losses and estimates of the rate of future prepayments. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company’s internal and affiliated investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, the Company’s internal investment professionals, who report to the Chief Investment Officer, compare the valuation received to independent third party pricing sources and consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. If the Company believes that significant discrepancies exist, the Company will perform additional procedures, which may include specific inquiry of the pricing source, to resolve the discrepancies.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability. Level 1 consists of publicly traded equity securities and highly liquid, direct obligations of the U.S. Government whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government agency securities, fixed maturity investments and nonredeemable preferred stocks that are not actively traded. Included in Level 2 are $158.9 million of securities, which are valued based upon a non-binding broker quote and validated with other observable market data by management. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes. The Company believes these estimates reflect fair value, but the Company is unable to verify inputs to the valuation methodology. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. The Company’s internal and affiliated investment professionals review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.

Table of Contents

The following table presents the Company’s investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of March 31, 2015:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. Government and government agency obligations	$3,540	$130,802	$—	$134,342
State and local government obligations	—	329,419	2,923	332,342
Residential mortgage-backed securities	—	187,127	—	187,127
Commercial mortgage-backed securities	—	16,407	—	16,407
Corporate obligations	—	196,451	7,150	203,601
Other debt obligations	—	125,666	2,462	128,128
Redeemable preferred stocks	3,844	—	497	4,341
Total fixed maturities	7,384	985,872	13,032	1,006,288
Equity securities:				
Common stocks	61,817	—	2,839	64,656
Nonredeemable preferred stocks	19,001	5,044	—	24,045
Total equity securities	80,818	5,044	2,839	88,701
Total fixed maturities and equity securities	88,202	990,916	15,871	1,094,989
Cash and cash equivalents	64,526	—	—	64,526
Total fixed maturities, equity securities and cash and cash equivalents at fair value	$152,728	$990,916	$15,871	$1,159,515

The following table presents the Company’s investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of December 31, 2014:

	Level 1	Level 2	Level 3	Total
	(Dollars in thousands)			
Fixed maturities:				
U.S. Government and government agency obligations	$2,911	$110,535	$—	$113,446
State and local government obligations	—	338,694	2,887	341,581
Residential mortgage-backed securities	—	192,555	—	192,555
Commercial mortgage-backed securities	—	16,998	—	16,998
Corporate obligations	—	192,314	7,100	199,414
Other debt obligations	—	102,454	3,995	106,449
Redeemable preferred stocks	3,808	—	495	4,303
Total fixed maturities	6,719	953,550	14,477	974,746
Equity securities:				
Common stocks	58,839	—	3,988	62,827
Nonredeemable preferred stocks	16,887	5,514	—	22,401
Total equity securities	75,726	5,514	3,988	85,228
Total fixed maturities and equity securities	82,445	959,064	18,465	1,059,974
Cash and cash equivalents	53,583	—	—	53,583
Total fixed maturities, equity securities and cash and cash equivalents at fair value	$136,028	$959,064	$18,465	$1,113,557

Table of Contents

The previous tables exclude other invested assets of $47.1 million and $46.8 million at March 31, 2015 and December 31, 2014, respectively. Other invested assets include investments in limited partnerships which are accounted for under the equity method. Equity method investments are not reported at fair value.
The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the three months ended March 31, 2015, the Company transferred two nonredeemable preferred stocks, with an aggregate value of $0.5 million , from Level 2 to Level 1 due to increases in trading activity.
During the three months ended March 31, 2014, the Company transferred five nonredeemable preferred stocks, with an aggregate value of $4.9 million, from Level 1 to Level 2 due to decreases in trading activity.

Table of Contents

The following tables present a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three months ended March 31, 2015 and 2014. The transfers out of Level 3 during the three months ended March 31, 2015 were due to increases in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

	Three Months Ended March 31, 2015				
	State and Local Government Obligations	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stock	Common Stock
	(Dollars in thousands)				
Beginning balance at January 1, 2015	$2,887	$7,100	$3,995	$495	$3,988
Total gains or (losses):					
Included in earnings	—	—	—	—	—
Included in other comprehensive income	36	138	(6)	2	(183)
Purchases and issuances	—	—	1,000	—	—
Sales, settlements and redemptions	—	(88)	(2,527)	—	—
Transfers in and/or (out) of Level 3	—	—	—	—	(966)
Ending balance at March 31, 2015	$2,923	$7,150	$2,462	$497	$2,839
The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date	$—	$—	$—	$—	$—

	Three Months Ended March 31, 2014					
	State and Local Government Obligations	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stock	Common Stock	Nonredeemable Preferred Stock
	(Dollars in thousands)					
Beginning balance at January 1, 2014	$859	$4,969	$3,311	$487	$1,500	$ 583
Total gains or (losses):						
Included in earnings	—	—	—	—	—	—
Included in other comprehensive income	1	57	2	1	50	—
Purchases and issuances	—	—	—	—	1,500	—
Sales, settlements and redemptions	—	(50)	(35)	—	—	(583)
Transfers in and/or (out) of Level 3	—	—	—	—	—	—
Ending balance at March 31, 2014	$860	$4,976	$3,278	$488	$3,050	$ —
The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date	$—	$—	$—	$—	$—	$ —

At March 31, 2015, the Company had 15 securities with a fair value of $15.9 million that are included in Level 3, which represented 1.4% of its total investments reported at fair value. The significant unobservable inputs used by the brokers and pricing services in establishing fair values of the Company's Level 3 securities are primarily spreads to U.S. Treasury rates and discounts to comparable securities. The specifics of such spreads and discounts were not made available to the Company. Significant increases (decreases) on spreads to U.S. Treasury rates and discount spreads to comparable securities would result in lower (higher) fair value measurements. Generally, a change in the assumption used for determining a spread is accompanied by market factors that

Table of Contents

warrant an adjustment for the credit risk and liquidity premium of the security. As the total fair value of Level 3 securities is 4.3% of the Company’s shareholders’ equity at March 31, 2015, any change in unobservable inputs would not have a material impact on the Company’s financial position.

4. Investments

The cost or amortized cost and fair value of investments in fixed maturities and equity securities are as follows:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
March 31, 2015				
Fixed maturities:				
U.S. Government and government agency obligations	$130,310	$4,044	$(12)	$134,342
State and local government obligations	319,979	12,769	(406)	332,342
Residential mortgage-backed securities	179,694	8,054	(621)	187,127
Commercial mortgage-backed securities	15,413	1,002	(8)	16,407
Corporate obligations	196,421	8,694	(1,514)	203,601
Other debt obligations	127,311	947	(130)	128,128
Redeemable preferred stocks	4,168	176	(3)	4,341
Total fixed maturities	973,296	35,686	(2,694)	1,006,288
Equity securities:				
Common stocks	56,877	9,650	(1,871)	64,656
Nonredeemable preferred stocks	22,688	1,470	(113)	24,045
Total equity securities	79,565	11,120	(1,984)	88,701
Total fixed maturities and equity securities	$1,052,861	$46,806	$(4,678)	$1,094,989
December 31, 2014				
Fixed maturities:				
U.S. Government and government agency obligations	$110,254	$3,206	$(14)	$113,446
State and local government obligations	329,725	12,193	(337)	341,581
Residential mortgage-backed securities	185,346	8,435	(1,226)	192,555
Commercial mortgage-backed securities	16,050	953	(5)	16,998
Corporate obligations	193,702	6,965	(1,253)	199,414
Other debt obligations	106,711	278	(540)	106,449
Redeemable preferred stocks	4,168	140	(5)	4,303
Total fixed maturities	945,956	32,170	(3,380)	974,746
Equity securities:				
Common stocks	54,663	9,643	(1,479)	62,827
Nonredeemable preferred stocks	21,689	963	(251)	22,401
Total equity securities	76,352	10,606	(1,730)	85,228
Total fixed maturities and equity securities	$1,022,308	$42,776	$(5,110)	$1,059,974

The table above excludes other invested assets of $47.1 million and $46.8 million at March 31, 2015 and December 31, 2014, respectively. Other invested assets include investments in limited partnerships which are accounted for under the equity method. Equity method investments are not reported at fair value.

State and local government obligations represented approximately 33.0% of the Company’s fixed maturity portfolio at March 31, 2015, with approximately $285.2 million, or 85.8%, of the Company’s state and local government obligations held in special revenue obligations, and the remaining amount held in general obligations. The Company’s state and local government obligations portfolio is high quality, as 98.8% of such securities were rated investment grade (as determined by nationally recognized agencies) at March 31, 2015. The Company had no state and local government obligations for any state, municipality or political subdivision that comprised 10% or more of the total amortized cost or fair value of such obligations at March 31, 2015.

Table of Contents

The non-credit portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned were $3.3 million at both March 31, 2015 and December 31, 2014.
The amortized cost and fair value of fixed maturities at March 31, 2015, by contractual maturity, are shown below. Other debt obligations, which are primarily comprised of asset-backed securities other than mortgage-backed securities, are categorized based on their average maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 3.9 years in the Company's investment portfolio.
Amortized cost and fair value of the fixed maturities in the Company's investment portfolio were as follows:

	Amortized Cost	Fair Value
	(Dollars in thousands)	
Due in one year or less	$27,856	$28,251
Due after one year through five years	304,376	313,734
Due after five years through ten years	357,867	368,794
Due after ten years	88,090	91,975
	778,189	802,754
Mortgage-backed securities	195,107	203,534
Total	$973,296	$1,006,288

Gains and losses on the sale of investments, including other-than-temporary impairment charges and other invested assets' gains or losses, were as follows:

	Three Months Ended March 31,	
	2015	2014
	(Dollars in thousands)	
Fixed maturity gains	$82	$476
Fixed maturity losses	(23)	(189)
Equity security gains	709	515
Equity security losses	(93)	(46)
Other invested assets, net gains	394	1,849
Net realized gains on investments	$1,069	$2,605

Pre-tax net realized gains on investments of $1.1 million for the three months ended March 31, 2015 were generated from net realized gains associated with the sales or redemptions of securities of $0.7 million and net realized gains associated with other invested assets of $0.4 million. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Pre-tax net realized gains on investments of $2.6 million for the three months ended March 31, 2014 were generated from net realized gains associated with other invested assets of $1.8 million and net realized gains associated with sales or redemptions of securities of $1.0 million. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Offsetting these gains for the three months ended March 31, 2014, were other-than-temporary impairment charges of $0.2 million related to three mortgage-backed securities for which previous impairment charges had been recorded.

Table of Contents

Realized gains (losses) and changes in unrealized appreciation related to fixed maturities, equity securities and other invested assets are as follows:

TRANSACTIONS WITH MANAGEMENT AND OTHERS

Executive Officer and Director-Related Employees of the Company

Ty Deese, an adult child of George E. Deese, the chairman of the board, president and chief executive officer of the company, was employed as the president of a company subsidiary through November 2007. He was paid an aggregate salary and bonus of $202,364 in fiscal 2007.

Charles Avera, the brother of Stephen R. Avera, the senior vice president, secretary and general counsel of the company, was employed as a national accounts vice president of a company subsidiary throughout fiscal 2007. He was paid an aggregate salary and bonus of $150,984 in fiscal 2007. He also received payments of $154,872 in connection with our Stock Appreciation Rights Plan.

A. Ryals McMullian, an adult child of Amos R. McMullian, a director, was employed by the company throughout fiscal 2007 as associate general counsel. He was paid an aggregate salary and bonus of $185,472 in fiscal 2007. He also received payments of $212,949 in connection with our Stock Appreciation Rights Plan.

Any transaction between the company and a related party is disclosed to the nominating/corporate governance committee and then presented to the full board for evaluation and approval. The company s policies with respect to related party transactions are set forth in our corporate governance guidelines and our code of business conduct & ethics which states that the company does not engage in transactions with related parties if such a transaction would cast into doubt the independence of the director, present the appearance of a conflict of interest or violate any applicable law. Each of the transactions set forth above were reviewed and approved by our board in accordance with the company s policy.

Table of Contents

AUDIT COMMITTEE REPORT

The following Report of the audit committee does not constitute soliciting material and should not be deemed filed or incorporated by reference into any other Flowers Foods filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate this Report by reference therein.

During fiscal 2007, the audit committee conducted ten meetings. At each meeting the audit committee met with the senior members of the company s management team (including the chief financial officer), internal auditors and the company s independent registered public accounting firm, PricewaterhouseCoopers LLP. At each of its regularly scheduled meetings, the audit committee conducted private sessions with the independent registered public accounting firm, and separately with the director of internal audit, the chief financial officer, the company s compliance officer and the company s general counsel to discuss financial management, accounting and internal controls, compliance matters and legal issues. The audit committee has reviewed and discussed with management and PricewaterhouseCoopers LLP the company s audited consolidated financial statements for the fiscal year ended December 29, 2007 and the company s disclosures under Management s Discussion and Analysis of Financial Condition and Results of Operations in the Annual Report on Form 10-K, including a discussion of the quality of the accounting principles, the reasonableness of significant accounting judgments and estimates and the clarity of disclosures in the financial statements. The audit committee reviewed management s representations and reviewed certifications prepared by the chief executive officer, chief financial officer and chief accounting officer that the unaudited quarterly and audited consolidated financial statements of the company fairly present, in all material respects, the financial condition and results of operations of the company. Management advised the audit committee that the company s financial statements were prepared in accordance with generally accepted accounting principles, and reviewed significant accounting issues with the audit committee. These reviews included discussions with PricewaterhouseCoopers LLP of the matters required to be discussed pursuant to the Statement on Auditing Standards No. 61, Communication with Audit Committees, as amended, including the quality of the company s accounting principles, the reasonableness of significant judgments and the clarity of disclosures in the financial statements. The audit committee has also received the written disclosures and the letter from PricewaterhouseCoopers LLP required by Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees, and has discussed with PricewaterhouseCoopers LLP matters relating to its independence from the company, including a review of audit and non-audit fees. The audit committee has also monitored the scope and adequacy of the company s internal audit program and reviewed internal audit staffing levels.

The audit committee has been updated periodically on management s process to assess the adequacy of the company s internal control over financial reporting, the framework used to make the assessment, and management s conclusions on the effectiveness of the company s internal control over financial reporting. The audit committee has also discussed with PricewaterhouseCoopers LLP the company s internal control assessment process, management s assessment with respect thereto and PricewaterhouseCoopers LLP s evaluation of the company s internal control over financial reporting.

In performing all of its functions, the audit committee acts in an oversight capacity on behalf of the board of directors. The audit committee reviews the company s earnings releases before issuance and its Quarterly Reports on Form 10-Q and Annual Report on Form 10-K prior to filing with the SEC. In its oversight role, the audit committee relies on the representations of management, which has the primary responsibility for establishing and maintaining adequate internal controls over financial reporting and for preparing the financial statements and other reports, and of the independent registered public accounting firm, who is engaged to audit and report on the consolidated financial statements of the company and its subsidiaries and the effectiveness of the company s internal control over financial reporting.

39

Table of Contents

Based on its review and discussions, the audit committee recommended to our board of directors (and the board of directors has approved) that our audited financial statements be included in our Annual Report on Form 10-K for the fiscal year ended December 29, 2007. The audit committee and the board of directors also have appointed PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending January 3, 2009. The board of directors is recommending that the shareholders of Flowers Foods, Inc. ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm.

The Audit Committee
of the Board of Directors:

Franklin L. Burke, Chairman
Joe E. Beverly
Benjamin H. Griswold, IV
C. Martin Wood III

40

Table of Contents

PROPOSAL II

AMENDMENT OF THE RESTATED ARTICLES OF INCORPORATION

Our board of directors has unanimously approved, and recommends to the shareholders for their adoption, an amendment to the company s Restated Articles of Incorporation (the Restated Articles) that would increase the number of authorized shares of our common stock from 120,000,000 to 500,000,000, and increase the aggregate number of authorized shares of all classes of the company s capital stock from 121,000,000 to 501,000,000 (the proposed amendment is referred to as the Amendment).

The following is the text of the first sentence of Article Two, Section One of the Restated Articles of Incorporation as proposed to be amended:

SECTION 1. Authorized Capital Stock. The Corporation shall have the authority to issue not more than five hundred one million (501,000,000) shares of capital stock consisting of five hundred million (500,000,000) shares of Common Stock having a par value of $.01 per share, and one million (1,000,000) shares of Preferred Stock of which: (i) one hundred thousand (100,000) shares shall be designated Series A Junior Participating Preferred Stock, having a par value per share of $100 (the Series A Preferred Stock) and (ii) nine hundred thousand (900,000) shares of preferred stock, having a par value per share of $0.01 (the Preferred Stock) to be issued in one or more series, in the manner provided below.

Currently, the company is authorized by the Restated Articles to issue 121,000,000 shares of capital stock, of which 120,000,000 shares are common stock, par value $.01 per share, and 1,000,000 shares are preferred stock with 100,000 shares of preferred stock designated as Series A Junior Participating Preferred Stock, par value $.01 per share. If the Amendment is adopted by the shareholders, then the authorization pertaining to all capital stock will be increased to 501,000,000 shares, the authorization pertaining to common stock will be increased to 500,000,000 shares, and the authorization relating to preferred stock will remain at 1,000,000.

As of March 28, 2008, there were 92,147,046 shares of Flowers common stock outstanding and entitled to vote. In addition, as of March 28, 2008, a total of 14,136,975 shares were reserved for issuance under the company s Equity and Performance Incentive Plan. Of the preferred stock authorized under the Restated Articles, 100,000 shares have been designated as Series A Junior Participating Preferred Stock, none of which is outstanding.

Largely due to four three-for-two stock splits since our spin-off from Flowers Industries in 2001, the number of shares of the company s common stock outstanding has increased significantly. With 92,147,046 shares currently outstanding and only 120,000,000 shares authorized, the company does not have many shares remaining available for issuance.

Our board is seeking approval for the additional authorized common stock at this time because opportunities requiring prompt action may arise in the future, and the board believes the delay and expense in seeking shareholder approval for additional authorized common stock could deprive the company and its shareholders of the ability to benefit effectively from opportunities and/or cause the loss of attractive acquisition or financing arrangements. For example, the additional shares could be issued to take advantage of future opportunities to structure and consummate financing transactions, mergers and acquisitions, for stock splits, stock dividends and to implement future equity based benefit plans. Such authorized but unissued shares of common stock will provide the company with additional flexibility. Our board will have the authority to issue such shares of common stock for any proper corporate purpose without further shareholder approval, unless such approval is required by applicable law or by the NYSE Rules. Except for issuances of shares of common stock in connection with its equity-based benefit plans, the company does not have at this time any plan, commitment, arrangement, understanding or agreement, either oral or written, to issue any of the additional shares of our common stock.

The terms of the additional shares of common stock would be identical to those of the currently outstanding shares of common stock. The proposed amendment would not alter the relative rights and limitations of the common stock. Under our Restated Articles, our shareholders do not have preemptive rights with respect to our common stock. Thus, should our board elect to issue additional shares of our common stock, existing holders of our common stock would not have any preferential rights to purchase such shares. Depending on the circumstances, any issuance of additional shares of our common stock could adversely affect the existing holders of shares of our common stock,

Table of Contents

including in connection with a third party seeking to acquire control of the Company, by diluting the ownership, voting power and earnings per share of the existing holders of our common stock.

If the proposed amendment is adopted, it would become effective upon filing of a Certificate of Amendment to our Restated Articles of Incorporation with the Secretary of State of the State of Georgia, which we currently anticipate would occur as soon as practicable following the 2008 annual meeting. However, if our shareholders approve the proposed amendment to our Restated Articles, our board retains discretion under Georgia law not to implement the proposed amendment. If our board was to exercise such discretion, the number of authorized shares would remain unchanged.

The Amendment described in this section requires the affirmative vote of the holders of a majority of the shares of our common stock for approval.

YOUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR PROPOSAL II

Table of Contents

PROPOSAL III

RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Our audit committee and board of directors have appointed PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending January 3, 2009. Our board of directors recommends that this appointment be ratified.

Representatives of PricewaterhouseCoopers LLP will be present at the meeting and will have the opportunity to make a statement, if they desire to do so, and to respond to appropriate questions.

We have been advised by PricewaterhouseCoopers LLP that neither the firm, nor any member of the firm, has any financial interest, direct or indirect, in any capacity in the company or its subsidiaries.

If the shareholders of the company do not ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal 2008, the audit committee will reconsider the appointment.

YOUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR PROPOSAL III

FISCAL 2007 AND FISCAL 2006 AUDIT FIRM FEE SUMMARY

During fiscal 2007 and fiscal 2006, we retained our principal accountant, PricewaterhouseCoopers LLP, to provide services in the following categories and amounts:

Audit Fees. Fees for audit services totaled approximately $1,365,000 in 2007 and $1,315,000 in 2006, including fees associated with annual audits and the reviews of our Quarterly Reports on Form 10-Q and Annual Reports on Form 10-K.

Audit Related Fees. Fees for audit related services totaled approximately $354,000 in 2007 and $89,900 in 2006. Audit related services principally include services related to audits of certain employee benefit plans and accounting consultations.

Tax Fees. Fees for tax services, including tax compliance, tax advice and tax planning, totaled approximately $440,000 in 2007 and $275,000 in 2006.

All Other Fees. Fees for all other services not described above totaled approximately $4,500 in 2007 and $4,500 in 2006, and were related to software licensing agreements in both 2007 and 2006.

All non-audit services were reviewed by the audit committee, which concluded that the provision of such services by PricewaterhouseCoopers LLP was compatible with the maintenance of that firm s independence in the conduct of its auditing function. On an ongoing basis all audit and permissible non-audit services provided by PricewaterhouseCoopers LLP are pre-approved by the audit committee on a case-by-case basis.

Representatives from PricewaterhouseCoopers LLP are expected to be present at the annual meeting. They will be provided the opportunity to make a statement, if they desire to do so, and will be available for appropriate questions.

43

Table of Contents

SHAREHOLDER PROPOSALS

In order to properly submit a proposal for inclusion in the proxy statement for the 2009 annual meeting, you must follow the procedures outlined in Rule 14a-8 of the Exchange Act. To be eligible for inclusion, we must receive your shareholder proposal at our principal corporate offices in Thomasville, Georgia as set forth below no later than December 18, 2008.

If you wish to present a proposal before the 2009 annual meeting, but do not wish to have the proposal considered for inclusion in the proxy statement and proxy card, you must follow the procedures outlined in our amended and restated bylaws. We must receive your shareholder proposal at the address noted below by March 3, 2009. If your proposal is not properly brought before the annual meeting in accordance with our amended and restated bylaws, the chairman of the board of directors may declare such proposal not properly brought before the annual meeting, and it will not be acted upon.

Any proposals or notices should be sent to:

Stephen R. Avera
Senior Vice President,
Secretary and General Counsel
Flowers Foods, Inc.
1919 Flowers Circle
Thomasville, Georgia 31757

Table of Contents

[Form of Paper Proxy Front]

FLOWERS FOODS, INC.

Dear Shareholder,

Please take note of the important information enclosed with this proxy. Your vote is important, and we encourage you to exercise your right to vote your shares. Please mark the boxes on the reverse side of this proxy card to indicate your vote. Then sign the card and return it in the enclosed postage-paid envelope, or follow the instructions on the reverse side of this proxy card for Internet or telephone voting. Your vote must be received prior to the annual meeting of shareholders on May 30, 2008.

If you are a participant in the Flowers Foods, Inc. 401(k) Retirement Savings Plan, you have the right to direct Mercer Trust Company, the trustee of the 401(k) plan, how to vote the Flowers Foods, Inc. common stock allocated to your account. Any unvoted or unallocated shares will be voted by the trustee in the same proportion on each proposal as the trustee votes the shares of stock credited to the 401(k) plan participants accounts for which the trustee receives voting directions from the 401(k) plan participants. The number of shares you are eligible to vote is based on your balance in the 401(k) plan on March 28, 2008, the record date for the annual meeting. Because all of the shares in the 401(k) plan are registered in the name of Mercer Trust Company, as trustee, you will not be able to vote your shares in the 401(k) plan in person at the annual meeting on May 30, 2008.

If you own stock directly in your own name as well as in the 401(k) plan, separate share totals are indicated on the reverse side of this voting instruction form. If you own stock indirectly through a bank or broker, as well as in the 401(k) plan, you will receive a separate voting instruction form from the bank or broker.

Thank you.

Flowers Foods, Inc.

FLOWERS FOODS, INC.
1919 Flowers Circle
Thomasville, Georgia 31757

THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS
FOR THE ANNUAL MEETING OF SHAREHOLDERS TO BE HELD ON May 30, 2008

The undersigned hereby appoints George E. Deese, R. Steve Kinsey and Stephen R. Avera as proxies, with power to act without the other, and with full power of substitution, and hereby authorizes them to represent and vote, as designated on the reverse side, all the shares of common stock of Flowers Foods, Inc. held of record on March 28, 2008 by the undersigned at the annual meeting of shareholders to be held on May 30, 2008, and at any adjournment or postponement thereof. The above-named proxies of the undersigned are authorized to vote, in their discretion, upon such other matters as may properly come before the annual meeting and any adjournment or postponement thereof.

If you are a participant in the Flowers Foods, Inc. 401(k) Retirement Savings Plan, you have the right to direct Mercer Trust Company, the trustee of the 401(k) plan, how to vote the Flowers Foods, Inc. common shares allocated to your account. This proxy card also acts as a voting instruction form to provide voting directions to the trustee.

The proxies will vote on the proposals set forth in the Notice of Annual Meeting and Proxy Statement as specified on the reverse side and are authorized to vote, in their discretion, on any other business that may properly come before the Annual Meeting.

WHEN PROPERLY EXECUTED, THIS PROXY WILL BE VOTED IN ACCORDANCE WITH THE INSTRUCTIONS INDICATED ON THE REVERSE SIDE. IF NO INDICATION IS MADE, THIS PROXY WILL BE VOTED FOR THE ELECTION OF THE DIRECTOR-NOMINEES LISTED ON THE REVERSE SIDE, FOR PROPOSAL 2 AND FOR PROPOSAL 3, AND IN THE DISCRETION OF THE PROXIES AS TO ANY OTHER MATTER THAT MAY PROPERLY COME BEFORE THE ANNUAL MEETING.

PLEASE VOTE, DATE AND SIGN ON THE REVERSE SIDE AND RETURN THE PROXY IN THE RETURN ENVELOPE PROVIDED.

Table of Contents

[Form of Paper Proxy Back]

FLOWERS FOODS, INC.
ATTN: SHAREHOLDER RELATIONS DEPT.
1919 Flowers Circle
Thomasville, GA 31757

VOTE BY INTERNET www.proxyvote.com

Use the Internet to transmit your voting instructions and for electronic delivery of information up until 11:59 P.M. Eastern Time on May 29, 2008 (May 28, 2008 for 401(k) plan participants). Have your proxy card in hand when you access the web site. You will be prompted to enter the 12-digit Control Number which is located below to obtain your records and to create an electronic voting instruction form.

VOTE BY PHONE 1-800-690-6903

Use any touch-tone telephone to transmit your voting instructions up until 11:59 P.M. Eastern Time on May 29, 2008 (May 28, 2008 for 401(k) plan participants). Have your proxy card in hand when you call. You will be prompted to enter the 12-digit Control Number which is located below and then follow the simple instructions the Vote Voice provides you.

VOTE BY MAIL

Mark, sign, and date your proxy card and return it in the postage-paid envelope we have provided or return it to Flowers Foods, Inc., c/o ADP, 51 Mercedes Way, Edgewood, NY 11717.

TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK AS FOLLOWS:

THIS PROXY CARD IS VALID ONLY WHEN SIGNED AND DATED

FLOWERS FOODS, INC.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR ALL THE DIRECTOR-NOMINEES:

1. Election of Directors

Director-nominees proposed for election in Class I to serve until 2011:

01) Benjamin H. Griswold, IV, 02) Joseph L. Lanier, Jr., 03) Jackie M. Ward, 04) C. Martin Wood III

o	FOR ALL	o	WITHHOLD ALL	o	WITHHOLD AUTHORITY TO VOTE FOR ANY INDIVIDUAL DIRECTOR-NOMINEE (Write number(s) of director-nominee(s) on the line below)

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE FOLLOWING PROPOSAL:

2. To approve an amendment to the company s Restated Articles of Incorporation to increase the number of authorized shares of common stock to 500,000,000 shares.

o FOR o AGAINST o ABSTAIN

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR THE FOLLOWING PROPOSAL:

3. To ratify the appointment of PricewaterhouseCoopers LLP as the independent registered public accounting firm for Flowers Foods, Inc. for the 2008 fiscal year.

o FOR o AGAINST o ABSTAIN

Please date this proxy and sign it exactly as your name or names appear on your stock certificates or on a label affixed hereto. When shares are held jointly, EACH joint owner should sign. When signing as attorney, executor, administrator, trustee, guardian, corporate officer, etc., give full title as such. If shares are held by a corporation, please sign in full the corporate name by its president or other authorized officer. If shares are held by a partnership, please sign in the partnership name by an authorized person.

Signature (PLEASE SIGN WITHIN BOX) Date Signature (Joint Owners) Date