

MERCURY GENERAL CORP  
Form 10-Q  
April 30, 2019  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
For the Quarterly Period Ended March 31, 2019  
Commission File No. 001-12257

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MERCURY GENERAL CORPORATION  
(Exact name of registrant as specified in its charter)

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|   |   |
|---|---|
| California  | 95-2211612                              |
| (State or other jurisdiction of<br>incorporation or organization) | (I.R.S. Employer<br>Identification No.) |

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|  |            |
|--|------------|
| 4484 Wilshire Boulevard, Los Angeles, California | 90010      |
| (Address of principal executive offices)         | (Zip Code) |

Registrant's telephone number, including area code: (323) 937-1060

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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 every Interactive Data File required to be submitted 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 such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
Emerging growth company

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

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

At April 25, 2019, the registrant had issued and outstanding an aggregate of 55,352,577 shares of its Common Stock.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (in thousands)

|   | March 31,<br>2019 | December 31,<br>2018 |
|---|-------------------|----------------------|
|   | (unaudited)       |                      |
| <b>ASSETS</b>   |                   |                      |
| Investments, at fair value:   |                   |                      |
| Fixed maturity securities (amortized cost \$3,011,979; \$2,969,541) | \$3,077,373       | \$ 2,985,161         |
| Equity securities (cost \$577,263; \$544,082)                       | 616,500           | 529,631              |
| Short-term investments (cost \$367,837; \$254,518)                  | 367,351           | 253,299              |
| Total investments   | 4,061,224         | 3,768,091            |
| Cash  | 270,105           | 314,291              |
| Receivables:  |                   |                      |
| Premium   | 579,963           | 555,038              |
| Accrued investment income   | 43,936            | 45,373               |
| Other   | 6,330             | 6,132                |
| Total receivables   | 630,229           | 606,543              |
| Reinsurance recoverables  | 114,500           | 221,088              |
| Deferred policy acquisition costs                                   | 219,723           | 215,131              |
| Fixed assets (net of accumulated depreciation \$364,015; \$359,269) | 155,844           | 153,023              |
| Operating lease right-of-use assets                                 | 41,275            | —                    |
| Current income taxes  | 27,051            | 38,885               |
| Deferred income taxes   | —                 | 13,339               |
| Goodwill  | 42,796            | 42,796               |
| Other intangible assets, net  | 14,437            | 15,534               |
| Other assets  | 29,536            | 45,008               |
| Total assets  | \$5,606,720       | \$ 5,433,729         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                         |                   |                      |
| Loss and loss adjustment expense reserves                           | \$1,787,612       | \$ 1,829,412         |
| Unearned premiums   | 1,273,661         | 1,236,181            |
| Notes payable   | 371,834           | 371,734              |
| Accounts payable and accrued expenses                               | 137,258           | 115,071              |
| Operating lease liabilities   | 43,439            | —                    |
| Deferred income taxes   | 6,166             | —                    |
| Other liabilities   | 267,456           | 263,647              |
| Total liabilities   | 3,887,426         | 3,816,045            |
| Commitments and contingencies                                       |                   |                      |
| Shareholders' equity:   |                   |                      |
| Common stock without par value or stated value:                     |                   |                      |
| Authorized 70,000 shares; issued and outstanding 55,350; 55,340     | 98,495            | 98,026               |
| Retained earnings   | 1,620,799         | 1,519,658            |
| Total shareholders' equity  | 1,719,294         | 1,617,684            |
| Total liabilities and shareholders' equity                          | \$5,606,720       | \$ 5,433,729         |

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

|  | Three Months Ended |             |
|--|--------------------|-------------|
|  | March 31,          |             |
|  | 2019               | 2018        |
| Revenues:                              |                    |             |
| Net premiums earned                    | \$870,245          | \$808,084   |
| Net investment income                  | 34,174             | 31,510      |
| Net realized investment gains (losses) | 111,074            | (58,735 )   |
| Other                                  | 2,250              | 2,325       |
| Total revenues                         | 1,017,743          | 783,184     |
| Expenses:                              |                    |             |
| Losses and loss adjustment expenses    | 630,416            | 632,234     |
| Policy acquisition costs               | 148,413            | 140,984     |
| Other operating expenses               | 67,489             | 65,399      |
| Interest                               | 4,256              | 4,266       |
| Total expenses                         | 850,574            | 842,883     |
| Income (loss) before income taxes      | 167,169            | (59,699 )   |
| Income tax expense (benefit)           | 31,302             | (17,092 )   |
| Net income (loss)                      | \$135,867          | \$(42,607 ) |
| Net income (loss) per share:           |                    |             |
| Basic                                  | \$2.46             | \$(0.77 )   |
| Diluted                                | \$2.45             | \$(0.77 )   |
| Weighted average shares outstanding:   |                    |             |
| Basic                                  | 55,341             | 55,332      |
| Diluted                                | 55,348             | 55,332      |

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

(unaudited)

|   | Three Months Ended |              |
|---|--------------------|--------------|
|   | March 31,          |              |
|   | 2019               | 2018         |
| Common stock, beginning of year           | \$98,026           | \$97,523     |
| Proceeds from stock options exercised     | 453                | —            |
| Share-based compensation expense          | 16                 | 23           |
| Common stock, end of period               | 98,495             | 97,546       |
| Retained earnings, beginning of year      | 1,519,658          | 1,663,864    |
| Net income (loss)                         | 135,867            | (42,607 )    |
| Dividends paid to shareholders            | (34,726 )          | (34,582 )    |
| Retained earnings, end of period          | 1,620,799          | 1,586,675    |
| Total shareholders' equity, end of period | \$ 1,719,294       | \$ 1,684,221 |

See accompanying Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | 2019                            | 2018        |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                 |             |
| Net income (loss)   | \$ 135,867                      | \$(42,607 ) |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |             |
| Depreciation and amortization   | 15,085                          | 14,148      |
| Net realized investment (gains) losses  | (111,074 )                      | 58,735      |
| Increase in premiums receivable   | (24,923 )                       | (35,117 )   |
| Decrease in reinsurance recoverables  | 106,588                         | 3,673       |
| Changes in current and deferred income taxes                                      | 31,338                          | (17,087 )   |
| Increase in deferred policy acquisition costs                                     | (4,592 )                        | (4,058 )    |
| (Decrease) increase in loss and loss adjustment expense reserves                  | (41,800 )                       | 20,360      |
| Increase in unearned premiums   | 37,480                          | 48,417      |
| Increase in accounts payable and accrued expenses                                 | 22,742                          | 24,761      |
| Share-based compensation  | 16                              | 23          |
| Other, net  | 7,960                           | 7,103       |
| Net cash provided by operating activities   | 174,687                         | 78,351      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                                 |             |
| Fixed maturity securities available for sale in nature:                           |                                 |             |
| Purchases   | (146,592 )                      | (213,947 )  |
| Sales   | 15,197                          | 60,238      |
| Calls or maturities   | 80,099                          | 62,673      |
| Equity securities available for sale in nature:                                   |                                 |             |
| Purchases   | (256,696 )                      | (249,177 )  |
| Sales   | 227,787                         | 221,616     |
| Changes in securities payable and receivable                                      | 15,901                          | 19,537      |
| (Increase) decrease in short-term investments                                     | (113,287 )                      | 57,110      |
| Purchases of fixed assets   | (8,430 )                        | (6,206 )    |
| Other, net  | 1,421                           | 3,044       |
| Net cash used in investing activities   | (184,600 )                      | (45,112 )   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                                 |             |
| Dividends paid to shareholders  | (34,726 )                       | (34,582 )   |
| Proceeds from stock options exercised   | 453                             | —           |
| Net cash used in financing activities   | (34,273 )                       | (34,582 )   |
| Net decrease in cash  | (44,186 )                       | (1,343 )    |
| Cash:   |                                 |             |
| Beginning of the year   | 314,291                         | 291,413     |
| End of period   | \$ 270,105                      | \$ 290,070  |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURE</b>  |                                 |             |
| Interest paid   | \$ 8,268                        | \$ 8,250    |
| Income taxes refunded, net  | \$ 36                           | \$ 6        |



See accompanying Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

1. General

Consolidation and Basis of Presentation

The interim consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the “Company”). For the list of the Company’s subsidiaries, see Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018. These interim financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”), which differ in some respects from those filed in reports to insurance regulatory authorities. The financial data of the Company included herein are unaudited. In the opinion of management, all material adjustments of a normal recurring nature have been made to present fairly the Company’s financial position at March 31, 2019 and the results of operations and cash flows for the periods presented. All intercompany transactions and balances have been eliminated.

Certain financial information that is normally included in annual financial statements prepared in accordance with GAAP, but that is not required for interim reporting purposes, has been omitted from the accompanying interim consolidated financial statements and related notes. Readers are urged to review the Company’s Annual Report on Form 10-K for the year ended December 31, 2018 for more complete descriptions and discussions. Operating results and cash flows for the three months ended March 31, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about the effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates. See Note 1. Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018.

Earnings per Share

There were no potentially dilutive securities with anti-dilutive effect for the three months ended March 31, 2019. Potentially dilutive securities representing approximately 55,000 shares of common stock were excluded from the computation of diluted earnings per common share for the three months ended March 31, 2018 because their effect would have been anti-dilutive. For the three months ended March 31, 2018, the dilutive impact of incremental shares was excluded as the Company generated a net loss.

Dividends per Share

The Company declared and paid a dividend per share of \$0.6275 and \$0.6250 during the three months ended March 31, 2019 and 2018, respectively.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs consist of commissions paid to outside agents, premium taxes, salaries, and certain other underwriting costs that are incremental or directly related to the successful acquisition of new and renewal insurance contracts and are amortized over the life of the related policy in proportion to premiums earned. Deferred policy acquisition costs are limited to the amount that will remain after deducting from unearned premiums and anticipated investment income, the estimated losses and loss adjustment expenses, and the servicing costs that will be incurred as premiums are earned. The Company's deferred policy acquisition costs are further limited by excluding those costs not directly related to the successful acquisition of insurance contracts.

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Deferred policy acquisition cost amortization was \$148.4 million and \$141.0 million for the three months ended March 31, 2019 and 2018, respectively. The Company does not defer advertising expenditures but expenses them as incurred. The Company recorded net advertising expense of approximately \$13.6 million and \$13.7 million for the three months ended March 31, 2019 and 2018, respectively.

### Reinsurance

Liabilities for unearned premiums and unpaid losses are stated in the accompanying consolidated financial statements before deductions for ceded reinsurance. Unpaid losses and unearned premiums that are ceded to reinsurers are carried in reinsurance recoverables and other assets, respectively, in the Company's consolidated balance sheets. Earned premiums are stated net of deductions for ceded reinsurance.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2019. The Treaty provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake.

The Company recognized ceded premiums earned of approximately \$15 million and \$13 million for the three months ended March 31, 2019 and 2018, respectively, which are included in net premiums earned in its consolidated statements of operations, and ceded losses and loss adjustment expenses of approximately \$(58) million and \$1 million for the three months ended March 31, 2019 and 2018, respectively, which are included in losses and loss adjustment expenses in its consolidated statements of operations. The negative ceded losses and loss adjustment expenses for the three months ended March 31, 2019 resulted from re-estimation of the catastrophe loss reserves, including estimated subrogation that primarily benefited the Company's reinsurers, on the 2018 Camp and Woolsey Fires and the 2017 Southern California wildfires, which have been ceded to reinsurers under the Treaty. See Note 11. Loss and Loss Adjustment Expense Reserves for additional information.

The Company's insurance subsidiaries, as primary insurers, are required to pay losses to the extent reinsurers are unable to discharge their obligations under the reinsurance agreements.

### Revenue from Contracts with Customers (Topic 606)

The Company's revenue from contracts with customers is commission income earned from third-party insurers by its 100% owned insurance agencies, which amounted to approximately \$4.2 million and \$4.3 million, with related expenses of \$2.7 million and \$2.8 million, for the three months ended March 31, 2019 and 2018, respectively. All of the commission income, net of related expenses, is included in other revenues in the Company's consolidated statements of operations, and in other income of the Property and Casualty business segment in the Company's segment reporting (see Note 14. Segment Information).

As of March 31, 2019 and December 31, 2018, the Company had no contract assets and contract liabilities, and no remaining performance obligations associated with unrecognized revenues.

## 2. Recently Issued Accounting Standards

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2018-15, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software under

Subtopic 350-40. This ASU also requires an entity to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement and present such expense in the same line item in the statement of income as the fees associated with the hosting element (service) of the arrangement and classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element. The entity is also required to present the capitalized implementation costs in the statement of financial position in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented. ASU 2018-15 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-15 on its consolidated financial statements and related disclosures.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820), Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement." The amendments in this ASU require certain existing disclosure

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requirements in Topic 820 to be modified or removed, and certain new disclosure requirements to be added to the Topic. In addition, this ASU allows entities to exercise more discretion when considering fair value measurement disclosures. ASU 2018-13 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company is in the process of evaluating the impact of ASU 2018-13 on its consolidated financial statements and related disclosures.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment." ASU 2017-04 removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of Step 2 of the goodwill impairment test and requires an entity to recognize an impairment charge for the amount by which the carrying amount of a reporting unit exceeds its fair value. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 will be effective for the Company beginning January 1, 2020 with early adoption permitted. The Company does not anticipate that ASU 2017-04 will have a material impact on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326)." The amendments in this ASU replace the "incurred loss" methodology for recognizing credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of information including past events, current conditions and reasonable and supportable forecasts that affect the collectibility of reported amounts of financial assets that are not accounted for at fair value through net income, such as loans, certain debt securities, trade receivables, net investment in leases, off-balance sheet credit exposures and reinsurance receivables. Under the current GAAP incurred loss methodology, recognition of the full amount of credit losses is generally delayed until the loss is probable of occurring. Current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probability threshold. Subsequently, the FASB has issued additional ASUs on Topic 326 that do not change the core principle of the guidance in ASU 2016-13 but clarify or address certain aspects of it. ASU 2016-13 and the additional ASUs on Topic 326 will be effective for the Company beginning January 1, 2020. While the Company is in the process of evaluating the impact of ASU 2016-13, it does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures as most of its financial instruments with potential exposure to material credit losses are accounted for at fair value through net income.

### 3. Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, options sold, total return swap, accounts payable, and unsecured notes payable. Due to their short-term maturities, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried at fair value in the consolidated balance sheets.

The following table presents the fair values of financial instruments:

|                        | March 31,<br>2019 | December 31,<br>2018 |
|------------------------|-------------------|----------------------|
| (Amounts in thousands) |                   |                      |
| Assets                 |                   |                      |
| Investments            | \$4,061,224       | \$ 3,768,091         |
| Note receivable        | 5,588             | 5,557                |
| Liabilities            |                   |                      |
| Total return swap      | \$2,312           | \$ 4,851             |
| Options sold           | 716               | 3                    |
| Unsecured notes        | 372,638           | 362,674              |

### Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments at the time an eligible item is first recognized. The cost of investments sold is determined on a first-in and first-out method and realized gains and losses are included in net realized investment gains (losses) in the Company's consolidated statements of operations. See Note 4. Fair Value Option for additional information.

In the normal course of investing activities, the Company either forms or enters into relationships with variable interest entities ("VIEs"). A VIE is an entity that either has investors that lack certain essential characteristics of a controlling financial interest, such as simple majority kick-out rights, or lacks sufficient funds to finance its own activities without financial support provided by other entities. The Company performs ongoing qualitative assessments of the VIEs to determine whether the Company has a controlling financial interest in the VIE and therefore is the primary beneficiary. The Company is deemed to have a controlling

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financial interest when it has both the ability to direct the activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant to the VIE. Based on the Company's assessment, if it determines it is the primary beneficiary, the Company consolidates the VIE in its consolidated financial statements.

The Company forms special purpose investment vehicles to facilitate its investment activities involving derivative instruments such as total return swaps, or limited partnerships such as private equity funds. These special purpose investment vehicles are consolidated VIEs as the Company has determined it is the primary beneficiary of such VIEs. Creditors have no recourse against the Company in the event of default by these VIEs. The Company had no implied or unfunded commitments to these VIEs at March 31, 2019 and December 31, 2018. The Company's financial or other support provided to these VIEs and its loss exposure are limited to its collateral and original investment.

The Company also invests directly in limited partnerships such as private equity funds. These investments are non-consolidated VIEs as the Company has determined it is not the primary beneficiary. The Company's maximum exposure to loss is limited to the total carrying value that is included in equity securities in the Company's consolidated balance sheets. At March 31, 2019 and December 31, 2018, the Company had no outstanding unfunded commitments to these VIEs whereby the Company may be called by the partnerships during the commitment period to fund the purchase of new investments and the expenses of the partnerships.

### Note Receivable

In August 2017, the Company completed the sale of approximately six acres of land located in Brea, California (the "Property"), for a total sale price of approximately \$12.2 million. Approximately \$5.7 million of the total sale price was received in the form of a promissory note (the "Note") and the remainder in cash. The Note is secured by a first trust deed and an assignment of rents on the Property, and bears interest at an annual rate of 3.5%, payable in monthly installments. The Note matures in August 2020. Interest earned on the Note is recognized in other revenues in the Company's consolidated statements of operations. The Company elected to apply the fair value option to the Note at the time it was first recognized. The fair value of note receivable is included in other assets in the Company's consolidated balance sheets, while the changes in fair value of note receivable are included in net realized investment gains or losses in the Company's consolidated statements of operations.

### Options Sold

The Company writes covered call options through listed and over-the-counter exchanges. When the Company writes an option, an amount equal to the premium received by the Company is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated by the Company as realized gains from investments on the expiration date. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining whether the Company has realized a gain or loss. The Company, as writer of an option, bears the market risk of an unfavorable change in the price of the security underlying the written option. Liabilities for covered call options are included in other liabilities in the Company's consolidated balance sheets.

### Total Return Swap

The fair value of the total return swap reflects the estimated amount that, upon termination of the contract, would be received for selling an asset or paid to transfer a liability in an orderly transaction.

### Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at March 31, 2019 and December 31, 2018 was obtained from a third party pricing service.

For additional disclosures regarding methods and assumptions used in estimating fair values, see Note 5. Fair Value Measurements.



#### 4. Fair Value Option

The Company applies the fair value option to all fixed maturity and equity investment securities and short-term investments at the time an eligible item is first recognized. In addition, the Company elected to apply the fair value option to the note receivable recognized as part of the sale of land in August 2017. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as the expansion of the use of fair value measurement by the Company consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

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Gains or losses due to changes in fair value of financial instruments measured at fair value pursuant to application of the fair value option are included in net realized investment gains or losses in the Company's consolidated statements of operations. Interest and dividend income on investment holdings are recognized on an accrual basis at each measurement date and are included in net investment income in the Company's consolidated statements of operations, while interest earned on the note receivable is included in other revenues in the Company's consolidated statements of operations.

The following table presents gains (losses) due to changes in fair value of investments and the note receivable that are measured at fair value pursuant to the application of the fair value option:

|                           | Three Months Ended     |            |
|---------------------------|------------------------|------------|
|                           | March 31,              |            |
|                           | 2019                   | 2018       |
|                           | (Amounts in thousands) |            |
| Fixed maturity securities | \$49,775               | \$(46,213) |
| Equity securities         | 53,687                 | (11,886 )  |
| Short-term investments    | 734                    | (392 )     |
| Total investments         | \$104,196              | \$(58,491) |
| Note receivable           | 31                     | (41 )      |
| Total gains (losses)      | \$104,227              | \$(58,532) |

## 5. Fair Value Measurements

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price.

Accordingly, when market observable data are not readily available, the Company's own assumptions are used to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based on the level of judgment associated with inputs used to measure their fair values and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;

Level 2

- Quoted prices for identical or similar assets or liabilities in non-active markets; or

- Either directly or indirectly observable inputs as of the reporting date.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

#### Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company's fair value measurements are based on the market approach, which utilizes market transaction data for the same or similar instruments.

The Company obtained unadjusted fair values on 98.3% of its investment portfolio from an independent pricing service. For a private equity fund that was classified as Level 3 and included in equity securities at March 31, 2019 and December 31, 2018, the Company obtained specific unadjusted broker quotes based on net fund value and, to a lesser extent, unobservable inputs from

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at least one knowledgeable outside security broker to determine the fair value. The fair value of the private equity fund was \$1.2 million and \$1.4 million at March 31, 2019 and December 31, 2018, respectively.

Level 1 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets.

Additional pricing services and closing exchange values are used as a comparison to ensure that reasonable fair values are used in pricing the investment portfolio.

U.S. government bonds /Short-term bonds: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets in active markets.

Options sold: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on unadjusted quoted prices for identical instruments in active markets.

Level 2 measurements - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability.

Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs such as quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential and commercial mortgage loans valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. The Company had holdings of \$22.4 million and \$24.8 million in commercial mortgage-backed securities at March 31, 2019 and December 31, 2018, respectively.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Total return swap: Valued based on multi-dimensional models using inputs such as interest rate yield curves, underlying debt/credit instruments and the appropriate benchmark spread for similar assets in active markets, observable for substantially the full term of the contract.

Collateralized loan obligations ("CLOs"): Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets.

Other asset-backed securities: Comprised of securities that are collateralized by non-mortgage assets, such as automobile loans, valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets.

Note receivable: Valued based on observable inputs, such as benchmark yields, and considering any premium or discount for the differential between the stated interest rate and market interest rates, based on quoted market prices of similar instruments.

Level 3 measurements - Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Private equity fund: Private equity fund, excluding a private equity fund measured at net asset value ("NAV"), is valued based on underlying investments of the fund or assets similar to such investments in active markets, taking into consideration specific unadjusted broker quotes based on net fund value and unobservable inputs from at least one knowledgeable outside security broker related to liquidity assumptions.

Fair value measurement using NAV practical expedient - The fair value of the Company's investment in private equity fund measured at net asset value is determined using NAV as advised by the external fund manager and the third party administrator. The NAV of the Company's limited partnership interest in this fund is based on the manager's and the administrator's valuation of the underlying holdings in accordance with the fund's governing documents and GAAP. In accordance with applicable accounting

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guidance, this investment, measured at fair value using the NAV practical expedient, is not classified in the fair value hierarchy. The strategy of the fund is to provide current income to investors by investing mainly in equity tranches and sub-investment grade rated debt tranches of CLO issuers in the new and secondary markets, and equity interests in vehicles established to purchase and warehouse loans in anticipation of a CLO closing or to satisfy regulatory risk retention requirements associated with certain CLOs. The Company has made all of its capital contributions in the fund and had no outstanding unfunded commitments at March 31, 2019 with respect to this fund. The underlying assets of the fund are expected to be liquidated over the period of approximately one to four years from March 31, 2019. The Company does not have the contractual option to redeem but will receive distributions based on the liquidation of the underlying assets and the interest proceeds from the underlying assets. In addition, the Company does not have the ability to withdraw from the fund, or to sell, assign, pledge or transfer its investment, without the consent from the general partner of the fund.

The Company's financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains or losses in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair values:

|  | March 31, 2019         |             |         |             |
|--|------------------------|-------------|---------|-------------|
|  | Level 1                | Level 2     | Level 3 | Total       |
|  | (Amounts in thousands) |             |         |             |
| Assets   |                        |             |         |             |
| Fixed maturity securities:                                     |                        |             |         |             |
| U.S. government bonds  | \$23,786               | \$—         | \$—     | \$23,786    |
| Municipal securities   | —                      | 2,695,108   | —       | 2,695,108   |
| Mortgage-backed securities                                     | —                      | 28,438      | —       | 28,438      |
| Corporate securities   | —                      | 118,024     | —       | 118,024     |
| Collateralized loan obligations                                | —                      | 172,963     | —       | 172,963     |
| Other asset-backed securities                                  | —                      | 39,054      | —       | 39,054      |
| Total fixed maturity securities                                | 23,786                 | 3,053,587   | —       | 3,077,373   |
| Equity securities:   |                        |             |         |             |
| Common stock   | 513,908                | —           | —       | 513,908     |
| Non-redeemable preferred stock                                 | —                      | 33,739      | —       | 33,739      |
| Private equity fund  | —                      | —           | 1,213   | 1,213       |
| Private equity fund measured at net asset value <sup>(1)</sup> |                        |             |         | 67,640      |
| Total equity securities  | 513,908                | 33,739      | 1,213   | 616,500     |
| Short-term investments:  |                        |             |         |             |
| Short-term bonds   | 32,801                 | 19,869      | —       | 52,670      |
| Money market instruments                                       | 314,681                | —           | —       | 314,681     |
| Total short-term investments                                   | 347,482                | 19,869      | —       | 367,351     |
| Other assets:  |                        |             |         |             |
| Note receivable  | —                      | 5,588       | —       | 5,588       |
| Total assets at fair value                                     | \$885,176              | \$3,112,783 | \$1,213 | \$4,066,812 |
| Liabilities  |                        |             |         |             |
| Other liabilities:   |                        |             |         |             |
| Total return swap  | \$—                    | \$2,312     | \$—     | \$2,312     |

|                                 |       |         |     |         |
|---------------------------------|-------|---------|-----|---------|
| Options sold                    | 716   | —       | —   | 716     |
| Total liabilities at fair value | \$716 | \$2,312 | \$— | \$3,028 |

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|  | December 31, 2018      |             |         |             |
|--|------------------------|-------------|---------|-------------|
|  | Level 1                | Level 2     | Level 3 | Total       |
|  | (Amounts in thousands) |             |         |             |
| Assets   |                        |             |         |             |
| Fixed maturity securities:                                     |                        |             |         |             |
| U.S. government bonds  | \$25,003               | \$—         | \$—     | \$25,003    |
| Municipal securities   | —                      | 2,620,132   | —       | 2,620,132   |
| Mortgage-backed securities                                     | —                      | 30,952      | —       | 30,952      |
| Corporate securities   | —                      | 105,524     | —       | 105,524     |
| Collateralized loan obligations                                | —                      | 165,789     | —       | 165,789     |
| Other asset-backed securities                                  | —                      | 37,761      | —       | 37,761      |
| Total fixed maturity securities                                | 25,003                 | 2,960,158   | —       | 2,985,161   |
| Equity securities:   |                        |             |         |             |
| Common stock   | 430,973                | —           | —       | 430,973     |
| Non-redeemable preferred stock                                 | —                      | 31,433      | —       | 31,433      |
| Private equity fund  | —                      | —           | 1,445   | 1,445       |
| Private equity fund measured at net asset value <sup>(1)</sup> |                        |             |         | 65,780      |
| Total equity securities  | 430,973                | 31,433      | 1,445   | 529,631     |
| Short-term investments:  |                        |             |         |             |
| Short-term bonds   | 31,472                 | 16,784      | —       | 48,256      |
| Money market instruments                                       | 205,043                | —           | —       | 205,043     |
| Total short-term investments                                   | 236,515                | 16,784      | —       | 253,299     |
| Other assets:  |                        |             |         |             |
| Note receivable  | —                      | 5,557       | —       | 5,557       |
| Total assets at fair value                                     | \$692,491              | \$3,013,932 | \$1,445 | \$3,773,648 |
| Liabilities  |                        |             |         |             |
| Other liabilities:   |                        |             |         |             |
| Total return swap  | \$—                    | \$4,851     | \$—     | \$4,851     |
| Options sold   | 3                      | —           | —       | 3           |
| Total liabilities at fair value                                | \$3                    | \$4,851     | \$—     | \$4,854     |

<sup>(1)</sup> The fair value is measured using the NAV practical expedient; therefore, it is not categorized within the fair value hierarchy. The fair value amount is presented in this table to permit reconciliation of the fair value hierarchy to the amounts presented in the Company's consolidated balance sheets.

The following table presents a summary of changes in fair value of Level 3 financial assets and financial liabilities:

|  | Private Equity Fund               |         |
|--|-----------------------------------|---------|
|  | Three Months Ended March 31, 2019 | 2018    |
|  | (Amounts in thousands)            |         |
| Beginning balance                            | \$1,445                           | \$1,481 |
| Realized gains (losses) included in earnings | 111                               | (31 )   |
| Settlements                                  | (343 )                            | —       |



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|  |         |         |
|--|---------|---------|
| Ending balance   | \$1,213 | \$1,450 |
| The amount of total gains (losses) for the period included in earnings attributable to assets still held at March 31 | \$103   | \$(31 ) |

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the three months ended March 31, 2019 and 2018.

At March 31, 2019, the Company did not have any nonrecurring fair value measurements of nonfinancial assets or nonfinancial

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liabilities.

Financial Instruments Disclosed, But Not Carried, at Fair Value

The following tables present the carrying value and fair value of the Company's financial instruments disclosed, but not carried, at fair value, and the level within the fair value hierarchy at which such instruments are categorized:

| March 31, 2019 |            |         |         |         |
|----------------|------------|---------|---------|---------|
| Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |

(Amounts in thousands)

Liabilities

Notes payable:

|                 |           |           |      |   |
|-----------------|-----------|-----------|------|---|
| Unsecured notes | \$371,834 | \$372,638 | \$ — | — |
|-----------------|-----------|-----------|------|---|

December 31, 2018

| Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
|----------------|------------|---------|---------|---------|
|----------------|------------|---------|---------|---------|

(Amounts in thousands)

Liabilities

Notes payable:

|                 |           |           |      |   |
|-----------------|-----------|-----------|------|---|
| Unsecured notes | \$371,734 | \$362,674 | \$ — | — |
|-----------------|-----------|-----------|------|---|

Unsecured Notes

The fair value of the Company's publicly traded \$375 million unsecured notes at March 31, 2019 and December 31, 2018 was based on the spreads above the risk-free yield curve. These spreads are generally obtained from the new issue market, secondary trading and broker-dealer quotes.

See Note 12. Notes Payable for additional information on unsecured notes.

6. Leases

The Company adopted ASU 2016-02, "Leases (Topic 842)," which supersedes the guidance in Accounting Standards Codification ("ASC") 840, "Leases," on January 1, 2019, using a modified retrospective transition, with the cumulative-effect adjustment to the opening balance of retained earnings as of the effective date (the "effective date method"). Under the effective date method, financial results reported in periods prior to 2019 are unchanged. In addition, the Company elected the package of practical expedients permitted under the transition guidance within the new standard, which allowed the Company not to reassess (a) whether arrangements contain leases, (b) lease classification and (c) initial direct costs. Adoption of the new standard resulted in the recognition of operating lease right-of-use ("ROU") assets and operating lease liabilities of approximately \$41 million and \$43 million, respectively, at the adoption date for the Company's operating leases. The difference of approximately \$2 million between the operating lease ROU assets and operating lease liabilities represents reclassification of deferred rent liability (the difference between the straight-line rent expenses and paid rent amounts under the leases) to operating lease ROU assets from other liabilities at the adoption date. The Company did not have any cumulative-effect adjustment as a result of the adoption.

The Company has operating leases for office space for insurance operations and administrative functions, automobiles for general uses and certain employees, and office equipment such as printers and computers. As of March 31, 2019, the Company's leases had remaining terms ranging from less than one year to approximately 7 years. These leases may contain provisions for periodic adjustments to rates and charges applicable under such lease agreements. These rates and charges also may vary with the Company's level of uses. Certain of these leases include one or more options to renew or early terminate, and the exercise of these options is at our sole discretion. Certain leases also include options to purchase the leased property. The Company's lease agreements do not contain any residual value

guarantees.

The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease ROU assets and operating lease liabilities in the Company's consolidated balance sheets. ROU assets represent the Company's right to use an underlying asset for the lease term and lease liabilities represent its obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

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The Company uses its estimated incremental borrowing rate for office space and office equipment leases, which is derived from information available at the lease commencement date, in determining the present value of lease payments, as the implicit rate is not readily available for such leases. The Company gives consideration to its recent debt issuances as well as publicly available data for instruments with similar characteristics when calculating its incremental borrowing rates. For automobile leases, the Company uses a rate implicit in the lease at the lease commencement date in determining the present value of lease payments, as the readily-determinable implicit rate is provided in such leases. The Company's lease terms include options to extend or terminate the lease when it is reasonably certain that it will exercise that option. The Company does not use the short-term lease exemption practical expedient and records all leases on the balance sheets, including leases with a term of twelve months or less. The Company accounts for the lease and non-lease components as a single lease component for all of its leases. Lease expense for scheduled lease payments is recognized on a straight-line basis over the lease term.

The components of lease expense were as follows:

| Lease Cost                          | Classification           | Three<br>Months<br>Ended<br>March 31,<br>2019<br>(Amounts<br>in<br>thousands) |
|-------------------------------------|--------------------------|---|
| Operating lease cost <sup>(1)</sup> | Other operating expenses | \$ 3,190  |
| Variable lease cost <sup>(1)</sup>  | Other operating expenses | 739   |
| Total lease cost                    |                          | 3,929   |

<sup>(1)</sup> Includes short-term leases, which are immaterial.

Supplemental balance sheet information related to leases was as follows:

|                             | March 31,<br>2019<br>(Amounts<br>in<br>thousands) |
|-----------------------------|---|
| Operating lease ROU assets  | \$ 41,275   |
| Operating lease liabilities | 43,439  |

Weighted-average lease term and discount rate were as follows:

|   | March 31,<br>2019 |
|---|-------------------|
| Weighted-average remaining lease term (in years): |                   |
| Operating leases                                  | 3.9               |
| Weighted-average discount rate:                   |                   |
| Operating leases                                  | 3.29 %            |

Supplemental cash flow and other information related to leases was as follows:

Three  
Months  
Ended

|   | March 31,<br>2019<br>(Amounts<br>in<br>thousands) |
|---|---|
| Cash paid for amounts included in the measurement of lease liabilities: |   |
| Operating cash flows from operating leases                              | \$ 3,316  |
| ROU assets obtained in exchange for lease liabilities:                  |   |
| Operating leases  | 1,892   |

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Maturities of lease liabilities as of March 31, 2019 were as follows:

| Year                    | Operating Leases<br>(Amounts in thousands) |
|-------------------------|--|
| Remainder of 2019       | \$ 10,171                                  |
| 2020                    | 12,455                                     |
| 2021                    | 9,699                                      |
| 2022                    | 7,573                                      |
| 2023                    | 4,130                                      |
| 2024 and thereafter     | 2,446                                      |
| Total lease payments    | 46,474                                     |
| Less: Imputed interest  | 3,035                                      |
| Total lease obligations | 43,439                                     |

As of March 31, 2019, the Company had additional operating lease commitments that have not yet commenced of approximately \$6.5 million with each lease term ranging from approximately 1 year to 8 years. These operating leases will commence in 2019.

Disclosures related to periods prior to adoption of ASC Topic 842

Total rent expense recognized under the Company's various lease agreements was \$3.6 million for the three months ended March 31, 2018. The following table presents future minimum commitments for operating leases as of December 31, 2018:

| Year Ending December 31, | Operating Leases<br>(Amounts in thousands) |
|--------------------------|--|
| 2019                     | \$ 12,812                                  |
| 2020                     | 11,547                                     |
| 2021                     | 8,732                                      |
| 2022                     | 6,972                                      |
| 2023                     | 3,659                                      |
| Thereafter               | 1,966                                      |

## 7. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by using derivative instruments is equity price risk. Equity contracts (options sold) on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities.

The Company also enters into derivative contracts to enhance returns on its investment portfolio.

On February 13, 2014, Fannette Funding LLC ("FFL"), a special purpose investment vehicle formed by and consolidated into the Company, entered into a total return swap agreement with Citibank. Under the agreement, FFL receives the income equivalent on underlying obligations due to Citibank and pays to Citibank interest on the outstanding notional amount of the underlying obligations. The total return swap is secured by approximately \$31 million of U.S. Treasuries as collateral, which are included in short-term investments on the consolidated balance sheets. The Company paid interest at the rate of LIBOR plus 128 basis points prior to the renewal of the agreement in January 2018, LIBOR plus 120 basis points subsequent to the January 2018 renewal through July 2018, and LIBOR plus 105 basis points subsequent to the July 2018 renewal on the outstanding notional amount of the underlying obligations, which was approximately \$106 million and \$100 million as of March 31, 2019 and December 31, 2018, respectively. The agreement had an initial term of one year, subject to periodic renewal. In July 2018, the agreement was renewed through January 24, 2020, and the interest rate was changed to LIBOR plus 105 basis points.



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The following tables present the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains or losses in the consolidated statements of operations:

|  | Liability Derivatives    |                      | Gains<br>(Losses) Recognized in<br>Income |      |
|--|--------------------------|----------------------|---|------|
|  | March 31,<br>2019        | December 31,<br>2018 | Three Months Ended<br>March 31,           |      |
|  | (Amount in<br>thousands) |                      | 2019                                      | 2018 |
| Options sold - Other liabilities                           | \$716                    | \$ 3                 |   |      |
| Total return swap - Other liabilities                      | 2,312                    | 4,851                |   |      |
| Total derivatives  | \$3,028                  | \$ 4,854             |   |      |
|  |                          |                      | (Amounts in thousands)                    |      |
| Total return swap - Net realized investment gains (losses) | \$ 1,766                 | \$ 602               |   |      |
| Options sold - Net realized investment gains (losses)      | 873                      | 2,922                |   |      |
| Total  | \$ 2,639                 | \$ 3,524             |   |      |

Most options sold consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. See Note 5. Fair Value Measurements for additional disclosures regarding options sold.

#### 8. Goodwill and Other Intangible Assets

##### Goodwill

There were no changes in the carrying amount of goodwill during the three months ended March 31, 2019 and 2018. Goodwill is reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three months ended March 31, 2019 and 2018. All of the Company's goodwill is associated with the Property and Casualty business segment (See Note 14. Segment Information for additional information on the reportable business segment).

##### Other Intangible Assets

The following table presents the components of other intangible assets:

|                                    | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Carrying<br>Amount | Useful Lives |
|------------------------------------|--------------------------|-----------------------------|------------------------|--------------|
|                                    | (Amounts in thousands)   |                             |                        | (in years)   |
| As of March 31, 2019:              |                          |                             |                        |              |
| Customer relationships             | \$53,212                 | \$(48,998)                  | \$ 4,214               | 11           |
| Trade names                        | 15,400                   | (6,577)                     | 8,823                  | 24           |
| Technology                         | 4,300                    | (4,300)                     | —                      | 10           |
| Insurance license                  | 1,400                    | —                           | 1,400                  | Indefinite   |
| Total other intangible assets, net | \$74,312                 | \$(59,875)                  | \$ 14,437              |              |
| As of December 31, 2018:           |                          |                             |                        |              |
| Customer relationships             | \$53,048                 | \$(47,897)                  | \$ 5,151               | 11           |
| Trade names                        | 15,400                   | (6,417)                     | 8,983                  | 24           |



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|                                    |          |            |             |            |
|------------------------------------|----------|------------|-------------|------------|
| Technology                         | 4,300    | (4,300     | ) —         | 10         |
| Insurance license                  | 1,400    | —          | 1,400       | Indefinite |
| Total other intangible assets, net | \$74,148 | \$ (58,614 | ) \$ 15,534 |            |

Other intangible assets are reviewed annually for impairment and more frequently if potential impairment indicators exist. No impairment indicators were identified during the three months ended March 31, 2019 and 2018.

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Other intangible assets with definite useful lives are amortized on a straight-line basis over their useful lives. Other intangible assets amortization expense was \$1.3 million and \$1.4 million for the three months ended March 31, 2019 and 2018, respectively.

The following table presents the estimated future amortization expense related to other intangible assets as of March 31, 2019:

| Year              | Amortization Expense<br>(Amounts in thousands) |
|-------------------|--|
| Remainder of 2019 | \$ 3,802                                       |
| 2020              | 922  |
| 2021              | 902  |
| 2022              | 878  |
| 2023              | 714  |
| Thereafter        | 5,819  |
| Total             | \$ 13,037                                      |

## 9. Share-Based Compensation

In February 2015, the Company's Board of Directors adopted the 2015 Incentive Award Plan (the "2015 Plan"), replacing the 2005 Equity Incentive Plan which expired in January 2015. The 2015 Plan was approved at the Company's Annual Meeting of Shareholders in May 2015. A maximum of 4,900,000 shares of common stock are authorized for issuance under the 2015 Plan upon exercise of stock options, stock appreciation rights and other awards, or upon vesting of restricted stock unit ("RSU") or deferred stock awards. As of March 31, 2019, the Company had 70,000 stock options granted and outstanding and 4,830,000 shares of common stock available for future grant under the 2015 Plan.

Share-based compensation expenses for all stock options granted or modified are based on their estimated grant-date fair values. These compensation costs are recognized on a straight-line basis over the requisite service period of the award. The Company estimates forfeitures expected to occur in determining the amount of compensation cost to be recognized in each period. As of March 31, 2019, all outstanding stock options have a term of ten years from the date of grant and become exercisable in four equal installments on the first through fourth anniversaries of the grant date. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

In February 2018, the Compensation Committee of the Company's Board of Directors awarded a total of 80,000 stock options to four senior executives under the 2015 Plan which will vest over the four-year requisite service period. 10,000 of these stock options were forfeited in February 2019 following the departure of a senior executive. The fair values of these stock options were estimated on the date of grant using a closed-form option valuation model (Black-Scholes).

The following table provides the assumptions used in the calculation of grant-date fair values of these stock options based on the Black-Scholes option pricing model:

|  |         |
|--|---------|
| Weighted-average grant-date fair value | \$8.09  |
| Expected volatility                    | 33.18 % |
| Risk-free interest rate                | 2.62 %  |
| Expected dividend yield                | 5.40 %  |
| Expected term in months                | 72      |

Expected volatilities are based on historical volatility of the Company's stock over the term of the stock options. The Company estimated the expected term of stock options, which represents the period of time that stock options granted are expected to be outstanding, by using historical exercise patterns and post-vesting termination behavior. The risk-free interest rate is determined based on U.S. Treasury yields with equivalent remaining terms in effect at the time of the grant.

As of March 31, 2019, the Company had \$0.4 million of unrecognized compensation expense related to stock options awarded under the 2015 Plan, which will be recognized ratably over the remaining vesting period of approximately 2.9 years.

The fair value of each RSU grant was determined based on the market price of the Company's common stock on the grant date for awards classified as equity and on each reporting date for awards classified as liability. The RSUs vested at the end of a three-year performance period beginning with the year of the grant, and then only if, and to the extent that, the Company's

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performance during the performance period achieved the threshold established by the Compensation Committee of the Company's Board of Directors. Performance thresholds were based on the Company's cumulative underwriting income, annual underwriting income, and net earned premium growth. Compensation cost was recognized based on management's best estimate of the performance goals that would be achieved at the end of the performance period, taking into account expected forfeitures. If the minimum performance goals were not expected to be met, no compensation cost was recognized and any recognized compensation cost was reversed.

In February 2019, based on certification by the Compensation Committee of the Company's Board of Directors of the results of the three-year performance period ended December 31, 2018, all of the outstanding RSUs granted in 2016 expired unvested because the Company did not meet the minimum three-year performance threshold.

In March 2018, based on certification by the Compensation Committee of the Company's Board of Directors of the results of the three-year performance period ended December 31, 2017, all of the outstanding RSUs granted in 2015 expired unvested because the Company did not meet the minimum three-year performance threshold. No RSUs or stock options were awarded during the three months ended March 31, 2019.

10. Income Taxes

For financial statement purposes, the Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return only if, the positions are "more-likely-than-not" sustainable. Once this threshold has been met, the Company's measurement of its expected tax benefits is recognized in its consolidated financial statements.

There was a \$71,000 increase to the total amount of unrecognized tax benefits related to tax uncertainties during the three months ended March 31, 2019. The increase was the result of tax positions taken regarding California state tax issues based on management's best judgment given the facts, circumstances, and information available at the reporting date.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service and the taxing authorities of various states. Tax years that remain subject to examination by major taxing jurisdictions are 2015 through 2017 for federal taxes and 2011 through 2017 for California state taxes. For tax years 2003 through 2010, the Company achieved a resolution with the Franchise Tax Board ("FTB") in December 2017 and paid a negotiated settlement amount in accordance with the settlement agreement provided by the FTB and signed by the Company. The settlement agreement was approved and executed in the first quarter of 2019.

The Company is currently under examination for tax years 2011 through 2016. For tax years 2011 through 2013, the FTB issued Notices of Proposed Assessments ("NPAs") to the Company, for which the Company submitted a formal protest in 2018. If a reasonable settlement is not reached, the Company intends to pursue other options, including a formal hearing with the FTB, an appeal with the California Office of Tax Appeals, or litigation in Superior Court. For tax years 2014 through 2016, the FTB commenced its audit in December 2017 and has not yet completed its audit.

The Company believes that the resolution of these examinations and assessments will not have a material impact on the consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company's assets and liabilities, and expected benefits of utilizing net operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates or laws is recognized

in earnings in the period that includes the enactment date.

At March 31, 2019, the Company's deferred income taxes were in a net liability position, which included a combination of ordinary and capital deferred tax expenses or benefits. In assessing the Company's ability to realize deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate character within the carryback and carryforward periods available under the tax law. Management considers the reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized

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in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes that it is more likely than not that the Company's deferred tax assets will be realized.

## 11. Loss and Loss Adjustment Expense Reserves

The following table presents the activity in loss and loss adjustment expense reserves:

|  | Three Months Ended     |              |
|--|------------------------|--------------|
|  | March 31,              |              |
|  | 2019                   | 2018         |
|  | (Amounts in thousands) |              |
| Gross reserves at January 1                              | \$ 1,829,412           | \$ 1,510,613 |
| Less reinsurance recoverables on unpaid losses           | (180,859 )             | (64,001 )    |
| Net reserves at January 1                                | 1,648,553              | 1,446,612    |
| Incurred losses and loss adjustment expenses related to: |                        |              |
| Current year   | 629,054                | 589,582      |
| Prior years  | 1,362                  | 42,652       |
| Total incurred losses and loss adjustment expenses       | 630,416                | 632,234      |
| Loss and loss adjustment expense payments related to:    |                        |              |
| Current year   | 274,273                | 254,841      |
| Prior years  | 344,718                | 345,826      |
| Total payments   | 618,991                | 600,667      |
| Net reserves at March 31                                 | 1,659,978              | 1,478,179    |
| Reinsurance recoverables on unpaid losses                | 127,634                | 52,794       |
| Gross reserves at March 31                               | \$ 1,787,612           | \$ 1,530,973 |

The increase in the provision for insured events of prior years in 2019 of approximately \$1.4 million was primarily attributable to higher than estimated automobile losses, partially offset by lower than estimated California homeowners losses largely due to reductions in the Company's retained losses on the Camp and Woolsey Fires under the Treaty after accounting for the assignment of subrogation rights and re-estimation of reserves as part of normal reserving procedures, as described further below. The increase in the provision for insured events of prior years in 2018 of approximately \$42.7 million was primarily attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims.

For the three months ended March 31, 2019 and 2018, the Company recorded catastrophe losses net of reinsurance of approximately \$5 million and \$9 million, respectively. Gross catastrophe losses due to the catastrophe events that occurred during the three months ended March 31, 2019 totaled approximately \$11 million resulting primarily from winter storms in California, with no reinsurance benefits used for these losses. These losses were partially offset by favorable development of approximately \$6 million on prior years' catastrophe losses, primarily from reductions in the Company's retained portion of losses on the Camp and Woolsey Fires, as described above and below. The 2018 catastrophe losses were primarily due to winter storms and mudslides in California and winter storms in the states along the Atlantic Seaboard, with no reinsurance benefits used for these losses.

During the first quarter of 2019, the Company completed the sale of its subrogation rights related to the 2018 Camp and Woolsey Fires and the 2017 Thomas Fire (which was a component of the "2017 Southern California fires") to a third party. The Company's reinsurers were the primary beneficiaries of this transaction, as they had absorbed most of the losses under the terms of the Treaty. The Company has re-estimated its gross and net losses from the 2018 Camp and Woolsey Fires and the 2017 Southern California fires. At March 31, 2019, the Company estimates that its total gross losses from these catastrophes, after accounting for the assignment of subrogation rights and adjustments made

to claims reserves as part of normal reserving procedures, were approximately \$208 million, and its total net losses, after reinsurance benefits, were approximately \$40 million. The Company benefited by approximately \$10 million, before taxes, in the first quarter of 2019 from the sale of the subrogation rights, including adjustments made to the associated claims as a result of normal reserving procedures, reductions in the Company's retained portion of losses on the Camp and Woolsey Fires, and reduced reinstatement premiums recognized.

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## 12. Notes Payable

The following table presents information about the Company's notes payable:

|  | Lender                               | Interest Rate                       | Maturity Date  | March 31, 2019         | December 31, 2018 |
|--|--------------------------------------|-------------------------------------|----------------|------------------------|-------------------|
|  |                                      |                                     |                | (Amounts in thousands) |                   |
| Senior unsecured notes <sup>(1)</sup>                            | Publicly traded                      | 4.40%                               | March 15, 2027 | \$375,000              | \$ 375,000        |
| Unsecured credit facility <sup>(2)</sup>                         | Bank of America and Wells Fargo Bank | LIBOR plus 112.5-162.5 basis points | March 29, 2022 | —                      | —                 |
| Total principal amount   |                                      |                                     |                | 375,000                | 375,000           |
| Less unamortized discount and debt issuance costs <sup>(3)</sup> |                                      |                                     |                | 3,166                  | 3,266             |
| Total debt   |                                      |                                     |                | \$371,834              | \$ 371,734        |

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured, senior obligations of the Company with a 4.4% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. These notes mature on March 15, 2027. The Company used the proceeds from the notes to pay off amounts outstanding under the existing loan and credit facilities and for general corporate purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate including debt issuance costs of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 17.9% at March 31, 2019, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of April 25, 2019, there have been no borrowings under this facility.

The unamortized discount and debt issuance costs are associated with the publicly traded \$375 million senior unsecured notes. These are amortized to interest expense over the life of the notes, and the unamortized balance is presented in the Company's consolidated balance sheets as a direct deduction from the carrying amount of the debt. The unamortized debt issuance cost of approximately \$0.2 million associated with the \$50 million five-year unsecured revolving credit facility maturing on March 29, 2022 is included in other assets in the Company's consolidated balance sheets and amortized to interest expense over the term of the credit facility.

## 13. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance to a Notice of Non-Compliance originally issued in February 2004 (as amended, "2004 NNC") alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee



charged by the consumer's insurance broker. The California DOI sought to impose a fine for each policy on which the Company allegedly permitted an agent to charge a broker fee, to impose a penalty for each policy on which the Company allegedly used a misleading advertisement, and to suspend certificates of authority for a period of one year. In January 2012, the administrative law judge bifurcated the 2004 NNC between (a) the California DOI's order to show cause (the "OSC"), in which the California DOI asserts the false advertising allegations and accusation, and (b) the California DOI's notice of noncompliance (the "NNC"), in which the California DOI asserts the unlawful rate allegations. In February 2012, the administrative law judge ("ALJ") submitted a proposed decision dismissing the NNC, but the Commissioner rejected the ALJ's proposed decision. The Company challenged the rejection in Los Angeles Superior Court in April 2012, and the Commissioner responded with a demurrer. Following a hearing, the Superior Court sustained the Commissioner's demurrer, based on the Company's failure to exhaust its administrative remedies, and the Company appealed.

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The Court of Appeal affirmed the Superior Court's ruling that the Company was required to exhaust its administrative remedies, but expressly preserved for later appeal the legal basis for the ALJ's dismissal: violation of the Company's due process rights. Following an evidentiary hearing in April 2013, post-hearing briefs, and an unsuccessful mediation, the ALJ closed the evidentiary record on April 30, 2014. Although a proposed decision was to be submitted to the Commissioner on or before June 30, 2014, after which the Commissioner would have 100 days to accept, reject or modify the proposed decision, the proposed decision was not submitted until December 8, 2014. On January 7, 2015, the Commissioner adopted the ALJ's proposed decision, which became the Commissioner's adopted order (the "Order"). The decision and Order found that from the period July 1, 1996, through 2006, the Company's "brokers" were actually operating as "de facto agents" and that the charging of "broker fees" by these producers constituted the charging of "premium" in excess of the Company's approved rates, and assessed a civil penalty in the amount of \$27.6 million against the Company. On February 9, 2015, the Company filed a Writ of Administrative Mandamus and Complaint for Declaratory Relief (the "Writ") in the Orange County Superior Court seeking, among other things, to require the Commissioner to vacate the Order, to stay the Order while the Superior Court action is pending, and to judicially declare as invalid the Commissioner's interpretation of certain provisions of the California Insurance Code. Subsequent to the filing of the Writ, a consumer group petitioned and was granted the right to intervene in the Superior Court action. The Court did not order a stay, and the \$27.6 million assessed penalty was paid in March 2015. The Company filed an amended Writ on September 11, 2015, adding an explicit request for a refund of the penalty, with interest.

On August 12, 2016, the Superior Court issued its ruling on the Writ, for the most part granting the relief sought by the Company. The Superior Court found that the Commissioner and the California DOI did commit due process violations, but declined to dismiss the case on those grounds. The Superior Court also agreed with the Company that the broker fees at issue were not premium, and that the penalties imposed by the Commissioner were improper, and therefore vacated the Order imposing the penalty. The Superior Court entered final judgment on November 17, 2016, issuing a writ requiring the Commissioner to refund the entire penalty amount within 120 days, plus prejudgment interest at the statutory rate of 7%. On January 12, 2017, the California DOI filed a notice of appeal of the Superior Court's judgment entered on November 17, 2016. While the appeal is still pending, the California DOI returned the entire penalty amount plus accrued interest, a total of \$30.9 million, to the Company in June 2017 in order to avoid accruing further interest. Because the matter has been appealed, the Company has not yet recognized the \$30.9 million as a gain in the consolidated statements of operations; instead, the Company recorded the \$30.9 million plus interest earned, a total of approximately \$31.8 million at March 31, 2019, in other liabilities in the consolidated balance sheets. The Company had filed a motion to dismiss the false advertising portion of the case based on the Superior Court's findings, but the ALJ denied that motion after the appeal was filed. The ALJ did, however, grant the Company's alternative request to stay further proceedings pending the final determination of the appeal. The Company has accrued a liability for the estimated cost to continue to defend itself in the false advertising OSC. Based upon its understanding of the facts and the California Insurance Code, the Company does not expect that the ultimate resolution of the false advertising OSC will be material to its financial position.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

#### 14. Segment Information

The Company is primarily engaged in writing personal automobile insurance and provides related property and casualty insurance products to its customers through 14 subsidiaries in 11 states, principally in California.

The Company has one reportable business segment - the Property and Casualty business segment.

The Company's Chief Operating Decision Maker evaluates operating results based on pre-tax underwriting results which is calculated as net premiums earned less (a) losses and loss adjustment expenses and (b) underwriting expenses (policy acquisition costs and other operating expenses).

Expenses are allocated based on certain assumptions that are primarily related to premiums and losses. The Company's net investment income, net realized investment gains or losses, other income, and interest expense are excluded in evaluating pretax

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underwriting profit. The Company does not allocate its assets, including investments, or income taxes in evaluating pre-tax underwriting profit.

**Property and Casualty Lines**

The Property and Casualty business segment offers several insurance products to the Company's individual customers and small business customers. These insurance products are: private passenger automobile which is the Company's primary business, and related insurance products such as homeowners, commercial automobile and commercial property. These related insurance products are primarily sold to the Company's individual customers and small business customers, which increases retention of the Company's private passenger automobile client base. The insurance products comprising the Property and Casualty business segment are sold through the same distribution channels, mainly through independent and 100% owned insurance agents, and go through a similar underwriting process.

**Other Lines**

The Other business segment represents net premiums written and earned from an operating segment that does not meet the quantitative thresholds required to be considered a reportable segment. This operating segment offers automobile mechanical protection warranties which are primarily sold through automobile dealerships and credit unions.

The following table presents the Company's operating results by reportable segment:

|  | Three Months Ended March 31,    |        |                                 |         |        |           |
|--|---------------------------------|--------|---------------------------------|---------|--------|-----------|
|  | 2019                            |        |                                 | 2018    |        |           |
|  | Property<br>& Other<br>Casualty | Total  | Property<br>& Other<br>Casualty | Total   |        |           |
|  | (Amounts in millions)           |        |                                 |         |        |           |
| Net premiums earned                    | \$863.1                         | \$ 7.1 | \$870.2                         | \$800.3 | \$ 7.8 | \$808.1   |
| Less:                                  |                                 |        |                                 |         |        |           |
| Losses and loss adjustment expenses    | 626.8                           | 3.6    | 630.4                           | 628.3   | 3.9    | 632.2     |
| Underwriting expenses                  | 212.5                           | 3.4    | 215.9                           | 202.6   | 3.8    | 206.4     |
| Underwriting gain (loss)               | 23.8                            | 0.1    | 23.9                            | (30.6 ) | 0.1    | (30.5 )   |
| Investment income                      |                                 |        | 34.2                            |         |        | 31.5      |
| Net realized investment gains (losses) |                                 |        | 111.1                           |         |        | (58.7 )   |
| Other income                           |                                 |        | 2.3                             |         |        | 2.3       |
| Interest expense                       |                                 |        | (4.3 )                          |         |        | (4.3 )    |
| Pre-tax income (loss)                  |                                 |        | \$167.2                         |         |        | \$(59.7 ) |
| Net income (loss)                      |                                 |        | \$135.9                         |         |        | \$(42.6 ) |



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The following table presents the Company's net premiums earned and direct premiums written by line of insurance business:

|                              | Three Months Ended March 31, |        |          |         |        |         |
|------------------------------|------------------------------|--------|----------|---------|--------|---------|
|                              | 2019                         |        |          | 2018    |        |         |
|                              | Property                     |        | Property |         |        |         |
|                              | & Other                      | Total  | & Other  | Total   |        |         |
|                              | Casualty                     |        | Casualty |         |        |         |
|                              | (Amounts in millions)        |        |          |         |        |         |
| Private passenger automobile | \$672.6                      | \$ —   | \$672.6  | \$627.0 | \$ —   | \$627.0 |
| Homeowners                   | 119.3                        | —      | 119.3    | 107.8   | —      | 107.8   |
| Commercial automobile        | 49.6                         | —      | 49.6     | 44.9    | —      | 44.9    |
| Other                        | 21.6                         | 7.1    | 28.7     | 20.6    | 7.8    | 28.4    |
| Net premiums earned          | \$863.1                      | \$ 7.1 | \$870.2  | \$800.3 | \$ 7.8 | \$808.1 |
| Private passenger automobile | \$705.3                      | \$ —   | \$705.3  | \$674.0 | \$ —   | \$674.0 |
| Homeowners                   | 130.9                        | —      | 130.9    | 115.3   | —      | 115.3   |
| Commercial automobile        | 54.4                         | —      | 54.4     | 49.7    | —      | 49.7    |
| Other                        | 24.7                         | 6.8    | 31.5     | 23.6    | 6.4    | 30.0    |
| Direct premiums written      | \$915.3                      | \$ 6.8 | \$922.1  | \$862.6 | \$ 6.4 | \$869.0 |

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for certain forward-looking statements. Certain statements contained in this report are forward-looking statements based on the Company's current expectations and beliefs concerning future developments and their potential effects on the Company. There can be no assurance that future developments affecting the Company will be those anticipated by the Company. Actual results may differ from those projected in the forward-looking statements. These forward-looking statements involve significant risks and uncertainties (some of which are beyond the control of the Company) and are subject to change based upon various factors, including but not limited to the following risks and uncertainties: changes in the demand for the Company's insurance products, inflation and general economic conditions, including general market risks associated with the Company's investment portfolio; the accuracy and adequacy of the Company's pricing methodologies; catastrophes in the markets served by the Company; uncertainties related to estimates, assumptions and projections generally; the possibility that actual loss experience may vary adversely from the actuarial estimates made to determine the Company's loss reserves in general; the Company's ability to obtain and the timing of the approval of premium rate changes for insurance policies issued in the states where it operates; legislation adverse to the automobile insurance industry or business generally that may be enacted in the states where the Company operates; the Company's success in managing its business in non-California states; the presence of competitors with greater financial resources and the impact of competitive pricing and marketing efforts; the ability of the Company to successfully manage its claims organization outside of California; the Company's ability to successfully allocate the resources used in the states with reduced or exited operations to its operations in other states; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs; and legal, cybersecurity, regulatory and litigation risks. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as the result of new information, future events or otherwise. For a more detailed discussion of some of the foregoing risks and uncertainties, see the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 13, 2019.

OVERVIEW

A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of weather and natural disasters on losses, general economic conditions, the general regulatory environment in states in which an insurer operates, state regulation of insurance including premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty insurance industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a significant impact on the Company's ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company's performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management's discussion and analysis, the Company's consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

B. Business

The Company is primarily engaged in writing personal automobile insurance through 14 insurance subsidiaries ("Insurance Companies") in 11 states, principally California. The Company also writes homeowners, commercial automobile, commercial property, mechanical protection, and umbrella insurance. The Company's insurance policies are mostly sold through independent agents who receive a commission for selling policies. The Company believes that it has thorough underwriting and claims handling processes that, together with its agent relationships, provide the Company with competitive advantages.





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The following tables present direct premiums written, by state and line of insurance business, for the three months ended March 31, 2019 and 2018:

Three Months Ended March 31, 2019  
(Dollars in thousands)

|                             | Private<br>Passenger<br>Automobile | Homeowners | Commercial<br>Automobile | Other Lines | Total     |         |
|-----------------------------|------------------------------------|------------|--------------------------|-------------|-----------|---------|
| California                  | \$616,065                          | \$114,534  | \$33,509                 | \$28,762    | \$792,870 | 86.0 %  |
| Other states <sup>(1)</sup> | 89,262                             | 16,379     | 20,854                   | 2,726       | 129,221   | 14.0 %  |
| Total                       | \$705,327                          | \$130,913  | \$54,363                 | \$31,488    | \$922,091 | 100.0 % |
|                             | 76.5 %                             | 14.2 %     | 5.9 %                    | 3.4 %       | 100.0 %   |         |

Three Months Ended March 31, 2018  
(Dollars in thousands)

|                             | Private<br>Passenger<br>Automobile | Homeowners | Commercial<br>Automobile | Other Lines | Total     |         |
|-----------------------------|------------------------------------|------------|--------------------------|-------------|-----------|---------|
| California                  | \$582,144                          | \$101,083  | \$28,854                 | \$27,751    | \$739,832 | 85.1 %  |
| Florida                     | 34,642                             | 1          | 4,374                    | 79          | 39,096    | 4.5 %   |
| Other states <sup>(1)</sup> | 57,204                             | 14,214     | 16,517                   | 2,152       | 90,087    | 10.4 %  |
| Total                       | \$673,990                          | \$115,298  | \$49,745                 | \$29,982    | \$869,015 | 100.0 % |
|                             | 77.5 %                             | 13.3 %     | 5.7 %                    | 3.5 %       | 100.0 %   |         |

<sup>(1)</sup> No individual state accounted for more than 4% of total direct premiums written.

### C. Regulatory and Legal Matters

The Department of Insurance (“DOI”) in each state in which the Company operates is responsible for conducting periodic financial, market conduct, and rating and underwriting examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices.

The following table presents a summary of recent examinations:

| State             | Exam Type                         | Period Under Review | Status   |
|-------------------|-----------------------------------|---------------------|--|
| CA,FL,GA,IL,OK,TX | Coordinated Multi-state Financial | 2014 to 2017        | Fieldwork began in the second quarter of 2018. |
| CA                | Rating and Underwriting           | 2014                | Fieldwork is completed. Awaiting draft report. |

During the course of and at the conclusion of these examinations, the examining DOI generally reports findings to the Company. None of the findings reported to date are expected to be material to the Company’s financial position.

In March 2019, the California DOI approved a 6.9% rate increase on the private passenger automobile line of insurance business in Mercury Insurance Company (“MIC”), which represented approximately 54% of the Company’s total net premiums earned for the three months ended March 31, 2019. The Company expects to implement this rate

increase in May 2019.

In January 2019, the California DOI approved a 6.9% rate increase on the private passenger automobile line of insurance business in California Automobile Insurance Company, which represented approximately 12% of the Company's total net premiums earned for the three months ended March 31, 2019. The Company implemented this rate increase in March 2019.

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

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The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018, and Note 13. Contingencies of the Notes to Consolidated Financial Statements of this Quarterly Report.

D. Critical Accounting Policies and Estimates

Loss and Loss Adjustment Expense Reserves ("Loss Reserves")

Preparation of the Company's consolidated financial statements requires management's judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the loss reserve that is required. A key assumption in estimating loss reserves is the degree to which the historical data used to analyze reserves will be predictive of ultimate claim costs on incurred claims. Changes in the regulatory and legal environments, results of litigation, medical costs, the cost of repair materials, and labor rates, among other factors, can impact this assumption. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount could be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company calculates a loss reserve point estimate rather than a range. There is inherent uncertainty with estimates and this is particularly true with loss reserve estimates. This uncertainty comes from many factors which may include changes in claims reporting and settlement patterns, changes in the regulatory and legal environments, uncertainty over inflation rates, and uncertainty for unknown items. The Company does not make specific provisions for these uncertainties, rather it considers them in establishing its loss reserve by reviewing historical patterns and trends and projecting these out to current loss reserves. The underlying factors and assumptions that serve as the basis for preparing the loss reserve estimate include paid and incurred loss development factors, expected average costs per claim, inflation trends, expected loss ratios, industry data, and other relevant information.

The Company also engages independent actuarial consultants to review the Company's loss reserves and to provide the annual actuarial opinions under statutory accounting principles as required by state regulation. The Company analyzes loss reserves quarterly primarily using the incurred loss, paid loss, average severity coupled with the claim count development methods, and the generalized linear model ("GLM") described below. When deciding among methods to use, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of insurance business or coverage within a line of insurance business. The Company may also evaluate qualitative factors such as known changes in laws or legal rulings that could affect claims handling or other external environmental factors or internal factors that could affect the settlement of claims. When establishing the loss reserve, the Company will generally analyze the results from all of the methods used rather than relying on a single method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of insurance business which have a long operating history.

The paid loss method analyzes historical payment patterns to estimate the amount of losses yet to be paid.

The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The average severity method coupled with the claim count development method provide meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing loss reserves. The claim count development method analyzes historical claim count development to estimate future incurred claim count

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development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts.

The GLM determines an average severity for each percentile of claims that have been closed as a percentage of estimated ultimate claims. The average severities are applied to open claims to estimate the amount of losses yet to be paid. The GLM utilizes operational time, determined as a percentile of claims closed rather than a finite calendar period, which neutralizes the effect of changes in the timing of claims handling.

The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company generally determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on loss reserves established by adjusters and average losses on previous similar catastrophes. For catastrophe losses on individual properties that are expected to be total losses, the Company typically establishes reserves at the policy limits.

At March 31, 2019 and December 31, 2018, the Company recorded its point estimate of approximately \$1.79 billion and \$1.83 billion (\$1.66 billion and \$1.65 billion, net of reinsurance), respectively, in loss reserves, which included approximately \$773.9 million and \$822.9 million (\$741.4 million and \$751.3 million, net of reinsurance), respectively, of incurred but not reported loss reserves (“IBNR”). IBNR includes estimates, based upon past experience, of ultimate developed costs, which may differ from case estimates, unreported claims that occurred on or prior to March 31, 2019 and December 31, 2018, and estimated future payments for reopened claims. Management believes that the liability for loss reserves is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provisions.

The Company evaluates its loss reserves quarterly. When management determines that the estimated ultimate claim cost requires a decrease for previously reported accident years, favorable development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, unfavorable development occurs and an increase in losses and loss adjustment expenses is reported in the current period.

For a further discussion of the Company’s reserving methods, see the Company’s Annual Report on Form 10-K for the year ended December 31, 2018.

## Investments

The Company’s fixed maturity and equity securities are classified as “trading” and carried at fair value as required when applying the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. The majority of equity holdings, including non-redeemable preferred stocks, are actively traded on national exchanges or trading markets, and are valued at the last transaction price on the balance sheet date.

## Fair Value of Financial Instruments

Financial instruments recorded in the consolidated balance sheets include investments, note receivable, other receivables, total return swap, accounts payable, options sold, and unsecured notes payable. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Due to their short-term maturity, the carrying values of other receivables and accounts payable approximate their fair values. All investments are carried on the consolidated balance sheets at fair value, as described in Note 3. Financial Instruments of the Notes to Consolidated Financial Statements.

The Company’s financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipal governments and agencies, certain corporate and other debt securities, equity securities, and exchange traded funds. At March 31, 2019, 98.3% of the fair value of these financial instruments is based on

observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary by financial instrument. Observable market prices and pricing parameters of a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

The Company may hold or acquire financial instruments that lack observable market prices or market parameters because they are less actively traded currently or in future periods. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including the type of financial instrument, whether

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it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise are not actively quoted.

Income Taxes

At March 31, 2019, the Company's deferred income taxes were in a net liability position mainly due to deferred tax liabilities generated by unrealized gains on securities held and deferred acquisition costs. These deferred tax liabilities were substantially offset by deferred tax assets resulting from unearned premiums, loss reserve discounting, and expense accruals. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established. Management's recoverability assessment of the Company's deferred tax assets which are ordinary in character takes into consideration the Company's strong history of generating ordinary taxable income and a reasonable expectation that it will continue to generate ordinary taxable income in the future. Further, the Company has the capacity to recoup its ordinary deferred tax assets through tax loss carryback claims for taxes paid in prior years. Finally, the Company has various deferred tax liabilities that represent sources of future ordinary taxable income.

Management's recoverability assessment with regard to its capital deferred tax assets is based on estimates of anticipated capital gains, tax-planning strategies available to generate future taxable capital gains, and the Company's capacity to absorb capital losses carried back to prior years, each of which would contribute to the realization of deferred tax benefits. The Company has significant unrealized gains in its investment portfolio that could be realized through asset dispositions, at management's discretion. In addition, the Company expects to hold certain debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a portion of the unrealized loss positions at period-end, are fully realizable at maturity. Management believes its long-term time horizon for holding these securities allows it to avoid any forced sales prior to maturity. Further, the Company has the capability to generate additional realized capital gains by entering into sale-leaseback transactions using one or more of its appreciated real estate holdings. Finally, the Company has the capacity to recoup capital deferred tax assets through tax capital loss carryback claims for taxes paid within permitted carryback periods.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flows from operations and believes that its liquidity needs can be met in future periods without the forced sale of its investments. This capability assists management in controlling the timing and amount of realized losses generated during future periods. By prudent utilization of some or all of these strategies, management has the intent and believes that it has the ability to generate capital gains and minimize tax losses in a manner sufficient to avoid losing the benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

The enactment of the Tax Cuts and Jobs Act of 2017 (the "Act") on December 22, 2017, which was effective for tax years beginning January 1, 2018, has impacted and will likely further impact the Company's business and investment strategies as well as financial results. There are complex factors at play, including the effect of insurance regulation and competition, which may require the tax benefits due to the reduction in the corporate tax rate to be passed on to consumers, and changing dynamics in the capital markets, which have caused and may further cause a shift in the Company's allocation between taxable and tax-exempt investments.

The Company's effective income tax rate can be affected by several factors. These generally include large changes in fully-taxable income including net realized investment gains or losses, tax-exempt investment income, non-deductible expenses, and periodically, non-routine tax items such as adjustments to unrecognized tax benefits related to tax uncertainties. The effective tax rate for the three months ended March 31, 2019 was 18.7%, compared to 28.6% for the same period in 2018. Tax-exempt investment income coupled with pre-tax income lowered the effective tax rate for the three months ended March 31, 2019 relative to the statutory tax rate of 21%, while tax-exempt investment income coupled with pre-tax loss increased the effective tax rate for the same period in 2018.

#### Contingent Liabilities

The Company has known, and may have unknown, potential liabilities which include claims, assessments, lawsuits, or regulatory fines and penalties relating to the Company's business. The Company continually evaluates these potential liabilities



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and accrues for them and/or discloses them in the notes to the consolidated financial statements where required. The Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition, results of operations, or cash flows. See "Regulatory and Legal Matters" above and Note 13. Contingencies of the Notes to Consolidated Financial Statements.

Premiums

The Company's insurance premiums are recognized as income ratably over the term of the policies and in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the consolidated balance sheets and are computed monthly on a pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs, and maintenance costs partially offset by investment income to related unearned premiums. To the extent that any of the Company's lines of insurance business become unprofitable, a premium deficiency reserve may be required.

RESULTS OF OPERATIONS

Three Months Ended March 31, 2019 Compared to Three Months Ended March 31, 2018

Revenues

Net premiums earned and net premiums written for the three months ended March 31, 2019 increased 7.7% and 6.4%, respectively, from the corresponding period in 2018. The increase in net premiums earned and net premiums written was primarily due to higher average premiums per policy arising from rate increases in the California private passenger automobile line of insurance business and growth in the number of homeowners policies written in California.

The Company, which predominantly offers six-month personal automobile insurance policies, reintroduced twelve-month personal automobile policies for new business in MIC, its largest insurance subsidiary, in March 2018. Twelve-month policies are generally sold for twice the price of six-month policies. MIC's net premiums written from twelve-month policies for the three months ended March 31, 2019 and 2018 was approximately \$76 million and \$31 million, respectively.

Net premiums earned included ceded premiums earned of \$14.6 million and \$12.6 million for the three months ended March 31, 2019 and 2018, respectively. Net premiums written included ceded premiums written of \$5.9 million and \$7.8 million for the three months ended March 31, 2019 and 2018, respectively. The increase in ceded premiums earned for the three months ended March 31, 2019 compared to the same period in 2018 resulted mostly from an increase in reinsurance rates, growth in the covered book of business, and an increase in reinstatement premiums following the Camp and Woolsey Fires in the fourth quarter of 2018 that caused higher losses than the wildfires in the fourth quarter of 2017. The decrease in ceded premiums written for the three months ended March 31, 2019 compared to the same period in 2018 was largely due to reductions in the estimated total losses and reinsurance benefits for the Camp and Woolsey Fires during the first quarter of 2019, which correspondingly lowered the reinstatement premiums previously ceded, as described further in Note 11. Loss and Loss Adjustment Expense Reserves of the Notes to Consolidated Financial Statements.

Net premiums earned, a GAAP measure, represents the portion of net premiums written that is recognized as revenue in the financial statements for the periods presented and earned on a pro-rata basis over the term of the policies. Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels.

The following is a reconciliation of net premiums earned to net premiums written:

Three Months  
Ended March 31,  
2019 2018

(Amounts in  
thousands)

|                                |           |           |
|--------------------------------|-----------|-----------|
| Net premiums earned            | \$870,245 | \$808,084 |
| Change in net unearned premium | 46,203    | 53,183    |
| Net premiums written           | \$916,448 | \$861,267 |

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## Expenses

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table presents the Insurance Companies' loss, expense, and combined ratios determined in accordance with GAAP:

|                               | Three Months<br>Ended March<br>31, |        |
|-------------------------------|------------------------------------|--------|
|                               | 2019                               | 2018   |
| Loss ratio                    | 72.4%                              | 78.2%  |
| Expense ratio                 | 24.8%                              | 25.5%  |
| Combined ratio <sup>(1)</sup> | 97.3%                              | 103.8% |

<sup>(1)</sup> Combined ratios for the three months ended March 31, 2019 and 2018 do not sum due to rounding.

Loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The Company's loss ratio was affected by unfavorable development of approximately \$1 million and \$43 million on prior accident years' loss reserves for the first quarter of 2019 and 2018, respectively. The majority of the unfavorable development in the first quarter of 2019 was attributable to higher than estimated automobile losses, partially offset by lower than estimated California homeowners losses largely due to reductions in the Company's retained losses on the Camp and Woolsey Fires under the catastrophe reinsurance treaty after accounting for the assignment of subrogation rights and re-estimation of reserves as part of normal reserving procedures, as described further in Note 11. Loss and Loss Adjustment Expense Reserves of the Notes to Consolidated Financial Statements. The majority of the unfavorable development in the first quarter of 2018 was attributable to higher than estimated California automobile losses resulting from severity in excess of expectations for bodily injury claims. In addition, the 2019 loss ratio was negatively impacted by approximately \$5 million of catastrophe losses, net of reinsurance benefits, primarily due to winter storms in California, partially offset by favorable development of approximately \$6 million on prior years' catastrophe losses, primarily from reductions in the Company's retained portion of losses on the Camp and Woolsey Fires, as described above. The 2018 loss ratio was negatively impacted by approximately \$9 million of catastrophe losses, primarily due to winter storms and mudslides in California and winter storms in the states along the Atlantic Seaboard. Excluding the effect of estimated prior accident years' loss development and catastrophe losses, the loss ratio was 71.7% and 71.8% for the three months ended March 31, 2019 and 2018, respectively. The slight decrease in the loss ratio primarily resulted from premium rate increases on automobile insurance policies, partially offset by higher loss severity.

Expense ratio is calculated by dividing the sum of policy acquisition costs and other operating expenses by net premiums earned. The expense ratio for the three months ended March 31, 2019 decreased compared to the same period in 2018, largely because growth in net premiums earned outpaced the increase in policy acquisition costs and other operating expenses.

Combined ratio is equal to loss ratio plus expense ratio and is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results, and a combined ratio over 100% generally reflects unprofitable underwriting results. Income tax expense (benefit) was \$31.3 million and \$(17.1) million for the three months ended March 31, 2019 and 2018, respectively. The \$48.4 million increase in income tax expense was primarily due to an increase in fully taxable income. Tax-exempt investment income, a component of total pre-tax income, remained relatively unchanged compared to the same period in 2018.



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## Investments

The following table presents the investment results of the Company:

|  | Three Months Ended March<br>31,<br>2019 |   | 2018        |   |
|--|---|---|-------------|---|
|  | (Dollars in thousands)                  |   |             |   |
| Average invested assets at cost <sup>(1)</sup> | \$3,888,592                             |   | \$3,629,913 |   |
| Net investment income <sup>(2)</sup>           |   |   |             |   |
| Before income taxes                            | \$34,174                                |   | \$31,510    |   |
| After income taxes                             | \$30,254                                |   | \$28,396    |   |
| Average annual yield on investments            |   |   |             |   |
| Before income taxes                            | 3.5                                     | % | 3.5         | % |
| After income taxes                             | 3.1                                     | % | 3.1         | % |
| Net realized investment gains (losses)         | \$111,074                               |   | \$(58,735)  |   |

(1) Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost. Average invested assets at cost are based on the monthly amortized cost of the invested assets for each period.

(2) Net investment income before and after income taxes increased largely due to higher average invested assets.

The following tables present the components of net realized investment gains (losses) included in net income:

|   | Three Months Ended March<br>31, 2019       |                             |           |
|---|--|-----------------------------|-----------|
|   | Gains (Losses) Recognized in<br>Net Income |                             |           |
|   | Sales                                      | Changes<br>in fair<br>value | Total     |
|   | (Amounts in thousands)                     |                             |           |
| Net realized investment gains (losses)      |  |                             |           |
| Fixed maturity securities <sup>(1)(2)</sup> | \$(100 )                                   | \$49,775                    | \$49,675  |
| Equity securities <sup>(1)(3)</sup>         | 5,250                                      | 53,687                      | 58,937    |
| Short-term investments <sup>(1)</sup>       | (942 )                                     | 734                         | (208 )    |
| Note receivable <sup>(1)</sup>              | —  | 31                          | 31        |
| Total return swap                           | (772 )                                     | 2,538                       | 1,766     |
| Options sold                                | 854  | 19                          | 873       |
| Total                                       | \$4,290                                    | \$106,784                   | \$111,074 |

|  | Three Months Ended March<br>31, 2018       |                             |       |
|--|--|-----------------------------|-------|
|  | Gains (Losses) Recognized in<br>Net Income |                             |       |
|  | Sales                                      | Changes<br>in fair<br>value | Total |
|  | (Amounts in thousands)                     |                             |       |
| Net realized investment gains (losses) |  |                             |       |

Net realized investment gains (losses)

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|   |           |             |             |
|---|-----------|-------------|-------------|
| Fixed maturity securities <sup>(1)(2)</sup> | \$(587 )  | \$(46,213 ) | \$(46,800 ) |
| Equity securities <sup>(1)(3)</sup>         | (3,128 )  | (11,886 )   | (15,014 )   |
| Short-term investments <sup>(1)</sup>       | (12 )     | (392 )      | (404 )      |
| Note receivable <sup>(1)</sup>              | —         | (41 )       | (41 )       |
| Total return swaps                          | 203       | 399         | 602         |
| Options sold                                | 2,361     | 561         | 2,922       |
| Total                                       | \$(1,163) | \$(57,572)  | \$(58,735)  |

<sup>(1)</sup> The changes in fair value of the investment portfolio and note receivable resulted from the application of the fair value option.

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(2) The increase in fair value of fixed maturity securities for the first quarter of 2019 was primarily due to decreases in market interest rates. The decrease in fair value of fixed maturity securities for the first quarter of 2018 was primarily due to increases in market interest rates.

(3) The primary cause for the increase in fair value of equity securities for the first quarter of 2019 was overall improvement in equity markets, and the main cause for the decrease for the first quarter of 2018 was overall decline in equity markets.

## Net Income

|  | Three Months Ended<br>March 31,                  |              |
|--|--|--------------|
|  | 2019   | 2018         |
|  | (Amounts in thousands,<br>except per share data) |              |
| Net income (loss)                                  | \$ 135,867                                       | \$ (42,607 ) |
| Basic average shares outstanding                   | 55,341   | 55,332       |
| Diluted average shares outstanding                 | 55,348   | 55,332       |
| Basic Per Share Data:                              |  |              |
| Net income (loss)                                  | \$ 2.46  | \$ (0.77 )   |
| Net realized investment gains (losses), net of tax | \$ 1.59  | \$ (0.84 )   |
| Diluted Per Share Data:                            |  |              |
| Net income (loss)                                  | \$ 2.45  | \$ (0.77 )   |
| Net realized investment gains (losses), net of tax | \$ 1.58  | \$ (0.84 )   |

## LIQUIDITY AND CAPITAL RESOURCES

## A. Cash Flows

The Company has generated positive cash flow from operations since the public offering of its common stock in November 1985. The Company does not attempt to match the duration and timing of asset maturities with those of liabilities; rather, it manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$637.5 million at March 31, 2019 as well as \$50 million of credit available on a \$50 million revolving credit facility, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. Investment maturities are also available to meet the Company's liquidity needs. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs or for future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided by operating activities for the three months ended March 31, 2019 was \$174.7 million, an increase of \$96.3 million compared to the corresponding period in 2018. The increase was primarily due to an increase in premium collections, partially offset by higher paid losses and loss adjustment expenses and operating expenses. The Company utilized the cash provided by operating activities during the three months ended March 31, 2019 primarily for the payment of dividends to its shareholders and net purchases of investment securities.





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The following table presents the estimated fair value of fixed maturity securities at March 31, 2019 by contractual maturity in the next five years:

|  | Fixed Maturity<br>Securities<br>(Amounts in thousands) |
|--|--|
| Due in one year or less                  | \$ 107,085   |
| Due after one year through two years     | 90,566   |
| Due after two years through three years  | 126,641  |
| Due after three years through four years | 118,696  |
| Due after four years through five years  | 87,110   |
| Total due within five years              | \$ 530,098   |

**B. Reinsurance**

For California homeowners policies, the Company has reduced its catastrophe exposure from earthquakes by placing earthquake risks directly with the California Earthquake Authority ("CEA"). However, the Company continues to have catastrophe exposure to fires following an earthquake.

The Company is party to a Catastrophe Reinsurance Treaty ("Treaty") covering a wide range of perils that is effective through June 30, 2019. For the 12 months ending June 30, 2019 and 2018, the Treaty provides \$205 million of coverage on a per occurrence basis after covered catastrophe losses exceed the \$10 million Company retention limit. The first \$190 million of losses above the Company's \$10 million retention are covered 100% by the reinsurers. Losses above \$200 million are shared pro-rata with 5% coverage by the reinsurers and 95% retention by the Company, up to \$15 million total coverage provided by the reinsurers. The Treaty specifically excludes coverage for any Florida business and for California earthquake losses on fixed property policies, such as homeowners, but does cover losses from fires following an earthquake. The annual premium for the Treaty is approximately \$22 million for the 12 months ending June 30, 2019, as compared to \$19 million for the 12 months ended June 30, 2018. The increase in the annual premium is primarily due to an increase in reinsurance rates and growth in the Company's homeowners insurance book of business covered by the Treaty. In addition to the annual premium, the Treaty is subject to reinstatement premiums based on the amount of reinsurance benefits paid to the Company, up to the maximum reinstatement premium of approximately \$22 million and \$19 million if the full amount of benefit is used for the 12 months ending June 30, 2019 and 2018, respectively. The total amount of reinstatement premiums is recorded as ceded reinstatement premiums written at the time of the catastrophe event based on the total amount of reinsurance benefits expected to be used for the event, and such reinstatement premiums are recognized ratably over the remaining term of the Treaty as ceded reinstatement premiums earned.

Two major catastrophe events that occurred in the fourth quarter of 2018, the Camp Fire in Northern California and the Woolsey Fire in Southern California, caused approximately \$146 million and \$41 million as of March 31, 2019, respectively, in losses to the Company, before reinsurance benefits. The combined loss to the Company from these two events, net of reinsurance benefits, totaled approximately \$30 million, after accounting for the sale of subrogation rights to a third party (See Note 11. Loss and Loss Adjustment Expense Reserves of the Notes to Consolidated Financial Statements above for more information on the sale), representing \$20 million for the Company's initial reinsurance retention for the two catastrophe events, \$10 million for each event, and approximately \$10 million Company retention from the first layer of reinstated reinsurance limit previously used up. The Company recorded a total of approximately \$15 million in ceded reinstatement premiums written and approximately \$9 million in ceded reinstatement premiums earned for reinstatement of the reinsurance benefits used under the Treaty related to these two catastrophe events.

The Company has incurred a total of approximately \$21 million in losses as of March 31, 2019, before reinsurance benefits, resulting from a destructive wildfire, known as the Carr Fire, that occurred in Shasta County of Northern California in the third quarter of 2018. The loss to the Company, net of reinsurance benefits, was approximately \$10

million, most of which is the Company's retention on the catastrophe event. The Company recorded approximately \$3 million in ceded reinstatement premiums written and approximately \$2 million in ceded reinstatement premiums earned for reinstatement of the reinsurance benefits used under the Treaty related to this catastrophe event.

As a result of reinsurance benefits used for the catastrophes described above under the Treaty ending June 30, 2019, the Company has exhausted the reinstated limit on the first layer (\$30 million limit in excess of \$10 million retention) of the Treaty, and a second reinstatement is not available under the current terms of the Treaty. Should there be another major catastrophe event within the Treaty period ending June 30, 2019, the Company would retain the first \$10 million of losses, retain the following \$30 million of losses reflecting that the reinstated first layer limit has been used up, and have available \$60 million in reinsurance coverage for losses above \$40 million up to \$100 million, 100% reinsurance coverage for losses above \$100 million up to \$200

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million and 5% reinsurance coverage for losses above \$200 million up to \$500 million.

The Company carries a commercial umbrella reinsurance treaty and seeks facultative arrangements for large property risks. In addition, the Company has other reinsurance in force that is not material to the consolidated financial statements. If any reinsurers are unable to perform their obligations under a reinsurance treaty, the Company will be required, as primary insurer, to discharge all obligations to its policyholders in their entirety.

## C. Invested Assets

## Portfolio Composition

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well-diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy enables the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a market risk and consistent asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

The following table presents the composition of the total investment portfolio of the Company at March 31, 2019:

|  | Cost <sup>(1)</sup> | Fair Value  |
|--|---------------------|-------------|
| (Amounts in thousands)   |                     |             |
| Fixed maturity securities:                                     |                     |             |
| U.S. government bonds  | \$23,821            | \$23,786    |
| Municipal securities   | 2,628,281           | 2,695,108   |
| Mortgage-backed securities                                     | 28,033              | 28,438      |
| Corporate securities   | 117,653             | 118,024     |
| Collateralized loan obligations                                | 175,401             | 172,963     |
| Other asset-backed securities                                  | 38,790              | 39,054      |
|  | 3,011,979           | 3,077,373   |
| Equity securities:   |                     |             |
| Common stock   | 472,028             | 513,908     |
| Non-redeemable preferred stock                                 | 34,429              | 33,739      |
| Private equity fund  | 1,137               | 1,213       |
| Private equity fund measured at net asset value <sup>(2)</sup> | 69,669              | 67,640      |
|  | 577,263             | 616,500     |
| Short-term investments   | 367,837             | 367,351     |
| Total investments  | \$3,957,079         | \$4,061,224 |

<sup>(1)</sup> Fixed maturities and short-term bonds at amortized cost; equities and other short-term investments at cost.

<sup>(2)</sup> The fair value is measured using the NAV practical expedient. See Note 5. Fair Value Measurements of the Notes to Consolidated Financial Statements for additional information.

At March 31, 2019, 64.9% of the Company's total investment portfolio at fair value and 85.7% of its total fixed maturity securities at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of non-redeemable preferred stocks, dividend-bearing common stocks on which dividend income is partially

tax-sheltered by the 50% corporate dividend received deduction, and private equity funds including a fund measured at net asset value. At March 31, 2019, 85.7% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis.

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## Fixed Maturity Securities and Short-Term Investments

Fixed maturity securities include debt securities, which are mostly long-term bonds and other debt with maturities of at least one year from purchase, and which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations, or other economic factors. Short-term instruments include money market accounts, options, and short-term bonds that are highly rated short duration securities and redeemable within one year.

A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy has resulted in a portfolio with a moderate duration. The Company's portfolio is heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The holdings that are heavily weighted with high coupon issues, are expected to be called prior to maturity. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms) which determine sensitivity to changes in interest rates, modified duration is considered a better indicator of price volatility than simple maturity alone.

The following table presents the maturities and durations of the Company's fixed maturity securities and short-term investments:

|   | March 31, 2019 | December 31,<br>2018 |
|---|----------------|----------------------|
|   | (in years)     |                      |
| Fixed Maturity Securities                             |                |                      |
| Nominal average maturity:                             |                |                      |
| excluding short-term investments                      | 14.4           | 14.2                 |
| including short-term investments                      | 12.8           | 13.1                 |
| Call-adjusted average maturity:                       |                |                      |
| excluding short-term investments                      | 4.9            | 4.9                  |
| including short-term investments                      | 4.4            | 4.5                  |
| Modified duration reflecting anticipated early calls: |                |                      |
| excluding short-term investments                      | 4.2            | 4.3                  |
| including short-term investments                      | 3.7            | 4.0                  |
| Short-Term Investments                                | —              | —                    |

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of A+, at fair value, at March 31, 2019, consistent with the average rating at December 31, 2018. The Company's municipal bond holdings of which 97.8% were tax exempt, represented 85.7% of its fixed maturity securities portfolio at March 31, 2019, at fair value, and are broadly diversified geographically. See Part I-Item 3. Quantitative and Qualitative Disclosures About Market Risks for a breakdown of municipal bond holdings by state.

To calculate the weighted-average credit quality ratings disclosed throughout this Quarterly Report on Form 10-Q, individual securities were weighted based on fair value and credit quality ratings assigned by nationally recognized securities rating organizations.

Taxable holdings consist principally of investment grade issues. At March 31, 2019, fixed maturity securities holdings rated below investment grade and non-rated bonds totaled \$36.8 million and \$65.2 million, respectively, at fair value, and represented 1.2% and 2.1%, respectively, of total fixed maturity securities. The majority of non-rated issues are a result of municipalities pre-funding and collateralizing those issues with U.S. government securities with an implicit AAA equivalent credit risk. At December 31, 2018, fixed maturity securities holdings rated below investment grade

and non-rated bonds totaled \$36.0 million and \$76.4 million, respectively, at fair value, and represented 1.2% and 2.6%, respectively, of total fixed maturity securities.

Credit ratings for the Company's fixed maturity securities portfolio were stable during the three months ended March 31, 2019, with 97.0% of fixed maturity securities at fair value experiencing no change in their overall rating. 2.3% and 0.7% of fixed maturity securities at fair value experienced upgrades and downgrades, respectively, during the three months ended March 31, 2019; the downgrades were slight and still within the investment grade portfolio.

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The following table presents the credit quality ratings of the Company's fixed maturity securities by security type at fair value:

| Security Type                    | March 31, 2019<br>(Dollars in thousands) |                   |                  |                    |                                | Total Fair Value <sup>(1)</sup> |   |
|----------------------------------|--|-------------------|------------------|--------------------|--------------------------------|---------------------------------|---|
|                                  | AAA <sup>(1)</sup>                       | AA <sup>(1)</sup> | A <sup>(1)</sup> | BBB <sup>(1)</sup> | Non-Rated/Other <sup>(1)</sup> |                                 |   |
| U.S. government bonds:           |  |                   |                  |                    |                                |                                 |   |
| Treasuries                       | \$23,786                                 | \$—               | \$—              | \$—                | \$—                            | \$23,786                        |   |
| Total                            | 23,786                                   | —                 | —                | —                  | —                              | 23,786                          |   |
|                                  | 100.0                                    | % —               | % —              | % —                | % —                            | % 100.0                         | % |
| Municipal securities:            |  |                   |                  |                    |                                |                                 |   |
| Insured                          | 30,232                                   | 158,199           | 127,601          | 70,919             | 14,086                         | 401,037                         |   |
| Uninsured                        | 31,441                                   | 720,273           | 1,266,485        | 219,184            | 56,688                         | 2,294,071                       |   |
| Total                            | 61,673                                   | 878,472           | 1,394,086        | 290,103            | 70,774                         | 2,695,108                       |   |
|                                  | 2.3                                      | % 32.6            | % 51.7           | % 10.8             | % 2.6                          | % 100.0                         | % |
| Mortgage-backed securities:      |  |                   |                  |                    |                                |                                 |   |
| Commercial                       | 8,381                                    | 5,277             | 4,759            | 4,032              | —                              | 22,449                          |   |
| Agencies                         | 1,730                                    | —                 | —                | —                  | —                              | 1,730                           |   |
| Non-agencies:                    |  |                   |                  |                    |                                |                                 |   |
| Prime                            | —  | 57                | 153              | —                  | 925                            | 1,135                           |   |
| Alt-A                            | —  | 870               | —                | 538                | 1,716                          | 3,124                           |   |
| Total                            | 10,111                                   | 6,204             | 4,912            | 4,570              | 2,641                          | 28,438                          |   |
|                                  | 35.5                                     | % 21.8            | % 17.3           | % 16.1             | % 9.3                          | % 100.0                         | % |
| Corporate securities:            |  |                   |                  |                    |                                |                                 |   |
| Basic materials                  | —  | —                 | —                | 3,957              | 2,709                          | 6,666                           |   |
| Communications                   | —  | —                 | 333              | 343                | —                              | 676                             |   |
| Consumer, cyclical               | —  | —                 | —                | 7,469              | 1,823                          | 9,292                           |   |
| Consumer, non-cyclical           | —  | —                 | 439              | 3,297              | 124                            | 3,860                           |   |
| Energy                           | —  | —                 | 2,911            | 19,272             | 4,033                          | 26,216                          |   |
| Financial                        | —  | 10,532            | 24,844           | 19,793             | 5,164                          | 60,333                          |   |
| Industrial                       | —  | —                 | —                | 4,153              | —                              | 4,153                           |   |
| Technology                       | —  | —                 | —                | —                  | —                              | —                               |   |
| Utilities                        | —  | —                 | 6,266            | —                  | 562                            | 6,828                           |   |
| Total                            | —  | 10,532            | 34,793           | 58,284             | 14,415                         | 118,024                         |   |
|                                  | —  | % 8.9             | % 29.5           | % 49.4             | % 12.2                         | % 100.0                         | % |
| Collateralized loan obligations: |  |                   |                  |                    |                                |                                 |   |
| Corporate                        | 19,626                                   | 20,978            | 124,627          | —                  | 7,732                          | 172,963                         |   |
| Total                            | 19,626                                   | 20,978            | 124,627          | —                  | 7,732                          | 172,963                         |   |
|                                  | 11.3                                     | % 12.1            | % 72.1           | % —                | % 4.5                          | % 100.0                         | % |
| Other asset-backed securities    |  |                   |                  |                    |                                |                                 |   |
|                                  | 6,036                                    | —                 | 15,630           | 10,371             | 7,017                          | 39,054                          |   |
|                                  | 15.5                                     | % —               | % 40.0           | % 26.5             | % 18.0                         | % 100.0                         | % |
| Total                            | \$121,232                                | \$916,186         | \$1,574,048      | \$363,328          | \$102,579                      | \$3,077,373                     |   |
|                                  | 3.9                                      | % 29.8            | % 51.1           | % 11.9             | % 3.3                          | % 100.0                         | % |

<sup>(1)</sup> Intermediate ratings are included at each level (e.g., AA includes AA+, AA and AA-).

U.S. Government Bonds

The Company had \$23.8 million and \$25.0 million at fair value (each representing 0.8% of its fixed maturity securities portfolio) in U.S. government bonds at March 31, 2019 and December 31, 2018, respectively. At March 31, 2019, Moody's and Fitch ratings for U.S. government-issued debt were Aaa and AAA, respectively, although a significant increase in government

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deficits and debt could lead to a downgrade. The Company understands that market participants continue to use rates of return on U.S. government debt as a risk-free rate and have continued to invest in U.S. Treasury securities. The modified duration of the U.S. government bonds portfolio reflecting anticipated early calls was 1.6 years and 1.7 years at March 31, 2019 and December 31, 2018, respectively.

## Municipal Securities

The Company had \$2.70 billion and \$2.62 billion, or 87.6% and 87.8% of its fixed maturity securities portfolio, at fair value, in municipal securities, \$401.0 million and \$404.8 million of which were insured, at March 31, 2019 and December 31, 2018, respectively. The underlying ratings for insured municipal bonds have been factored into the average rating of the securities by the rating agencies with no significant disparity between the absolute securities ratings and the underlying credit ratings as of March 31, 2019 and December 31, 2018.

At March 31, 2019 and December 31, 2018, 62.0% and 62.6%, respectively, of the insured municipal securities, at fair value, most of which were investment grade, were insured by bond insurers that provide credit enhancement and ratings reflecting the credit of the underlying issuers. At March 31, 2019 and December 31, 2018, the average rating of the Company's insured municipal securities was A+, which corresponded to the average rating of the investment grade bond insurers. The remaining 38.0% and 37.4% of insured municipal securities at March 31, 2019 and December 31, 2018, respectively, were non-rated or below investment grade, and were insured by bond insurers that the Company believes did not provide credit enhancement. The modified duration of the municipal securities portfolio reflecting anticipated early calls was 4.2 years at March 31, 2019 and December 31, 2018.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings, which generally allows it to recover the full principal amounts upon maturity and avoid forced sales prior to maturity of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of municipal bonds.

## Mortgage-Backed Securities

At March 31, 2019 and December 31, 2018, the mortgage-backed securities portfolio of \$28.4 million and \$31.0 million, or 0.9% and 1.0%, respectively, of the Company's fixed maturity securities portfolio, at fair value, was categorized as loans to "prime" residential and commercial real estate borrowers, except for \$3.1 million and \$3.2 million, respectively, at fair value (\$3.1 million and \$3.2 million at amortized cost) of Alt-A mortgages. Alt-A mortgage-backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with credit profiles stronger than those of sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. The Company had holdings of \$22.4 million and \$24.8 million at fair value (\$22.2 million and \$24.5 million at amortized cost) in commercial mortgage-backed securities at March 31, 2019 and December 31, 2018, respectively.

The weighted-average rating of the Company's Alt-A mortgage-backed securities at March 31, 2019 and December 31, 2018 was BB, while the weighted-average rating of the entire mortgage-backed securities portfolio was A+ at March 31, 2019 and December 31, 2018. The modified duration of the mortgage-backed securities portfolio reflecting anticipated early calls was 4.1 years and 4.0 years at March 31, 2019 and December 31, 2018, respectively.

## Corporate Securities

Corporate securities included in fixed maturity securities are as follows:

|  | March 31, | December 31, |
|--|-----------|--------------|
|  | 2019      | 2018         |

|   | (Amounts in thousands) |   |           |   |
|---|------------------------|---|-----------|---|
| Corporate securities at fair value                      | \$118,024              |   | \$105,524 |   |
| Percentage of total fixed maturity securities portfolio | 3.8                    | % | 3.5       | % |
| Modified duration                                       | 2.5 years              |   | 2.4 years |   |
| Weighted-average rating                                 | BBB+                   |   | BBB       |   |

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## Collateralized Loan Obligations

Collateralized loan obligations included in fixed maturity securities are as follows:

|   | March 31,<br>2019      | December 31,<br>2018 |   |  |
|---|------------------------|----------------------|---|--|
|   | (Amounts in thousands) |                      |   |  |
| Collateralized loan obligations at fair value           | \$ 172,963             | \$ 165,789           |   |  |
| Percentage of total fixed maturity securities portfolio | 5.6                    | % 5.6                | % |  |
| Modified duration                                       | 5.3 years              | 5.5 years            |   |  |
| Weighted-average rating                                 | A+                     | A+                   |   |  |

## Other Asset-Backed Securities

Other asset-backed securities included in fixed maturity securities are as follows:

|   | March 31,<br>2019      | December 31,<br>2018 |   |  |
|---|------------------------|----------------------|---|--|
|   | (Amounts in thousands) |                      |   |  |
| Other asset-backed securities at fair value             | \$ 39,054              | \$ 37,761            |   |  |
| Percentage of total fixed maturity securities portfolio | 1.3                    | % 1.3                | % |  |
| Modified duration                                       | 3.5<br>years           | 2.1 years            |   |  |
| Weighted-average rating                                 | A                      | A+                   |   |  |

## Equity Securities

Equity holdings of \$616.5 million and \$529.6 million at fair value, as of March 31, 2019 and December 31, 2018, respectively, consist of non-redeemable preferred stocks, common stocks on which dividend income is partially tax-sheltered by the 50% corporate dividend received deduction, and private equity funds including a fund measured at net asset value. The Company had a net gain (loss) of \$53.7 million and \$(11.9) million due to changes in fair value of the Company's equity securities portfolio for the three months ended March 31, 2019 and 2018, respectively. The primary cause for the increase in fair value of the Company's equity securities portfolio for the three months ended March 31, 2019 was overall improvement in equity markets, and the main cause for the decrease for the three months ended March 31, 2018 was overall decline in equity markets.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At March 31, 2019, 15.2% of the total investment portfolio at fair value was held in equity securities, compared to 14.1% at December 31, 2018.

## D. Debt

On March 8, 2017, the Company paid off the total outstanding balance of \$320 million under the existing loan and credit facility agreements with the proceeds from its public offering of \$375 million of senior notes, and terminated the agreements.

On March 8, 2017, the Company completed a public debt offering issuing \$375 million of senior notes. The notes are unsecured senior obligations of the Company with a 4.40% annual coupon payable on March 15 and September 15 of each year commencing September 15, 2017. The notes mature on March 15, 2027. The Company used the proceeds from the notes to pay off amounts outstanding under the existing loan and credit facilities and for general corporate

purposes. The Company incurred debt issuance costs of approximately \$3.4 million, inclusive of underwriters' fees. The notes were issued at a slight discount of 99.847% of par, resulting in the effective annualized interest rate including debt issuance costs of approximately 4.45%.

On March 29, 2017, the Company entered into an unsecured credit agreement that provides for revolving loans of up to \$50 million and matures on March 29, 2022. The interest rates on borrowings under the credit facility are based on the Company's debt to total capital ratio and range from LIBOR plus 112.5 basis points when the ratio is under 15% to LIBOR plus 162.5 basis points when the ratio is greater than or equal to 25%. Commitment fees for the undrawn portions of the credit facility range from 12.5 basis points when the ratio is under 15% to 22.5 basis points when the ratio is greater than or equal to 25%. The debt to total capital ratio is expressed as a percentage of (a) consolidated debt to (b) consolidated shareholders' equity plus consolidated debt. The Company's debt to total capital ratio was 17.9% at March 31, 2019, resulting in a 15 basis point commitment fee on the \$50 million undrawn portion of the credit facility. As of April 25, 2019, there have been no borrowings under this facility.

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The Company was in compliance with all of its financial covenants pertaining to minimum statutory surplus, debt to total capital ratio, and risk based capital ratio under the unsecured credit facility at March 31, 2019.

For additional information on debt, see Note 12. Notes Payable of the Notes to Consolidated Financial Statements.

#### E. Regulatory Capital Requirements

Among other considerations, industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.53 billion at March 31, 2019, and net premiums written of \$3.6 billion for the twelve months ended on that date, the ratio of net premiums written to surplus was 2.32 to 1 at March 31, 2019.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risks

The Company is subject to various market risk exposures primarily due to its investing and borrowing activities. Primary market risk exposures are changes in interest rates, equity prices, and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of creditworthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

##### Overview

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile, and regulatory requirements of the subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The Company's investment committee focuses on strategies to enhance after-tax yields, mitigate market risks, and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration, and credit ratings. Asset allocation limits place restrictions on the total amount of funds that may be invested within an asset class. Duration limits on the fixed maturity securities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

##### Credit Risk

Credit risk results from uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a high credit quality fixed maturity securities portfolio. As of March 31, 2019, the estimated weighted-average credit quality rating of the fixed maturity securities portfolio was A+, at fair value, consistent with the average rating at December 31, 2018.

The following table presents municipal securities by state in descending order of holdings at fair value at March 31, 2019:

| States       | Fair Value             | Average Rating |
|--------------|------------------------|----------------|
|              | (Amounts in thousands) |                |
| Texas        | \$ 385,608             | A+             |
| Florida      | 261,007                | A+             |
| Illinois     | 229,225                | A-             |
| Pennsylvania | 163,984                | A+             |

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|              |              |    |
|--------------|--------------|----|
| California   | 152,257      | A+ |
| Other states | 1,503,027    | A+ |
| Total        | \$ 2,695,108 |    |

At March 31, 2019, the municipal securities portfolio was broadly diversified among the states and the largest holdings were in populous states such as Texas and Florida. These holdings were further diversified primarily among cities, counties, schools, public works, hospitals, and state general obligations. The Company seeks to minimize overall credit risk and ensure diversification by limiting exposure to any particular issuer.

Taxable fixed maturity securities represented 14.3% of the Company's total fixed maturity securities portfolio at fair value

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at March 31, 2019. 5.4% of the Company's taxable fixed maturity securities at fair value were comprised of U.S. government bonds, which were rated AAA at March 31, 2019. 3.3% of the Company's taxable fixed maturity securities at fair value, representing 0.5% of its total fixed maturity securities portfolio at fair value, were rated below investment grade at March 31, 2019. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

**Equity Price Risk**

Equity price risk is the risk that the Company will incur losses due to adverse changes in the equity markets.

At March 31, 2019, the Company's primary objective for common equity investments was current income. The fair value of the equity investments consisted of \$513.9 million in common stocks, \$33.7 million in non-redeemable preferred stocks, and \$68.9 million in private equity funds. Common stocks are typically valued for future economic prospects as perceived by the market.

Common stocks represented 12.7% of total investments at fair value at March 31, 2019. Beta is a measure of a security's systematic (non-diversifiable) risk, which is measured by the percentage change in an individual security's return for a 1% change in the return of the market.

Based on hypothetical reductions in the overall value of the stock market, the following table illustrates estimated reductions in the overall value of the Company's common stock portfolio at March 31, 2019 and December 31, 2018:

|  | March<br>31, 2019                                 | December<br>31, 2018 |
|--|---|----------------------|
|  | (Amounts in<br>thousands, except<br>average Beta) |                      |
| Average Beta   | 0.84  | 0.78                 |
| Hypothetical reduction of 25% in the overall value of the stock market | \$107,921   | \$84,040             |
| Hypothetical reduction of 50% in the overall value of the stock market | \$215,842   | \$168,080            |

**Interest Rate Risk**

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. The Company faces interest rate risk as it invests a substantial amount of funds in interest sensitive assets and holds interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from widening credit spreads and credit exposure to collateralized securities.

The fixed maturity securities portfolio, which represented 75.8% of total investments at March 31, 2019 at fair value, is subject to interest rate risk. The change in market interest rates is inversely related to the change in the fair value of the fixed maturity securities portfolio. A common measure of the interest sensitivity of fixed maturity securities is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age to receive the present value of all the cash flows produced by such assets, including reinvestment of interest. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity securities with a goal of maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturities tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Fixed maturity securities purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The modified duration of the overall fixed maturity securities portfolio reflecting anticipated early calls was 3.7 years and 4.0 years at March 31, 2019 and December 31, 2018, respectively.

If interest rates were to rise by 100 and 200 basis points, the Company estimates that the fair value of its fixed maturity securities portfolio at March 31, 2019 would decrease by \$129.2 million and \$258.4 million, respectively. Conversely, if interest rates were to decrease, the fair value of the Company's fixed maturity securities portfolio would rise, and it may cause a higher number of the Company's fixed maturity securities to be called away. The proceeds from the called fixed maturity securities would likely be reinvested at lower yields, which would result in lower overall investment income for the Company.



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### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this Quarterly Report on Form 10-Q. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

#### Changes in Internal Control over Financial Reporting

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings

The Company is, from time to time, named as a defendant in various lawsuits or regulatory actions incidental to its insurance business. The majority of lawsuits brought against the Company relate to insurance claims that arise in the normal course of business and are reserved for through the reserving process. For a discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

The Company establishes reserves for non-insurance claims related lawsuits, regulatory actions, and other contingencies when the Company believes a loss is probable and is able to estimate its potential exposure. For loss contingencies believed to be reasonably possible, the Company also discloses the nature of the loss contingency and an estimate of the possible loss, range of loss, or a statement that such an estimate cannot be made. While actual losses may differ from the amounts recorded and the ultimate outcome of the Company's pending actions is generally not yet determinable, the Company does not believe that the ultimate resolution of currently pending legal or regulatory proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition or cash flows.

In all cases, the Company vigorously defends itself unless a reasonable settlement appears appropriate. For a discussion of legal matters, see the Company's Annual Report on Form 10-K for the year ended December 31, 2018. See also "Overview-C. Regulatory and Legal Matters" in Part I-Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

There are no environmental proceedings arising under federal, state, or local laws or regulations to be discussed.

Item 1A. Risk Factors

The Company's business, results of operations, and financial condition are subject to various risks. These risks are described elsewhere in this Quarterly Report on Form 10-Q and in the Company's other filings with the United States Securities and Exchange Commission, including the Company's Annual Report on Form 10-K for the year ended December 31, 2018. The risk factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 have not changed in any material

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respect.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosure

Not applicable.

Item 5. Other Information

On April 26, 2019, the Compensation Committee of the Board of Directors approved a cash bonus plan covering the Company's named executive officers for 2019 (the "2019 Bonus Plan"). The bonuses payable under the 2019 Bonus Plan will be determined by the Compensation Committee after evaluating Company performance relative to specified corporate goals adopted by the Compensation Committee, which for 2019 will relate to the Company's combined ratio and policies in force. The target bonus percentage for each named executive officer as a percentage of his annual base salary is: George Joseph, Chairman of the Board, 100%; Gabe Tirador, Chief Executive Officer and President, 100%; and Theodore Stalick, Senior Vice President and Chief Financial Officer, 80%. Christopher Graves, the Company's Vice President and Chief Investment Officer, is eligible to receive an annual discretionary bonus, which is determined each year by Messrs. Joseph and Tirador based on their subjective review of his individual performance and the performance of the Company's investment department, and will not be a participant in the 2019 Bonus Plan. The Company expects to adopt a similar bonus program for future years, which will reward achievement at specified levels of corporate financial performance and will contain target bonuses consistent with those disclosed above.

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Item 6. Exhibits

- 3.1 Articles of Incorporation of the Company, as amended to date, were filed as an exhibit to Registrant's Form 10-K for the fiscal year ended December 31, 1997, and are incorporated herein by this reference.
- 3.2 Amended and Restated Bylaws of the Company were filed as an exhibit to Registrant's Form 10-Q for the quarterly period ended September 30, 2007, and are incorporated herein by this reference.
- 15.1 Report of Independent Registered Public Accounting Firm.
- 15.2 Awareness Letter of Independent Registered Public Accounting Firm.
- 31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema Document.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document.

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SIGNATURES

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

MERCURY GENERAL CORPORATION

Date: April 30, 2019 By: /s/ Gabriel Tirador  
Gabriel Tirador  
President and Chief Executive Officer

Date: April 30, 2019 By: /s/ Theodore R. Stalick  
Theodore R. Stalick  
Senior Vice President and Chief Financial Officer