Employers Holdings, Inc.
Form 10-Q
October 27, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

R QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____ to ____

Commission file number: 001-33245

EMPLOYERS HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Nevada	04-3850065
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

10375 Professional Circle, Reno, Nevada 89521
(Address of principal executive offices and zip code)
(888) 682-6671
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes R No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," "non-accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer R Accelerated filer o Non-accelerated filer o Smaller reporting company o

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

Class	October 20, 2016
Common Stock, $0.01 par value per share	32,087,739 shares outstanding

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PART I – FINANCIAL INFORMATION
Item 1. Consolidated Financial Statements
Employers Holdings, Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands, except share data)

	As of September 30, 2016 (unaudited)	As of December 31, 2015
Assets		
Available for sale:		
Fixed maturity securities at fair value (amortized cost $2,273,100 at September 30, 2016 and $2,221,100 at December 31, 2015)	$ 2,383,900	$ 2,288,500
Equity securities at fair value (cost $114,400 at September 30, 2016 and $137,500 at December 31, 2015)	184,500	198,700
Short-term investments at fair value (amortized cost $14,000 at September 30, 2016)	14,000	—
Total investments	2,582,400	2,487,200
Cash and cash equivalents	84,100	56,600
Restricted cash and cash equivalents	2,700	2,500
Accrued investment income	20,300	20,600
Premiums receivable (less bad debt allowance of $10,700 at September 30, 2016 and $12,200 at December 31, 2015)	317,100	301,100
Reinsurance recoverable for:		
Paid losses	8,300	7,700
Unpaid losses	591,500	628,200
Deferred policy acquisition costs	46,800	44,300
Deferred income taxes, net	41,100	67,900
Property and equipment, net	22,600	24,900
Intangible assets, net	8,300	8,500
Goodwill	36,200	36,200
Contingent commission receivable—LPT Agreement	31,100	29,200
Other assets	31,800	40,900
Total assets	$ 3,824,300	$ 3,755,800
Liabilities and stockholders' equity		
Claims and policy liabilities:		
Unpaid losses and loss adjustment expenses	$ 2,330,000	$ 2,347,500
Unearned premiums	325,600	308,900
Total claims and policy liabilities	2,655,600	2,656,400
Commissions and premium taxes payable	50,500	52,500
Accounts payable and accrued expenses	17,500	24,100
Deferred reinsurance gain—LPT Agreement	177,800	189,500
Notes payable	32,000	32,000
Other liabilities	40,800	40,500
Total liabilities	$ 2,974,200	$ 2,995,000
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.01 par value; 150,000,000 shares authorized; 56,124,974 and 55,589,454 shares issued and 32,109,976 and 32,216,480 shares outstanding at September 30, 2016 and December 31, 2015, respectively	$ 600	$ 600

Preferred stock, $0.01 par value; 25,000,000 shares authorized; none issued	—	—
Additional paid-in capital	368,600	357,200
Retained earnings	744,500	682,000
Accumulated other comprehensive income, net	117,600	83,600
Treasury stock, at cost (24,014,998 shares at September 30, 2016 and 23,372,974 shares at December 31, 2015)	(381,200)	(362,600)
Total stockholders’ equity	850,100	760,800
Total liabilities and stockholders’ equity	$ 3,824,300	$ 3,755,800

See accompanying unaudited notes to the consolidated financial statements.

Employers Holdings, Inc. and Subsidiaries
Consolidated Statements of Comprehensive Income
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues	(unaudited)		(unaudited)	
Net premiums earned	$173,300	$179,000	$522,800	$508,600
Net investment income	17,900	18,500	54,100	53,800
Net realized gains on investments	1,600	2,000	9,100	5,100
Other income	—	—	600	100
Total revenues	192,800	199,500	586,600	567,600
Expenses				
Losses and loss adjustment expenses	109,000	115,800	328,000	323,500
Commission expense	21,300	21,000	63,500	62,600
Underwriting and other operating expenses	31,700	31,600	101,600	97,600
Interest expense	400	700	1,200	2,100
Total expenses	162,400	169,100	494,300	485,800
Net income before income taxes	30,400	30,400	92,300	81,800
Income tax expense	7,800	5,900	21,100	14,100
Net income	$22,600	$24,500	$71,200	$67,700
Comprehensive income				
Unrealized (losses) gains during the period (net of tax (benefit) expense of $(2,300) and $(5,900) for the three months ended September 30, 2016 and 2015, respectively, and $21,500 and $(14,200) for the nine months ended September 30, 2016 and 2015, respectively)	$(4,200)	$(11,100)	$39,900	$(26,500)
Reclassification adjustment for realized gains in net income (net of taxes of $600 and $700 for the three months ended September 30, 2016 and 2015, respectively, and $3,200 and $1,800 for the nine months ended September 30, 2016 and 2015, respectively)	(1,000)	(1,300)	(5,900)	(3,300)
Other comprehensive (loss) income, net of tax	(5,200)	(12,400)	34,000	(29,800)
Total comprehensive income	$17,400	$12,100	$105,200	$37,900
Net realized gains on investments				
Net realized gains on investments before credit related impairments	$1,600	$2,100	$14,400	$5,300
Other than temporary impairment recognized in earnings	—	(100)	(5,300)	(200)
Net realized gains on investments	$1,600	$2,000	$9,100	$5,100
Earnings per common share (Note 11):				
Basic	$0.70	$0.76	$2.19	$2.12
Diluted	$0.69	$0.75	$2.16	$2.08
Cash dividends declared per common share	$0.09	$0.06	$0.27	$0.18

See accompanying unaudited notes to the consolidated financial statements.

Employers Holdings, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(in thousands)

	Nine Months Ended September 30,	
	2016	2015
Operating activities	(unaudited)	
Net income	$71,200	$67,700
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,400	5,900
Stock-based compensation	4,300	3,200
Amortization of premium on investments, net	11,400	9,500
Allowance for doubtful accounts	(1,500)	3,700
Deferred income tax expense	8,500	4,500
Realized gains on investments, net	(9,100)	(5,100)
Excess tax benefits from stock-based compensation	—	(800)
Other	(200)	(100)
Change in operating assets and liabilities:		
Premiums receivable	(14,500)	(14,300)
Reinsurance recoverable for paid and unpaid losses	36,100	38,000
Federal income taxes	3,000	2,200
Unpaid losses and loss adjustment expenses	(17,500)	(11,800)
Unearned premiums	16,700	16,300
Accounts payable, accrued expenses and other liabilities	(6,200)	2,400
Deferred reinsurance gain—LPT Agreement	(11,700)	(14,600)
Contingent commission receivable—LPT Agreement	(1,900)	(2,800)
Other	2,000	(9,900)
Net cash provided by operating activities	97,000	94,000
Investing activities		
Purchase of fixed maturity securities	(325,200)	(365,600)
Purchase of equity securities	(38,800)	(77,700)
Purchase of short-term investments	(8,000)	(18,500)
Proceeds from sale of fixed maturity securities	111,700	87,000
Proceeds from sale of equity securities	70,200	21,400
Proceeds from maturities and redemptions of investments	145,100	214,000
Capital expenditures	(3,900)	(7,400)
Change in restricted cash and cash equivalents	(200)	7,700
Net cash used in investing activities	(49,100)	(139,100)
Financing activities		
Acquisition of treasury stock	(18,600)	—
Cash transactions related to stock-based compensation	7,100	3,100
Dividends paid to stockholders	(8,800)	(5,800)
Payments on notes payable and capital leases	(100)	(400)
Excess tax benefits from stock-based compensation	—	800
Net cash used in financing activities	(20,400)	(2,300)
Net increase (decrease) in cash and cash equivalents	27,500	(47,400)
Cash and cash equivalents at the beginning of the period	56,600	103,600
Cash and cash equivalents at the end of the period	$84,100	$56,200

See accompanying unaudited notes to the consolidated financial statements.

Employers Holdings, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

1. Basis of Presentation and Summary of Operations

Employers Holdings, Inc. (EHI) is a Nevada holding company. Through its wholly owned insurance subsidiaries, Employers Insurance Company of Nevada (EICN), Employers Compensation Insurance Company (ECIC), Employers Preferred Insurance Company (EPIC), and Employers Assurance Company (EAC), EHI is engaged in the commercial property and casualty insurance industry, specializing in workers' compensation products and services. Unless otherwise indicated, all references to the "Company" refer to EHI, together with its subsidiaries.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal, recurring adjustments) necessary for a fair presentation of the Company's consolidated financial position and results of operations for the periods presented have been included. The results of operations for an interim period are not necessarily indicative of the results for an entire year. These financial statements have been prepared consistent with the accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

The Company considers an operating segment to be any component of its business whose operating results are regularly reviewed by the Company's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance based on discrete financial information. Currently, the Company has one operating segment, workers' compensation insurance and related services.

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. As a result, actual results could differ from these estimates. The most significant areas that require management judgment are the estimate of unpaid losses and loss adjustment expenses (LAE), evaluation of reinsurance recoverables, recognition of premium revenue, deferred income taxes, and investments.

Reclassifications

Certain prior period information has been reclassified to conform to the current period presentation.

2. Change in Estimates

The Company reduced its estimated reserves ceded under the Loss Portfolio Transfer Agreement (LPT Reserve Adjustment) as a result of the determination that an adjustment was necessary to reflect observed favorable paid loss trends during the second quarter of 2016. The following table shows the financial statement impact related to the reduction in estimated reserves ceded under the Loss Portfolio Transfer Agreement (LPT Agreement).

	Nine Months Ended September 30, 2016 (in millions, except per share data)
Change in estimated reserves ceded under the LPT Agreement	$ (5.0)
Cumulative adjustment to the Deferred Gain[1]	(3.1)
Net income impact of change in estimate	3.1

EPS impact of change in estimate	
Basic	0.10
Diluted	0.09

(1) The cumulative adjustment to the Deferred reinsurance gain–LPT Agreement (Deferred Gain) was also recognized in losses and LAE incurred in the Consolidated Statement of Comprehensive Income, so that the Deferred Gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement.

The Company increased its estimate of contingent commission receivable – LPT Agreement (LPT Contingent Commission Adjustment) as a result of the determination that an adjustment was necessary to reflect observed favorable paid loss trends during the second quarter of 2016. The following table shows the financial statement impact related to these changes in estimates.

	Nine Months Ended September 30, 2016 (in millions, except per share data)
Change in estimate of contingent commission receivable – LPT Agreement	$ 1.9
Cumulative adjustment to the Deferred Gain[1]	(1.8)
Net income impact of change in estimate	1.8
EPS impact of change in estimate	
Basic	0.06
Diluted	0.05

(1) The cumulative adjustment to the Deferred Gain was also recognized in losses and LAE incurred in the Consolidated Statement of Comprehensive Income, so that the Deferred Gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement.

3. New Accounting Standards

Recently Adopted Accounting Standards

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2016-09, Compensation - Stock Compensation (Topic 718). This update simplifies several aspects of the accounting for share-based payment award transactions, including income taxes and classification of awards on the balance sheet and on the statement of cash flows. This update becomes effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2016 and early adoption is permitted. The Company elected to early adopt this standard in the quarter ended September 30, 2016 with an effective date of January 1, 2016. Adoption of this standard had the following impacts on the Company's consolidated financial statements:

- Consolidated Statements of Comprehensive Income – This standard requires that the tax effects of stock-based compensation be recognized in the income tax expense. Net tax benefits related to stock-based compensation of $0.1 million and $1.4 million were recognized as reductions to Income tax expense and increases to Net income in the Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016, respectively. These changes had no impact on the Company's basic and diluted earnings per share for the three months ended September 30, 2016, but increased basic and diluted earnings per share by $0.04 for the nine months ended September 30, 2016. This standard also requires that assumed proceeds under the treasury stock method be modified to exclude the excess tax benefits that would have been recognized in Additional paid-in capital. These changes were applied on a prospective basis.
- Consolidated Statements of Cash Flows – This standard requires that the excess tax benefits from stock-based compensation be reported as cash flows from operating activities rather than the previous requirement to present the excess tax benefits from stock-based compensation as an inflow from financing activities and an outflow from operating activities. This update resulted in a change in presentation that was applied on a prospective basis and prior periods have not been adjusted.

This standard allows the Company to make a policy election as to whether it will include an estimate of stock-based compensation awards expected to be forfeited or whether it will account for forfeitures as they occur. The Company

has elected to continue to estimate forfeitures in the computation of its stock-based compensation, consistent with previous guidance, and had no impact on the Company's consolidated financial statements.
Finally, this standard allows the Company to withhold an amount in excess of the supplemental rate from an employee’s stock-based compensation for federal tax withholding purposes without triggering liability accounting. It also clarifies that all cash payments made to tax authorities on an employee’s behalf should be presented as cash flows from financing activities in the Consolidated Statements of Cash Flows. This update related to tax withholding and presentation of cash flows had no impact on the Company's consolidated financial statements.
Recently Issued Accounting Standards – Not Yet Adopted
In January 2016, the FASB issued ASU Number 2016-01, Financial Instruments - Overall (Subtopic 825-10). This update replaces the guidance to classify equity securities with readily determinable fair values into different categories (trading or available-for-sale) and requires equity securities to be measured at fair value with changes in fair value recognized through net income.

Additionally, this update eliminates the method and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost. It requires financial instruments to be measured at fair value using the exit price notion. Furthermore, this update clarifies that an evaluation of deferred tax assets related to available-for-sale securities is needed, in combination with an evaluation of other deferred tax assets, to determine if a valuation allowance is required. This update becomes effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This update will result in a reclassification adjustment, net of tax, to retained earnings from accumulated other comprehensive income, which will be determined based on the fair value of securities at the effective date of adoption.

In February 2016, the FASB issued ASU Number 2016-02, Leases (Topic 842). This update provides guidance on a new lessee model that includes the recognition of assets and liabilities arising from lease transactions on the balance sheet. Additionally, the update provides clarity on the definition of a lease and the distinction between finance and operating leases. Furthermore, the update requires certain qualitative and quantitative disclosures pertaining to the amounts recorded in the financial statements. This update becomes effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2018 and early adoption is permitted. The Company has not yet estimated the full impact that the adoption will have on its consolidated financial condition and results of operations.

In June 2016, the FASB issued ASU Number 2016-13, Financial Instruments - Credit Losses (Topic 326). This update replaces the incurred loss impairment methodology for recognizing credit losses on financial instruments with a methodology that reflects an entity's current estimate of all expected credit losses. This update requires financial assets measured at amortized cost to be presented net of an allowance for credit losses. Additionally, this update requires credit losses on available-for-sale debt securities to be presented as an allowance rather than as a write-down, allowing an entity to also record reversals of credit losses in current period net income. This update becomes effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company has not yet estimated the full impact that the adoption will have on its consolidated financial condition and results of operations.

In August 2016, the FASB issued ASU Number 2016-15, Statement of Cash Flows (Topic 230). This update provides guidance and clarification on eight specific cash flow issues due to diversity in practice of how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The cash flow issues affected are debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, distributions received from equity method investees, beneficial interest in securitization transactions, and separately identifiable cash flows and application of the predominance principle. This update becomes effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company has not yet estimated the full impact that the adoption will have on its consolidated financial condition and results of operations.

4. Fair Value of Financial Instruments

The carrying value and the estimated fair value of the Company’s financial instruments were as follows:

	September 30, 2016		December 31, 2015	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(in millions)			
Financial assets				
Investments	$2,582.4	$2,582.4	$2,487.2	$2,487.2
Cash and cash equivalents	84.1	84.1	56.6	56.6

Restricted cash and cash equivalents	2.7	2.7	2.5	2.5
Financial liabilities				
Notes payable	$ 32.0	$ 35.0	$ 32.0	$ 36.6

Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based upon the levels of judgment associated with the inputs used to measure their fair value. Level inputs are defined as follows:

- Level 1 - Inputs are unadjusted quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2 - Inputs other than Level 1 prices that are observable for similar assets or liabilities through corroboration with market data at the measurement date.

- Level 3 - Inputs that are unobservable that reflect management's best estimate of what willing market participants would use in pricing the assets or liabilities at the measurement date.

Fair values of available-for-sale fixed maturity and equity securities are based on quoted market prices, where available. If quoted market prices and an estimate determined by using objectively verifiable information are unavailable, the Company produces an estimate of fair value based on internally developed valuation techniques, which, depending on the level of observable market inputs, will render the fair value estimate as Level 2 or Level 3. The Company bases all of its estimates of fair value for assets on the bid price, as it represents what a third-party market participant would be willing to pay in an arm's length transaction.

These methods of valuation will only produce an estimate of fair value if there is objectively verifiable information to produce a valuation. If objectively verifiable information is not available, the Company would be required to produce an estimate of fair value using some of the same methodologies, making assumptions for market-based inputs that are unavailable.

The Company's estimates of fair value for financial liabilities are based on the interest rates for notes with similar durations to discount the projection of future payments on notes payable. The fair value measurements for notes payable have been determined to be Level 2.

The following table presents the items on the accompanying Consolidated Balance Sheets that are stated at fair value and the corresponding fair value measurements.

	September 30, 2016			December 31, 2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
	(in millions)					
Fixed maturity securities						
U.S. Treasuries	$—	$127.9	$—	$—	$120.2	$—
U.S. Agencies	—	13.0	—	—	24.4	—
States and municipalities	—	897.2	—	—	854.5	—
Corporate securities	—	996.5	—	—	925.3	—
Residential mortgage-backed securities	—	235.0	—	—	237.9	—
Commercial mortgage-backed securities	—	86.5	—	—	80.3	—
Asset-backed securities	—	27.8	—	—	45.9	—
Total fixed maturity securities	$—	$2,383.9	$—	$—	$2,288.5	$—
Equity securities						