SAFETY INSURANCE GROUP INC
Form 10-Q
August 05, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 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: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	13-4181699
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 Custom House Street, Boston, Massachusetts 02110

(Address of principal executive offices including zip code)

(617) 951-0600

(Registrant's telephone number, including area code)

Not Applicable

(Former name or former address, if changed since last report)

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of August 1, 2016 there were 15,158,074 shares of common stock with a par value of $0.01 per share outstanding.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	June 30, 2016 (Unaudited)	December 31, 2015
Assets		
Investments:		
Securities available for sale:		
Fixed maturities, at fair value (amortized cost: $1,068,806 and $1,063,971)	$ 1,112,277	$ 1,081,637
Equity securities, at fair value (cost: $103,898 and $102,541)	116,961	110,204
Other invested assets	19,304	17,602
Total investments	1,248,542	1,209,443
Cash and cash equivalents	44,053	47,494
Accounts receivable, net of allowance for doubtful accounts	195,509	178,567
Receivable for securities sold	518	260
Accrued investment income	8,469	8,922
Taxes recoverable	17,037	15,497
Receivable from reinsurers related to paid loss and loss adjustment expenses	26,444	40,972
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	78,043	68,261
Ceded unearned premiums	28,886	23,222
Deferred policy acquisition costs	72,386	68,937
Deferred income taxes	—	4,430
Equity and deposits in pools	27,695	23,558
Other assets	16,917	14,306
Total assets	$ 1,764,499	$ 1,703,869
Liabilities		
Loss and loss adjustment expense reserves	$ 544,082	$ 553,977
Unearned premium reserves	428,135	401,961
Accounts payable and accrued liabilities	51,762	53,722
Payable for securities purchased	7,093	8,607
Payable to reinsurers	23,177	11,547
Deferred income taxes	7,117	—
Other liabilities	23,098	29,556
Total liabilities	1,084,464	1,059,370
Commitments and contingencies (Note 7)		
Shareholders' equity		
	174	174

Common stock: $0.01 par value; 30,000,000 shares authorized; 17,437,644 and 17,373,643 shares issued		
Additional paid-in capital	182,278	179,896
Accumulated other comprehensive income, net of taxes	36,746	16,464
Retained earnings	544,672	531,800
Treasury stock, at cost: 2,279,570 shares	(83,835)	(83,835)
Total shareholders’ equity	680,035	644,499
Total liabilities and shareholders’ equity	$ 1,764,499	$ 1,703,869

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net earned premiums	$ 187,393	$ 182,447	$ 373,047	$ 365,011
Net investment income	9,641	10,317	19,268	20,874
Earnings from partnership investments	1,409	577	2,287	577
Net realized gains (losses) on investments	360	(173)	37	238
Net impairment losses on investments (a)	(137)	—	(429)	—
Finance and other service income	4,284	4,434	8,569	8,941
Total revenue	202,950	197,602	402,779	395,641
Losses and loss adjustment expenses	115,144	147,026	241,123	355,350
Underwriting, operating and related expenses	57,513	52,198	113,470	104,295
Interest expense	23	23	45	45
Total expenses	172,680	199,247	354,638	459,690
Income (loss) before income taxes	30,270	(1,645)	48,141	(64,049)
Income tax expense (credit)	8,905	(592)	14,106	(27,925)
Net income (loss)	$ 21,365	$ (1,053)	$ 34,035	$ (36,124)
Earnings (loss) per weighted average common share:				
Basic	$ 1.42	$ (0.07)	$ 2.26	$ (2.43)
Diluted	$ 1.41	$ (0.07)	$ 2.25	$ (2.43)
Cash dividends paid per common share	$ 0.70	$ 0.70	$ 1.40	$ 1.40
Number of shares used in computing earnings (loss) per share:				
Basic	14,960,516	14,879,047	14,932,237	14,851,742
Diluted	15,041,077	14,879,047	14,988,546	14,851,742

(a) No portion of the other-than-temporary impairments recognized in the period indicated were included in comprehensive income

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income (loss)	$ 21,365	$ (1,053)	$ 34,035	$ (36,124)
Other comprehensive income, net of tax:				
Unrealized holding gains or losses during the period, net of income tax expense (benefit) of $5,426, ($5,508), $10,934 and ($3,616).	10,077	(10,230)	20,306	(6,715)
Reclassification adjustment for losses or gains included in net income, net of income tax (expense) benefit of ($126), $60, ($13) and ($83).	(234)	112	(24)	(155)
Unrealized gains on securities available for sale	9,843	(10,118)	20,282	(6,870)
Comprehensive income (loss)	$ 31,208	$ (11,171)	$ 54,317	$ (42,994)

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2014	$ 173	$ 175,583	$ 28,715	$ 587,647	$ (83,835)	$ 708,283
Net loss, January 1 to June 30, 2015				(36,124)		(36,124)
Unrealized losses on securities available for sale, net of deferred federal income taxes			(6,870)			(6,870)
Restricted share awards issued	1	246				247
Recognition of employee share-based compensation, net of deferred federal income taxes		1,584				1,584
Exercise of options, net of federal income taxes		152				152
Dividends paid and accrued				(20,930)		(20,930)
Acquisition of treasury stock					—	—
Balance at June 30, 2015	$ 174	$ 177,565	$ 21,845	$ 530,593	$ (83,835)	$ 646,342

	Common	Additional Paid-in	Accumulated Other Comprehensive Income,	Retained	Treasury	Total Shareholders'

	Stock	Capital	Net of Taxes	Earnings	Stock	Equity
Balance at December 31, 2015	$ 174	$ 179,896	$ 16,464	$ 531,800	$ (83,835)	$ 644,499
Net income, January 1 to June 30, 2016				34,035		34,035
Unrealized gains on securities available for sale, net of deferred federal income taxes			20,282			20,282
Restricted share awards issued		280				280
Recognition of employee share-based compensation, net of deferred federal income taxes		1,851				1,851
Exercise of options, net of federal income taxes		251				251
Dividends paid and accrued				(21,163)		(21,163)
Balance at June 30, 2016	$ 174	$ 182,278	$ 36,746	$ 544,672	$ (83,835)	$ 680,035

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Six Months Ended June 30, 2016	2015
Cash flows from operating activities:		
Net income (loss)	$ 34,035	$ (36,124)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization, net	6,356	5,635
Provision (credit) for deferred income taxes	626	(2,171)
Net realized gains on investments	(37)	(238)
Net impairment losses on investments	429	—
Earnings from partnership investments	(2,287)	(577)
Changes in assets and liabilities:		
Accounts receivable	(16,942)	(16,522)
Accrued investment income	453	960
Receivable from reinsurers	4,746	(59,149)
Ceded unearned premiums	(5,664)	(1,564)
Deferred policy acquisition costs	(3,449)	(3,944)
Taxes recoverable	(1,540)	(29,129)
Other assets	(6,328)	(4,542)
Loss and loss adjustment expense reserves	(9,895)	78,423
Unearned premium reserves	26,174	26,020
Accounts payable and accrued liabilities	(1,936)	(21,285)
Payable to reinsurers	11,630	9,574
Other liabilities	(6,458)	19,194
Net cash provided by (used for) operating activities	29,913	(35,439)
Cash flows from investing activities:		
Fixed maturities purchased	(117,678)	(95,378)
Equity securities purchased	(10,705)	(20,102)
Other invested assets purchased	(2,013)	(3,404)
Proceeds from sales and paydowns of fixed maturities	43,085	70,432
Proceeds from maturities, redemptions, and calls of fixed maturities	64,462	67,028
Proceed from sales of equity securities	10,150	18,674
Proceeds from other invested assets redeemed	2,656	—
Fixed assets purchased	(2,375)	(2,139)
Net cash (used for) provided by investing activities	(12,418)	35,111
Cash flows from financing activities:		

Proceeds from stock options exercised	257	150
Excess tax (expense) benefit from stock options exercised	(6)	2
Dividends paid to shareholders	(21,187)	(20,986)
Net cash used for financing activities	(20,936)	(20,834)
Net decrease in cash and cash equivalents	(3,441)	(21,162)
Cash and cash equivalents at beginning of year	47,494	42,455
Cash and cash equivalents at end of period	$ 44,053	$ 21,293

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America ("GAAP"). 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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The consolidated financial statements include Safety Insurance Group, Inc. and its subsidiaries (the "Company"). The subsidiaries consist of Safety Insurance Company, Safety Indemnity Insurance Company, Safety Property and Casualty Insurance Company, Safety Asset Management Corporation ("SAMC"), and Safety Management Corporation, which is SAMC's holding company. All intercompany transactions have been eliminated.

The financial information for the quarter and year ended June 30, 2016 and 2015 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition, results of operations, and cash flows for the periods. The financial information as of December 31, 2015 is derived from the audited financial statements included in the Company's 2015 annual report on Form 10-K filed with the SEC on February 26, 2016.

These unaudited interim consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company's annual report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on February 26, 2016.

The Company is a leading provider of property and casualty insurance focused primarily on the Massachusetts market. The Company's principal product line is automobile insurance. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company, and Safety Property and Casualty Insurance Company (together referred to as the "Insurance Subsidiaries").

The Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire during 2008, personal umbrella insurance in New Hampshire during 2009, and commercial automobile insurance in New Hampshire during 2011. The Insurance Subsidiaries began writing all of these lines of business in Maine during 2016.

2. Recent Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (" ASU") 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Statements, which amends the guidance for the impairment of financial instruments and is expected to result in more timely recognition of impairment losses. The update introduces an impairment model referred to as the current expected credit loss (CECL) model. The impairment model is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses. The ASU is also intended to reduce the complexity of the current guidance by decreasing the number of credit impairment models that entities use to account for debt instruments. For public business entities that are SEC filers, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Entities may adopt the amendments in this update earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is assessing the impact that adoption of ASU No. 2016-13 will have on its financial position, results of operations and cash flows.

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In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASC update requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement, and be treated as discreet items in the reporting period in which they occur. Additionally, excess tax benefits will be classified with other income tax cash flows as an operating activity and cash paid by an employer when directly withholding shares for tax withholding purposes will be classified as a financing activity. Awards that are used to settle employee tax liabilities will be allowed to qualify for equity classification for withholdings up to the maximum statutory tax rates in applicable jurisdictions. Regarding forfeitures, a company can make an entity-wide accounting policy election to either continue estimating the number of awards that are expected to vest or account for forfeitures when they occur. The updated guidance is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The impact of the adoption of ASU 2016-01 to the Company's financial position and results of operations is currently being evaluated.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). The amendments in this ASU update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and (4) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements. These amendments are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The impact of the adoption of ASU 2016-01 to the Company's financial position and results of operations is currently being evaluated.

In May 2015, the FASB issued ASU 2015-09, Disclosures about Short-Duration Contracts ("ASU 2015-09"). ASU 2015-09 requires companies that issue short duration contracts to disclose additional information, including: (i) incurred and paid claims development tables; (ii) frequency and severity of claims; and (iii) information about material changes in judgments made in calculating the liability for unpaid claim adjustment expenses, including reasons for the change and the effects on the financial statements. ASU 2015-09 is effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. The amendments in ASU 2015-09 should be applied retrospectively by providing comparative disclosures for each period presented, except for those requirements that apply only to the current period. As the requirements of this literature are disclosure only, the application of this guidance will not impact our financial condition, results of operations or cash flows.

In May 2015, the FASB issued ASU 2015-07, Fair Value Measurement Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent) ("ASU 2015-07"). ASU 2015-07 removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The reporting entity should continue to disclose information on investments for which fair value is measured at net asset value (or its equivalent) as a practical expedient to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value. ASU 2015-07 is effective for fiscal years beginning after December 31, 2015. The Company adopted the updated accounting guidance retrospectively. The Company adjusted its previously reported financial information included herein to reflect the change in accounting guidance for assets measured using the net asset value. The impact of adopting the new accounting standard resulted in excluding a real estate investment trust of $19,481 and $19,097 from the fair value level disclosures as of June 30, 2016 and December 31, 2015.

In April 2015, the FASB issued ASU No. 2015-03, Imputation of Interest ("ASU 2015-03"). ASU 2015-03 simplifies the presentation of debt issuance costs as the amendments in this update require that debt issuance costs be

Safety Insurance Group, Inc. and Subsidiaries

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(Dollars in thousands except per share and share data)

presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. ASU 2015-03 is effective for annual and interim reporting periods beginning after December 15, 2015. The standard requires a retrospective approach where the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. The standard also requires compliance with applicable disclosures for a change in an accounting principle. The Company's adoption of ASU 2015-03 had no impact on the Company's financial position, results of operations or cash flows.

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosures of Uncertainties about an Entity's Ability as a Going Concern" ("ASU 2014-15"). ASU 2014-15 provides guidance on determining when and how to disclose going concern uncertainties in the financial statements, and requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. ASU 2014-15 is effective for annual periods ending after December 15, 2016 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have any impact on its financial position, results of operations, or cash flows.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period" ("ASU 2014-12"), which revises the accounting treatment for stock compensation tied to performance targets. ASU 2014-12 is effective for calendar years beginning after December 15, 2015. The impact of adoption was not material to the Company's financial position, results of operations or cash flows.

In May 2014, the FASB issued as final, ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" which supersedes virtually all existing revenue recognition guidance under GAAP. The update's core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The update is effective for interim and annual reporting periods in fiscal years beginning after December 15, 2017 and allows early adoption. ASU 2014-09 allows for the use of either the retrospective or modified retrospective approach of adoption. The Company does not expect the adoption of ASU 2014-09 to have a material impact on its financial position, results of operations, or cash flows.

3. Earnings (loss) per Weighted Average Common Share

Basic earnings (loss) per weighted average common share (“EPS”) are calculated by dividing net income (loss) by the weighted average number of basic common shares outstanding during the period. Diluted earnings (loss) per share amounts are based on the weighted average number of common shares including non-vested performance stock grants and the net effect of potentially dilutive common stock options.

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(Dollars in thousands except per share and share data)

The following table sets forth the computation of basic and diluted EPS for the periods indicated.

	Three Months Ended June 30,			Six Months Ended June 30,		
	2016	2015		2016	2015	
Earnings attributable to common shareholders - basic and diluted:						
Net income (loss) from continuing operations	$ 21,365	$ (1,053)		$ 34,035	$ (36,124)	
Allocation of income for participating shares	(138)	—		(319)	—	
Net income (loss) from continuing operations attributed to common shareholders	$ 21,227	$ (1,053)		$ 33,716	$ (36,124)	
Earnings per share denominator - basis and diluted						
Total weighted average common shares outstanding, including participating shares	15,057,436	14,991,232		15,073,479	14,977,378	
Less: weighted average participating shares	(96,920)	(112,185)		(141,242)	(125,636)	
Basic earnings per share denominator	14,960,516	14,879,047		14,932,237	14,851,742	
Common equivalent shares- stock options	—	—	(1)	269	—	(3)
Common equivalent shares- non-vested performance stock grants	80,561	—	(2)	56,040	—	(4)
Diluted earnings per share denominator	15,041,077	14,879,047		14,988,546	14,851,742	
Basic earnings (loss) per share	$ 1.42	$ (0.07)		$ 2.26	$ (2.43)	
Diluted earnings (loss) per share	$ 1.41	$ (0.07)		$ 2.25	$ (2.43)	
Undistributed earnings (loss) attributable to common shareholders - basic and diluted:						
Net income (loss) from continuing operations attributable to common shareholders -Basic	$ 1.42	$ (0.07)		$ 2.26	$ (2.43)	
Dividends declared	(0.70)	(0.70)		(1.40)	(1.40)	
Undistributed earnings (loss)	$ 0.72	$ (0.77)		$ 0.86	$ (3.83)	
Net income (loss) from continuing operations attributable to common shareholders -Diluted	$ 1.41	$ (0.07)		$ 2.25	$ (2.43)	
Dividends declared	(0.70)	(0.70)		(1.40)	(1.40)	
Undistributed earnings (loss)	$ 0.71	$ (0.77)		$ 0.85	$ (3.83)	

(1) Excludes 1,713 of common equivalent shares related to stock options because their inclusion would be anti dilutive due to the net loss of the Company.
(2) Excludes 45,976 of common equivalent shares related to non-vested performance stock grants because their inclusion would be anti dilutive due to the net loss of the Company
(3) Excludes 1,971 of common equivalent shares related to stock options because their inclusion would be anti dilutive due to the net loss of the Company.
(4) Excludes 71,327 of common equivalent shares related to non-vested performance stock grants because their inclusion would be anti dilutive due to the net loss of the Company

Diluted EPS excludes stock options with exercise prices and exercise tax benefits greater than the average market price of the Company's common stock during the period because their inclusion would be anti-dilutive. There were 53 and 1,271 anti-dilutive shares related to non vested performance stock grants for the three and six months ended June 30, 2016, respectively.

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(Dollars in thousands except per share and share data)

4. Share-Based Compensation

Management Omnibus Incentive Plan

Long-term incentive compensation is provided under the Company’s 2002 Management Omnibus Incentive Plan (“the Incentive Plan”) which provides for a variety of share-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights and restricted stock (“RS”) awards.

The maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. The Incentive Plan was amended in March of 2013 to remove "share recycling" plan provisions. Hence, shares of stock covered by an award under the Incentive Plan that are forfeited are no longer available for issuance in connection with 2013 and future grants of awards. At June 30, 2016, there were 279,067 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

Accounting and Reporting for Stock-Based Awards

Accounting Standards Codification (“ASC”) 718, Compensation —Stock Compensation requires the Company to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period of the equity grant).

The following table summarizes stock option activity under the Incentive Plan for the six months ended June 30, 2016.

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	6,200	$ 42.85		
Exercised	(6,000)	$ 42.85		
Forfeitures	(200)	$ 42.85		
Outstanding at end of period	—	$ —	none	$ —
Exercisable at end of period	—	$ —	none	$ —

As of June 30, 2016, all stock option awards have expired and all compensation expense related to stock option awards has been recognized. The total intrinsic value of options exercised during the six months ended June 30, 2016 and 2015 was $85 and $74, respectively. Cash received from stock options exercised was $257 and $150 for the six months ended June 30, 2016 and 2015, respectively.

Restricted Stock

Service-based restricted stock awarded in the form of unvested shares is recorded at the market value of the Company's common stock on the grant date and amortized ratably as compensation expense over the requisite service period. Service-based restricted stock awards generally vest over a three-year period and vest 30% on the first and second anniversaries of the grant date and 40% on the third anniversary of the grant date, except for non-executive employees' restricted stock awards which vest ratably over a five-year service period and independent directors' stock awards which vest immediately. Our independent directors are subject to stock ownership guidelines, which require them to have a value four times their annual cash retainer.

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

In addition to service-based awards, the Company grants performance-based restricted shares to certain employees. These performance shares cliff vest after a three-year performance period provided certain performance measures are attained. A portion of these awards, which contain a market condition, vest according to the level of total shareholder return achieved by the Company compared to its property-casualty insurance peers over a three-year period. The remainders, which contain a performance condition, vest according to the level of Company's combined ratio results compared to a target based on its property-casualty insurance peers.

Actual payouts can range from 0% to 200% of target shares awarded depending upon the level of achievement of the respective market and performance conditions during a three calendar-year performance period. Compensation expense for share awards with a performance condition is based on the probable number of awards expected to vest using the performance level most likely to be achieved at the end of the performance period.

Performance-based awards with market conditions are accounted for and measured differently from awards that have a performance or service condition. The effect of a market condition is reflected in the award's fair value on the grant date. That fair value is recognized as compensation cost over the requisite service period regardless of whether the market-based performance objective has been satisfied.

All of the Company's restricted stock awards are issued as incentive compensation and are equity classified.

The following table summarizes restricted stock activity under the Incentive Plan during the six months ended June 30, 2016, assuming a target payout for the 2016 performance-based shares.

	Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of year	112,024	$ 54.44	99,101	$ 55.55

Granted	46,556	56.09	44,626	60.87
Vested and unrestricted	(56,279)	53.43	(15,289)	47.42
Forfeited	(5,520)	48.86	(27,661)	49.93
Outstanding at end of period	96,781	$ 55.85	100,777	$ 57.85

As of June 30, 2016, there was $8,562 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 2.3 years. The total fair value of the shares that were vested and unrestricted during the six months ended June 30, 2016 and 2015 was $3,732 and $2,897, respectively. For the six months ended June 30, 2016 and 2015, the Company recorded compensation expense related to restricted stock of $1,321 and $990, net of income tax benefits of $711 and $533, respectively.

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Safety Insurance Group, Inc. and Subsidiaries

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(Dollars in thousands except per share and share data)

5. Investments

The gross unrealized gains and losses on investments in fixed maturity securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, and other invested assets were as follows for the periods indicated.

	As of June 30, 2016				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 6,875	$ 91	$ —	$ —	$ 6,966
Obligations of states and political subdivisions	365,367	28,489	(175)	—	393,681
Residential mortgage-backed securities (1)	258,996	7,809	(75)	—	266,730
Commercial mortgage-backed securities	34,623	1,250	(12)	—	35,861
Other asset-backed securities	30,551	351	—	—	30,902
Corporate and other securities	372,394	9,935	(4,192)	—	378,137
Subtotal, fixed maturity securities	1,068,806	47,925	(4,454)	—	1,112,277
Equity securities (2)	103,898	16,874	(3,811)	—	116,961
Other invested assets (5)	19,304	—	—	—	19,304
Totals	$ 1,192,008	$ 64,799	$ (8,265)	$ —	$ 1,248,542

	As of December 31, 2015				
			Gross Unrealized Losses (3)		
	Cost or Amortized	Gross Unrealized	Non-OTTI Unrealized	OTTI Unrealized	Estimated Fair

	Cost	Gains	Losses	Losses (4)	Value
U.S. Treasury securities	$ 1,805	$ —	$ (4)	$ —	$ 1,801
Obligations of states and political subdivisions	377,188	21,160	(426)	—	397,922
Residential mortgage-backed securities (1)	237,896	5,188	(1,628)	—	241,456
Commercial mortgage-backed securities	28,851	30	(218)	—	28,663
Other asset-backed securities	24,037	39	(145)	—	23,931
Corporate and other securities	394,194	4,191	(10,521)	—	387,864
Subtotal, fixed maturity securities	1,063,971	30,608	(12,942)	—	1,081,637
Equity securities (2)	102,541	13,498	(5,835)	—	110,204
Other invested assets (5)	17,602	—	—	—	17,602
Totals	$ 1,184,114	$ 44,106	$ (18,777)	$ —	$ 1,209,443

(1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).

(2) Equity securities included interests in mutual funds held to fund the Company’s executive deferred compensation plan.

(3) Our investment portfolio included 259 and 514 securities in an unrealized loss position at June 30, 2016 and December 31, 2015, respectively.

(4) Amounts in this column represent other-than-temporary impairment (“OTTI”) recognized in accumulated other comprehensive income.

(5) Other invested assets are accounted for under the equity method which approximated fair value.

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The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below for the period indicated. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	As of June 30, 2016	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 30,606	$ 30,764
Due after one year through five years	254,828	258,737
Due after five years through ten years	171,530	176,936
Due after ten years through twenty years	283,751	308,136
Due after twenty years	3,922	4,212
Asset-backed securities	324,169	333,492
Totals	$ 1,068,806	$ 1,112,277

The gross realized losses and gains on sales of investments were as follows for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Gross realized gains				
Fixed maturity securities	$ 172	$ 82	$ 224	$ 265
Equity securities	685	506	1,111	1,443
Gross realized losses				
Fixed maturity securities	(409)	(727)	(991)	(1,218)
Equity securities	(88)	(34)	(307)	(252)
Net realized gains (losses) on investments	$ 360	$ (173)	$ 37	$ 238

In the normal course of business, the Company enters into transactions involving various types of financial instruments, including investments in fixed maturities and equity securities. Investment transactions have credit exposure to the extent that a counter party may default on an obligation to the Company. Credit risk is a consequence of carrying, trading and investing in securities. To manage credit risk, the Company focuses on higher quality fixed income securities, reviews the credit strength of all companies in which it invests, limits its exposure in any one investment and monitors the portfolio quality, taking into account credit ratings assigned by recognized statistical rating organizations.

The following tables as of June 30, 2016 and December 31, 2015 present the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The tables also present the length of time that they have been in a continuous unrealized loss position.

As of June 30, 2016		
Less than 12 Months	12 Months or More	Total