

State Auto Financial CORP
Form 10-Q
August 08, 2006
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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, 2006

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 000-19289

STATE AUTO FINANCIAL CORPORATION

(Exact name of Registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

31-1324304
(I.R.S. Employer
Identification No.)

518 East Broad Street, Columbus, Ohio
(Address of principal executive offices)

43215-3976
(Zip Code)

Registrant's telephone number, including area code: (614) 464-5000

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes No

On August 2, 2006, the Registrant had 40,971,162 Common Shares outstanding.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

PART I FINANCIAL STATEMENTS**Item 1. Condensed Consolidated Balance Sheets**

(\$ millions, except per share amount)

	June 30 2006 (unaudited)	December 31 2005 (see note 1)
Assets		
Fixed maturities, available for sale, at fair value (amortized cost \$1,617.1 and \$1,597.3, respectively)	\$ 1,596.1	1,617.3
Equity securities, available for sale, at fair value (cost \$223.7 and \$224.8, respectively)	258.0	255.6
Other invested assets	6.9	7.0
<i>Total investments</i>	1,861.0	1,879.9
Cash and cash equivalents	33.8	28.7
Securities lending collateral		99.0
Accrued investment income and other assets	44.0	45.1
Deferred policy acquisition costs	106.3	106.0
Net prepaid pension expense	55.5	59.2
Reinsurance recoverable on losses and loss expenses payable (affiliates \$4.8 and \$5.5, respectively)	15.3	17.4
Prepaid reinsurance premiums (affiliates none and \$0.2, respectively)	5.7	6.1
Due from affiliate	16.9	7.1
Current federal income taxes	19.0	3.7
Deferred federal income taxes	28.1	10.1
Property and equipment, at cost (net of accumulated depreciation of \$4.9 and \$4.8, respectively)	12.6	12.6
Total assets	\$ 2,198.2	2,274.9
Liabilities and Stockholders' Equity		
Losses and loss expenses payable (affiliates \$312.5 and \$302.6, respectively)	\$ 729.4	728.7
Unearned premiums (affiliates \$125.6 and \$128.4, respectively)	436.6	432.9
Notes payable (affiliates \$15.5)	118.5	118.7
Postretirement benefit liabilities	93.2	89.2
Securities lending obligation		99.0
Other liabilities	33.6	42.9
Total liabilities	1,411.3	1,511.4
Stockholders' equity:		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		
Common stock, without par value. Authorized 100.0 shares; 45.5 and 45.1 shares issued, respectively, at stated value of \$2.50 per share	113.8	112.8
Less 4.7 and 4.6 treasury shares, at cost, respectively	(57.7)	(56.8)
Additional paid-in capital	81.2	70.2

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Accumulated other comprehensive income	9.6	34.3
Retained earnings	640.0	603.0
<i>Total stockholders equity</i>	786.9	763.5
<i>Total liabilities and stockholders equity</i>	\$ 2,198.2	2,274.9

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

(\$ millions, except per share amounts)

	Three months ended June 30	
(unaudited)	2006	2005
Earned premiums (ceded to affiliates \$171.2 and \$171.3, respectively)	\$ 256.7	263.7
Net investment income	20.6	19.3
Net realized gains on investments	1.4	
Other income (affiliates \$0.7)	1.3	1.2
Total revenues	280.0	284.2
Losses and loss expenses (ceded to affiliates \$120.4 and \$95.6, respectively)	194.0	140.7
Acquisition and operating expenses	80.9	83.6
Interest expense (affiliates \$0.4 and \$0.7, respectively)	1.9	2.2
Other expenses, net	3.4	3.3
Total expenses	280.2	229.8
(Loss) income before federal income taxes	(0.2)	54.4
Federal income tax (benefit) expense	(4.3)	15.6
Net income	\$ 4.1	38.8
Earnings per common share:		
Basic	\$ 0.10	0.96
Diluted	\$ 0.10	0.94
Dividends paid per common share	\$ 0.090	0.045

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Income

(\$ millions, except per share amounts)

	Six months ended June 30	
(unaudited)	2006	2005
Earned premiums (ceded to affiliates \$341.2 and \$340.4, respectively)	\$ 512.8	526.8
Net investment income	41.0	38.3
Net realized gains on investments	0.5	2.4
Other income (affiliates \$1.5)	2.5	2.6
Total revenues	556.8	570.1
Losses and loss expenses (ceded to affiliates \$205.8 and \$186.4, respectively)	321.3	279.5
Acquisition and operating expenses	168.4	167.4
Interest expense (affiliates \$0.7 and \$1.4, respectively)	3.7	4.4
Other expenses, net	6.9	6.6
Total expenses	500.3	457.9
Income before federal income taxes	56.5	112.2
Federal income tax expense	12.2	32.6
Net income	\$ 44.3	79.6
Earnings per common share:		
Basic	\$ 1.09	1.98
Diluted	\$ 1.07	1.94
Dividends paid per common share	\$ 0.180	0.090

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Condensed Consolidated Statements of Cash Flows

<i>(\$ millions)</i>	Six months ended June 30	
<i>(unaudited)</i>	2006	2005
Cash flows from operating activities:		
Net income	\$ 44.3	79.6
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	4.9	4.8
Share-based compensation	4.1	0.6
Net realized gains on investments	(0.5)	(2.4)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(0.3)	(4.8)
Accrued investment income and other assets	1.0	1.2
Net prepaid pension expense	3.7	1.6
Postretirement benefit liabilities	4.0	4.4
Other liabilities and due to/from affiliates, net	(23.7)	(24.1)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	2.5	11.5
Losses and loss expenses payable	0.7	(9.3)
Unearned premiums	3.7	5.6
Federal income taxes	(20.2)	(2.3)
Cash provided from adding Meridian Security Insurance Company and Meridian Citizens Mutual Insurance Company business to the reinsurance pool, effective 1/1/2005		54.0
Net cash provided by operating activities	24.2	120.4
Cash flows from investing activities:		
Purchase of fixed maturities available-for-sale	(122.6)	(327.6)
Purchase of equity securities available-for-sale	(41.9)	(38.3)
Purchase of other invested assets	(0.3)	(2.8)
Maturities, calls and pay downs of fixed maturities available-for-sale	47.9	49.7
Sale of fixed maturities available-for-sale	51.3	163.3
Sale of equity securities available-for-sale	46.7	11.7
Sale of other invested assets	0.7	
Net additions of property and equipment	(0.2)	(0.2)
Net cash used in investing activities	(18.4)	(144.2)
Cash flows from financing activities:		
Proceeds from stock option exercises	4.2	2.7
Change in securities lending collateral	99.0	98.0
Change in securities lending obligation	(99.0)	(98.0)
Payment of common stock dividends	(7.3)	(1.3)
Excess tax benefits on share-based awards	2.4	
Net cash (used in) provided by financing activities	(0.7)	1.4
Net increase (decrease) in cash and cash equivalents	5.1	(22.4)

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Cash and cash equivalents at beginning of period	28.7	64.3
Cash and cash equivalents at end of period	\$ 33.8	41.9
Supplemental disclosures:		
Federal income taxes paid	\$ 29.4	34.9
Interest paid (affiliates \$0.7 and \$1.3, respectively)	\$ 3.8	4.6

See accompanying notes to condensed consolidated financial statements.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation (State Auto Financial or the Company) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six month period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006. The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2005 (the 2005 Form 10-K). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2005 Form 10-K.

Certain items in the prior period consolidated financial statements have been reclassified to conform to the 2006 presentation.

In September 2005, the Accounting Standards Executive Committee issued Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts (SOP 05-1), which is to be effective for fiscal years beginning after December 15, 2006, with earlier adoption encouraged. SOP 05-1 provides guidance on accounting for deferred acquisition costs on internal replacements of insurance contracts that are modifications to product features that occur by the exchange of a contract for a new contract. Insurance contracts issued by the Company include nonintegrated contract features as defined in SOP 05-1. Those nonintegrated contract features that provide coverage that is underwritten and priced only for that incremental insurance coverage do not result in reunderwriting or repricing of other components of the contract. Nonintegrated contract features do not change the existing base contract and do not require further evaluation under SOP 05-1. Given the nature of the policies written by the Company, the impact of SOP 05-1 upon implementation is not expected to be material.

In May 2005, the FASB issued FASB Statement 154, Accounting Changes and Error Corrections (SFAS 154) which replaces APB Opinion 20, Accounting Changes (APB 20) and FASB Statement 3, Reporting Accounting Changes in Interim Financial Statements (SFAS 3). SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS 154 requires voluntary changes in accounting principles be recognized retrospectively to prior periods financial statements, rather than recognition in the net income of the current period. Retrospective application requires restatement of prior period financial statements as if that accounting principle had always been used. SFAS 154 carries forward without change the guidance contained in APB 20 for reporting the corrections of errors in previously issued financial statements and changes in accounting estimates. The provisions of SFAS 154 are effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted SFAS 154 effective January 1, 2006 and there was no material impact on its financial position or results of operations.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which is to be effective for fiscal years beginning after December 15, 2006, with earlier adoption encouraged. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently assessing the impact of this new guidance, but does not believe it will be material.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements Continued (Unaudited)

2. Earnings per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

(\$ millions, except per share amounts)

	Three months ended June 30		Six months ended June 30	
	2006	2005	2006	2005
Numerator:				
Net income for basic earnings per share	\$ 4.1	38.8	\$ 44.3	79.6
Denominator:				
Basic weighted average shares outstanding	40.8	40.3	40.7	40.2
Effect of dilutive share-based awards	0.8	0.7	0.8	0.7
Diluted weighted average shares outstanding	41.6	41.0	41.5	40.9
Basic earnings per share	\$ 0.10	0.96	\$ 1.09	1.98
Diluted earnings per share	\$ 0.10	0.94	\$ 1.07	1.94

The following number of options to purchase shares of common stock was not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

(number of options in millions)

	Three months ended June 30		Six months ended June 30	
	2006	2005	2006	2005
Number of options		0.4		0.4

3. Share-Based Awards

Prior to January 1, 2006, the Company accounted for share-based compensation plans for employees and non-employee directors under the measurement and recognition provisions of Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, and related Interpretations, as permitted by Statement of Financial Accounting Standards 123, Accounting for Stock-Based Compensation (SFAS 123). Accordingly, share-based compensation was included as a pro forma disclosure in the financial statement footnotes. For share-based awards granted to the Company's independent insurance agencies, the Company recognized share-based compensation within its financial statements in accordance with SFAS 123 and related Interpretations.

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On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), Share-Based Payment (SFAS 123(R)), using the modified-prospective transition method. Under this transition method, share-based compensation expense in 2006 includes the expense associated with awards vesting in the period for (1) the unvested portion of all share-based awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and (2) all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

For the three months ended June 30, 2006 and 2005, results of operations include pre-tax expense of \$2.7 million and \$0.1 million, respectively, relating to share-based awards for employees, non-employee directors and independent insurance agencies of the Company. For the six months ended June 30, 2006 and 2005, results of operations include pre-tax expense of \$4.1 million and \$0.3 million, respectively. For the three and six months ended June 30, 2006, basic and diluted earnings per share were both reduced by \$0.05 and \$0.07, respectively. At June 30, 2006, there was \$8.5 million of total unrecognized share-based compensation expense related to non-vested service based awards. This expense is expected to be recognized as follows: \$2.5 million in 2006, \$3.6 million in 2007, \$2.0 million in 2008 and \$0.4 million in 2009. Unearned share-based compensation is amortized over the vesting period for the particular grant and is recognized systematically along with all other compensation expense, as either a component of loss and loss expenses and acquisition and operating expenses in the accompanying Condensed Consolidated Statements of Income.

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements Continued (Unaudited)

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to share-based employee and non-employee director compensation for the three and six months ended June 30, 2005.

(\$ millions, except per share amounts)	Three months ended		Six months ended	
	June 30, 2005		June 30, 2005	
Net income, as reported	\$	38.8	\$	79.6
Deduct: Total stock-based employee and non-employee director compensation expense determined under fair value based method for all awards, net of related tax effects		(0.9)		(1.7)
Pro-forma, net income	\$	37.9	\$	77.9
Earnings per share:				
Basic as reported	\$	0.96	\$	1.98
Basic pro-forma	\$	0.94	\$	1.94
Diluted as reported	\$	0.94	\$	1.94
Diluted pro-forma	\$	0.91	\$	1.87

The share-based compensation plan for key employees is the Amended and Restated Equity Incentive Compensation Plan (the Equity Plan). In May 2005, the Company's shareholders approved amendments to, and a restatement of, the Equity Plan, which was formerly called the 2000 Stock Option Plan. The share-based compensation plan for outside directors is the Outside Directors Restricted Share Unit Plan (the Outside Directors RSU Plan), which was approved by the Company's shareholders in May 2005. The Outside Directors RSU Plan replaced the 2000 Directors Stock Option Plan for outside directors (the Outside Directors Stock Option Plan).

Equity Plan

The 2000 Stock Option Plan provided only for the award of qualified and nonqualified stock options. The Equity Plan now provides for the award of qualified and nonqualified stock options, restricted shares, performance shares, performance units and other stock-based awards. The Company has reserved 3.5 million common shares under the Equity Plan (5.0 million common shares under the 2000 Stock Option Plan). As of June 30, 2006, a total of 1.5 million common shares were available for issuance under the Equity Plan. The Equity Plan provides that (i) no more than 33% of the common shares authorized for issuance under the Equity Plan may be granted in the form of awards other than stock options, (ii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year is equal to 1.5% of the total number of common shares of the Company outstanding as of December 31 of the prior year, and (iii) the maximum number of common shares subject to awards of stock options, restricted shares and performance shares that may be granted in any calendar year to any individual is 250,000 shares. The Equity Plan automatically terminates on July 1, 2010.

The Equity Plan provides that qualified stock options may be granted at an option price not less than the fair market value of the common shares at date of grant and that nonqualified stock options may be granted at any price determined by the Compensation Committee of the Board of

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Directors. Options granted generally vest over a three-year period, with one-third of the options vesting on each anniversary of the grant date, and must be exercised no later than ten years from the date of grant. Stock options granted under the Equity Plan for the three and six months ended June 30, 2006 were 284,800 and 314,800, respectively. Stock options granted under the Equity Plan for the three and six months ended June 30, 2005 were 376,500.

The Equity plan provides for the granting of restricted shares subject to a vesting schedule based on the employee's continued employment (Restriction Period), for which vesting is generally on the third anniversary after the date of grant. The Company recognizes compensation expense based on the number of restricted shares granted at the then grant date fair value over the Restricted Period. Restricted shares granted for the three and six months ended June 30, 2006 were 10,000 and 20,500 with an average grant date fair value of \$33.50 and \$32.72, respectively. There were no restricted shares granted by the Company prior to January 1, 2006.

Employee Stock Purchase Plan

The Company also has a broad-based employee stock purchase plan with a dividend reinvestment feature, under which employees of the Company may choose at two different specified time intervals each year to have up to 6% of their annual base earnings withheld to purchase the Company's common shares. The purchase price of the common shares is 85% of the lower of its beginning-of-interval or end-of-interval market price. There were 37,730 and 40,644 shares issued for the three months and six months ended June 30, 2006 and 2005, respectively.

Non-Employee Directors Plan

Under the Outside Directors Stock Option Plan, following each annual meeting of shareholders outside directors received nonqualified options to purchase 4,200 common shares at an option price equal to the fair market value of the common shares at the close of business on the last trading day immediately prior to the date of the annual meeting. These nonqualified options vested upon grant and are exercisable for 10 years from the date of grant. On May 11, 2005 (the date of the Company's 2005 annual meeting of shareholders), the Outside

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements Continued (Unaudited)

Directors Stock Option Plan was amended to prohibit the grant of further options under the plan.

The Outside Directors RSU Plan is an unfunded deferred compensation plan which provides each outside director with an award of 1,400 restricted share units (the "RSU award") following each annual meeting of shareholders, however, the amount of the award may change from year to year, based on the provision described below. The RSU awards are fully vested upon grant. RSU awards are not common shares of the Company and, as such, no participant has any rights as a holder of common shares under the Outside Directors RSU Plan. RSU awards represent the right to receive an amount, payable in cash or common shares of the Company, as previously elected by the outside director, equal to the value of a specified number of common shares of the Company at the end of the restricted period. Such election may be changed within the constraints set forth in the RSU Plan. The restricted period for the RSU awards begins on the date of grant and expires on the date the outside director retires from or otherwise terminates service as a director of the Company. During the restricted period, outside directors are credited with dividends, equivalent in value to those declared and paid on the Company's common shares, on all RSU awards granted to them. At the end of the restricted period, outside directors receive distributions of their RSU awards either (i) in a single lump sum payment, or (ii) in annual installment payments over a five- or ten-year period, as previously elected by the outside director. The administrative committee for the Outside Directors RSU Plan (currently the Company's Compensation Committee) retains the right to increase the annual number of RSU awards granted to each outside director to as many as 5,000 or to decrease such annual number to not less than 500, without seeking shareholder approval, if such increase or decrease is deemed appropriate by the administrative committee to maintain director compensation at appropriate levels. The Outside Directors RSU Plan automatically terminates on May 31, 2015. The Company accounts for the Outside Directors RSU Plan as a liability plan. There were 9,800 RSUs granted in the three and six months ended June 30, 2006 and 2005. During the six months ended June 30, 2006, 1,695 units were distributed in the form of common shares of the Company. No shares were distributed during the three months ended June 30, 2006.

Agent Stock Option Plan

The Company has a stock option incentive plan for certain designated independent insurance agencies ("Agent Stock Option Plan") that represent the Company and its affiliates. The Company has reserved 0.4 million shares of common stock under this plan. As of June 30, 2006, a total of 0.2 million shares were available for issuance under the Agent Stock Option Plan. The plan provides that the options become exercisable on the first day of the calendar year following the agency's achievement of specific production and profitability requirements over a period not greater than two calendar years from the date of grant or a portion thereof in the first calendar year in which an agency commences participation under the plan. Options granted under this plan have a ten year term. Stock options granted for the six months ended June 30, 2006 and 2005 were 16,452 and 27,060, respectively. Stock options granted for the three months ended June 30, 2006 and 2005 were none and 1,918, respectively.

Stock Options

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes closed-form pricing model. The following tables present the weighted-average assumptions used in the option pricing model for options granted to employees and non-employees (independent insurance agencies) during the three and six months ended June 30, 2006 and 2005. The expected life of the options for employees represents the period of time the options are expected to be outstanding and is based on historical trends. For non-employees the expected life of the option approximates the remaining contractual term of the option. Expected stock price volatility is based on the historical volatility of the Company's stock for a period approximating the expected life and the expected dividend yield is based on the Company's most recent period's dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term equal to the expected life.

The weighted average fair values and related assumptions for options granted to employees for the three and six months ended June 30, 2006 were as follows:

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	2006	2005
Fair value	\$ 13.77	\$ 11.26
Dividend yield	1.1%	0.7%
Risk free interest rate	5.2%	3.7%
Expected volatility factor	33.6%	36.5%
Expected life in years	7.0	7.2

For options granted under the Agency Stock Option Plan the fair value was estimated at the reporting date or vesting date. The weighted average fair value and related assumptions for the three and six months ended June 30, 2006 and 2005 were as follows:

	2006	2005
Fair value	\$ 16.02	\$ 14.67
Dividend yield	1.1%	0.7%
Risk free interest rate	5.2%	3.8%
Expected volatility factor	35.8%	36.9%
Expected life in years	8.9	7.0

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements Continued (Unaudited)

A summary of the Company's stock option activity for the three and six months ended June 30, 2006 and 2005, is as follows:

<i>(number of options in millions)</i>	Three months ended June 30				Six months ended June 30			
	2006		2005		2006		2005	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Outstanding, beginning	2.5	\$ 19.73	2.5	\$ 17.11	2.6	\$ 18.72	2.6	\$ 16.48
Granted	0.2	33.50	0.3	26.45	0.3	33.35	0.3	26.41
Exercised	(0.1)	10.63	(0.1)	10.88	(0.3)	11.09	(0.2)	8.23
Cancelled		27.92				27.92		17.45
<i>Outstanding, ending</i>	2.6	\$ 21.65	2.7	\$ 18.59	2.6	\$ 21.65	2.7	\$ 18.59

Intrinsic value for stock options is defined as the difference between the current market value and the grant price. For the six months ended June 30, 2006 and 2005, the total intrinsic value of stock options exercised was \$9.5 million and \$4.1 million, respectively. For the three months ended June 30, 2006 and 2005, the total intrinsic value of stock options exercised was \$3.1 million and \$1.5 million, respectively. The tax benefit for tax deductions from share-based awards totaled \$2.9 million and \$1.3 million for the six months ended June 30, 2006 and 2005, respectively. The tax benefit for tax deductions from stock options exercised totaled \$2.1 million and \$0.8 million for the three months ended June 30, 2006 and 2005, respectively.

A summary of information pertaining to all options outstanding and exercisable at June 30, 2006 is as follows:

<i>(number of options in millions)</i>	Options Outstanding			Options Exercisable	
	Number	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
Range of Exercise Prices					
Less than \$10.00		0.9	\$ 8.55		\$ 8.55
\$10.01 - \$20.00	1.4	4.5	15.33	1.4	15.33
\$20.01 - \$30.00	0.4	8.7	26.31	0.2	26.19
\$30.01 - \$40.00	0.8	8.7	32.05	0.3	30.94
<i>Total</i>	2.6	6.3	\$ 21.65	1.9	\$ 18.59

Aggregate intrinsic value for total options outstanding at June 30, 2006 is \$28.3 million. Aggregate intrinsic value for total options exercisable at June 30, 2006 is \$27.0 million.

4. Comprehensive Income

The components of accumulated other comprehensive income (loss), net of related tax, included in stockholders' equity at June 30, 2006 and 2005, include unrealized holding gains (losses), net of tax. The components of comprehensive income (loss), net of related tax, are as follows:

(\$ millions)	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Net income	\$ 4.1	38.8	\$ 44.3	79.6
Unrealized holding gains (losses), net of tax	(15.3)	19.9	(24.6)	(0.8)
<i>Comprehensive (loss) income</i>	\$ (11.2)	58.7	\$ 19.7	78.8

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STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements Continued (Unaudited)

5. Reinsurance

The following table provides a summary of the Company's reinsurance transactions with other insurers and reinsurers, as well as reinsurance transactions with affiliates:

(\$ millions)	Three months ended		Six months ended	
	June 30		June 30	
	2006	2005	2006	2005
Premiums earned:				
Assumed from other insurers and reinsurers	\$ 1.8	1.6	\$ 3.9	3.0
Assumed under State Auto Pool and other affiliate arrangements	245.2	250.0	489.5	498.5
Ceded to other insurers and reinsurers	(4.8)	(4.1)	(9.4)	(8.0)
Ceded under State Auto Pool and other affiliate arrangements	(171.2)	(171.3)	(341.2)	(340.4)
<i>Net assumed premiums earned</i>	\$ 71.0	76.2	\$ 142.8	153.1
Losses and loss expenses incurred:				
Assumed from other insurers and reinsurers	\$ 2.2	2.3	\$ 8.0	3.7
Assumed under State Auto Pool and other affiliate arrangements	185.3	131.7	304.4	260.0
Ceded to other insurers and reinsurers	(1.3)	(1.4)	(1.1)	(1.5)
Ceded under State Auto Pool and other affiliate arrangements	(120.4)	(95.6)	(205.8)	(186.4)
<i>Net assumed losses and loss expenses incurred</i>	\$ 65.8	37.0	\$ 105.5	75.8

6. Pension and Postretirement Benefit Plans

The following table provides components of net periodic cost for the State Auto Group of Companies pension and postretirement benefit plans:

(\$ millions)	Three months ended June 30				Six months ended June 30			
	Pension		Postretirement		Pension		Postretirement	
	2006	2005	2006	2005	2006	2005	2006	2005
Service cost	\$ 2.5	2.0	\$ 1.2	1.1	\$ 5.0	4.0	\$ 2.4	2.2
Interest cost	2.9	2.8	1.5	1.6	5.8	5.6	3.1	3.2
Expected return on plan assets	(4.3)	(4.2)		(0.1)	(8.5)	(8.4)	(0.1)	(0.1)
Amortization of prior service costs	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Amortization of transition assets	(0.1)	(0.1)			(0.3)	(0.3)		
Amortization of net loss	0.8	0.3	0.2	0.2	1.5	0.6	0.3	0.4