ERIE INDEMNITY CO
Form 10-Q
April 28, 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 March 31, 2016

Commission file number 0-24000

ERIE INDEMNITY COMPANY
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-0466020
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 Erie Insurance Place, Erie, Pennsylvania	16530
(Address of principal executive offices)	(Zip Code)

(814) 870-2000
(Registrant’s telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes X No ___

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 X 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes X No ___

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

Large Accelerated Filer X Accelerated Filer ___ Non-Accelerated Filer ___ Smaller Reporting Company ___
(Do not check if a 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 X

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of $0.0292 per share, was 46,189,068 at April 15, 2016.

The number of shares outstanding of the registrant's Class B Common Stock as of the latest practicable date, with no par value and a stated value of $70 per share, was 2,542 at April 15, 2016.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ERIE INDEMNITY COMPANY
STATEMENTS OF OPERATIONS (UNAUDITED)
(dollars in thousands, except per share data)

	Three months ended March 31, 2016	2015
Operating revenue		
Management fee revenue, net	$367,458	$343,234
Service agreement revenue	7,270	7,597
Total operating revenue	374,728	350,831
Operating expenses		
Commissions	208,714	193,717
Salaries and employee benefits	53,289	55,019
All other operating expenses	45,060	49,665
Total operating expenses	307,063	298,401
Net revenue from operations	67,665	52,430
Investment income		
Net investment income	4,662	4,541
Net realized investment losses	(1,088)	(240)
Net impairment losses recognized in earnings	(345)	(120)
Equity in (losses) earnings of limited partnerships	(670)	2,358
Total investment income	2,559	6,539
Income before income taxes	70,224	58,969
Income tax expense	24,329	20,136
Net income	$45,895	$38,833
Earnings Per Share		
Net income per share		
Class A common stock – basic	$0.99	$0.83
Class A common stock – diluted	$0.87	$0.74
Class B common stock – basic and diluted	$148	$125
Weighted average shares outstanding – Basic		
Class A common stock	46,189,068	46,189,068
Class B common stock	2,542	2,542
Weighted average shares outstanding – Diluted		
Class A common stock	52,523,927	52,634,752
Class B common stock	2,542	2,542
Dividends declared per share		

Class A common stock	$0.730	$0.681
Class B common stock	$109.500	$102.150

See accompanying notes to Financial Statements. See Note 10, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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ERIE INDEMNITY COMPANY
STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(in thousands)

	Three months ended March 31,	
	2016	2015
Net income	$45,895	$38,833
Other comprehensive income, net of tax		
Change in unrealized holding gains on available-for-sale securities	3,465	100
Comprehensive income	$49,360	$38,933

See accompanying notes to Financial Statements. See Note 10, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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ERIE INDEMNITY COMPANY
STATEMENTS OF FINANCIAL POSITION
(dollars in thousands, except per share data)

	March 31, 2016 (Unaudited)	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$105,282	$182,889
Available-for-sale securities	54,285	62,067
Trading securities	2,955	—
Receivables from Erie Insurance Exchange and affiliates	352,451	348,055
Prepaid expenses and other current assets	37,164	24,697
Federal income taxes recoverable	0	11,947
Accrued investment income	5,832	5,491
Total current assets	557,969	635,146
Available-for-sale securities	560,928	537,874
Limited partnership investments	82,912	88,535
Fixed assets, net	58,918	59,087
Deferred income taxes, net	35,250	40,686
Note receivable from Erie Family Life Insurance Company	25,000	25,000
Other assets	19,647	20,968
Total assets	$1,340,624	$1,407,296
Liabilities and shareholders' equity		
Current liabilities:		
Commissions payable	$202,816	$195,542
Agent bonuses	31,940	106,752
Accounts payable and accrued liabilities	79,333	88,532
Dividends payable	33,996	33,996
Deferred executive compensation	15,132	20,877
Federal income taxes payable	8,541	0
Total current liabilities	371,758	445,699
Defined benefit pension plans	162,981	172,700
Employee benefit obligations	1,072	1,234
Deferred executive compensation	18,446	16,580
Other long-term liabilities	1,500	1,580
Total liabilities	555,757	637,793
Shareholders’ equity		
Class A common stock, stated value $0.0292 per share; 74,996,930 shares authorized; 68,299,200 shares issued; 46,189,068 shares outstanding	1,992	1,992
Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value $70 per share; 3,070 shares authorized; 2,542 shares issued and outstanding	178	178
Additional paid-in-capital	16,311	16,311

Accumulated other comprehensive loss	(93,399)	(96,864)
Retained earnings	2,005,875	1,993,976
Total contributed capital and retained earnings	1,930,957	1,915,593
Treasury stock, at cost; 22,110,132 shares held	(1,155,108)	(1,155,108)
Deferred compensation	9,018	9,018
Total shareholders’ equity	784,867	769,503
Total liabilities and shareholders’ equity	$ 1,340,624	$ 1,407,296

See accompanying notes to Financial Statements.

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ERIE INDEMNITY COMPANY
STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	Three months ended March 31,	
	2016	2015
Cash flows from operating activities		
Management fee received	$363,848	$341,806
Service agreement fee received	7,270	7,597
Net investment income received	6,182	6,374
Limited partnership distributions	1,127	4,954
Decrease in reimbursements collected from affiliates	(785)	(412)
Commissions paid to agents	(172,625)	(169,821)
Agents bonuses paid	(103,933)	(79,483)
Salaries and wages paid	(45,732)	(42,486)
Pension contribution and employee benefits paid	(24,636)	(22,056)
General operating expenses paid	(52,220)	(61,715)
Income taxes paid	(258)	(9)
Net cash used in operating activities	(21,762)	(15,251)
Cash flows from investing activities		
Purchase of investments:		
Available-for-sale securities	(67,557)	(30,725)
Limited partnerships	(103)	(89)
Proceeds from investments:		
Available-for-sale securities	46,507	37,554
Limited partnerships	1,792	9,157
Net purchase of fixed assets	(3,496)	(2,428)
Net collections (distributions) on agent loans	1,008	(644)
Net cash (used in) provided by investing activities	(21,849)	12,825
Cash flows from financing activities		
Dividends paid to shareholders	(33,996)	(31,714)
Net cash used in financing activities	(33,996)	(31,714)
Net decrease in cash and cash equivalents	(77,607)	(34,140)
Cash and cash equivalents, beginning of period	182,889	91,747
Cash and cash equivalents, end of period	$105,282	$57,607

See accompanying notes to Financial Statements.

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NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

Erie Indemnity Company ("Indemnity", "we", "us", "our") is a publicly held Pennsylvania business corporation that has since its incorporation in 1925 served as the attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange ("Exchange"). The Exchange, which also commenced business in 1925, is a Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance. We function solely as the management company and all insurance operations are performed by the Exchange.

Our primary function, as attorney-in-fact, is to perform certain services for the Exchange relating to the sales, underwriting, and issuance of policies on behalf of the Exchange. This is done in accordance with a subscriber's agreement (a limited power of attorney) executed individually by each subscriber (policyholder), which appoints us as their common attorney-in-fact to transact certain business on their behalf and to manage the affairs of the Exchange. Pursuant to the subscriber's agreement and for its services as attorney-in-fact, we earn a management fee calculated as a percentage of the direct and assumed premiums written by the Exchange.

Our results of operations are tied to the growth and financial condition of the Exchange. If any events occurred that impaired the Exchange's ability to grow or sustain its financial condition, including but not limited to reduced financial strength ratings, disruption in the independent agency relationships, significant catastrophe losses, or products not meeting customer demands, the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of the Exchange almost certainly would have as a consequence a decline in the total premiums paid and a correspondingly adverse effect on the amount of the management fees we receive. We also have an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its management fee. See Note 11, "Concentrations of Credit Risk" contained within this report.

Note 2. Significant Accounting Policies

Basis of presentation
The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to the financial statements and footnotes included in our Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission on February 25, 2016.

The preparation of financial statements in conformity with GAAP requires us 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain prior period amounts have been reclassified on the statements of financial position to conform to the current period presentation. These reclassifications had no effect on the previously reported results of operations.

Recently issued accounting standards

In February 2015, the Financial Accounting Standards Board ("FASB") updated Accounting Standards Codification ("ASC") 810 "Consolidation", which amended the existing guidance for determining if a reporting entity has a variable interest in a legal entity. We adopted the new accounting principle on a retrospective basis as of December 31, 2015. In accordance with the new accounting guidance, Indemnity is not deemed to have a variable interest in the Exchange as the fees paid for services provided to the Exchange no longer represent a variable interest. The compensation received from the attorney-in-fact fee arrangement with the subscribers is for services provided by Indemnity acting in its role as attorney-in-fact and is commensurate with the level of effort required to perform those services. Under the previously issued accounting guidance, Indemnity was deemed to be the primary beneficiary of the Exchange and its financial position and operating results were consolidated with Indemnity. Following adoption of the new accounting guidance, the Exchange’s results are no longer required to be consolidated with Indemnity. There was no cumulative effect to Indemnity's shareholders’ equity or net income from no longer consolidating the Exchange's results with ours.

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In February 2016, the FASB issued Accounting Standards Update ("ASU") 2016-02, "Leases", which requires lessees to recognize assets and liabilities arising from operating leases on the statement of financial position and to disclose key information about leasing arrangements. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. Early adoption is permitted. We are currently evaluating the potential impact of this guidance on our financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments-Overall". ASU 2016-01 revises the accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. ASU 2016-01 is effective for interim and annual reporting periods beginning after December 15, 2017. We are currently evaluating the potential impact of this guidance on our financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers". ASU 2014-09 requires an entity to recognize revenue to depict the transfer of 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 guidance is effective for fiscal years beginning after December 15, 2017 including interim periods within that reporting period. We do not expect the adoption of this guidance to have a material impact on our financial statements.

Note 3. Earnings Per Share

Class A and Class B basic earnings per share and Class B diluted earnings per share are calculated under the two-class method. The two-class method allocates earnings to each class of stock based upon its dividend rights. Class B shares are convertible into Class A shares at a conversion ratio of 2,400 to 1. See Note 9, "Capital Stock".

Class A diluted earnings per share are calculated under the if-converted method, which reflects the conversion of Class B shares to Class A shares. Diluted earnings per share calculations include the dilutive effect of assumed issuance of stock-based awards under compensation plans that have the option to be paid in stock using the treasury stock method.

A reconciliation of the numerators and denominators used in the basic and diluted per-share computations is presented as follows for each class of common stock:

(dollars in thousands, except per share data)	Three months ended March 31,					
	2016			2015		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount
Class A – Basic EPS:						
Income available to Class A stockholders	$45,520	46,189,068	$ 0.99	$38,515	46,189,068	$ 0.83
Dilutive effect of stock-based awards	0	234,059	—	0	344,884	—
Assumed conversion of Class B shares	375	6,100,800	—	318	6,100,800	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	$45,895	52,523,927	$ 0.87	$38,833	52,634,752	$ 0.74
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	$375	2,542	$ 148	$318	2,542	$ 125

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Note 4. Fair Value

Our available-for-sale and trading securities are recorded at fair value, which is the price that would be received to sell the asset in an orderly transaction between willing market participants as of the measurement date.

Valuation techniques used to derive the fair value of our available-for-sale and trading securities are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding fair market value for these securities. Although the majority of our prices are obtained from third party sources, we also perform an internal pricing review for securities with low trading volumes under current market conditions. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

- Level 3 – Unobservable inputs for the asset or liability.

Estimates of fair values for our investment portfolio are obtained primarily from a nationally recognized pricing service. Our Level 1 category includes those securities valued using an exchange traded price provided by the pricing service. The methodologies used by the pricing service that support a Level 2 classification of a financial instrument include multiple verifiable, observable inputs including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data. Pricing service valuations for Level 3 securities are based upon proprietary models and are used when observable inputs are not available or in illiquid markets.

In limited circumstances we adjust the price received from the pricing service when, in our judgment, a better reflection of fair value is available based upon corroborating information and our knowledge and monitoring of market conditions such as a disparity in price of comparable securities and/or non-binding broker quotes. In other circumstances, certain securities are internally priced because prices are not provided by the pricing service.

We perform continuous reviews of the prices obtained from the pricing service. This includes evaluating the methodology and inputs used by the pricing service to ensure that we determine the proper classification level of the financial instrument. Price variances, including large periodic changes, are investigated and corroborated by market data. We have reviewed the pricing methodologies of our pricing service as well as other observable inputs, such as data, and transaction volumes and believe that their prices adequately consider market activity in determining fair value. Our review process continues to evolve based upon accounting guidance and requirements.

When a price from the pricing service is not available, values are determined by obtaining broker/dealer quotes and/or market comparables. When available, we obtain multiple quotes for the same security. The ultimate value for these securities is determined based upon our best estimate of fair value using corroborating market information. Our evaluation includes the consideration of benchmark yields, reported trades, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data.

For certain securities in an illiquid market, there may be no prices available from a pricing service and no comparable market quotes available. In these situations, we value the security using an internally-developed, risk-adjusted discounted cash flow model.

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The following tables present our fair value measurements on a recurring basis by asset class and level of input:

(in thousands)	At March 31, 2016 Fair value measurements using: Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Available-for-sale securities:				
States & political subdivisions	$242,524	$0	$242,524	$ 0
Corporate debt securities	256,498	0	251,677	4,821
Residential mortgage-backed securities	14,875	0	14,875	0
Commercial mortgage-backed securities	35,596	0	35,596	0
Collateralized debt obligations	54,770	0	42,733	12,037
Other debt securities	2,018	0	2,018	0
Total fixed maturities	606,281	0	589,423	16,858
Common stock	8,932	8,932	0	0
Total available-for-sale securities	615,213	8,932	589,423	16,858
Trading securities:				
Common stock	2,955	2,955	0	0
Other investments (1)	4,302	—	—	—
Total	$622,470	$11,887	$589,423	$ 16,858

(in thousands)	At December 31, 2015 Fair value measurements using: Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Available-for-sale securities:				
States & political subdivisions	$231,847	$ 0	$231,847	$ 0
Corporate debt securities	250,333	0	250,264	69
Residential mortgage-backed securities	13,513	0	13,513	0
Commercial mortgage-backed securities	37,571	0	37,571	0
Collateralized debt obligations	51,745	0	43,168	8,577
Other debt securities	2,200	0	2,200	0
Total fixed maturities	587,209	0	578,563	8,646
Common stock	12,732	12,732	0	0
Total available-for-sale securities	599,941	12,732	578,563	8,646
Other investments (1)	4,526	—	—	—
Total	$604,467	$ 12,732	$578,563	$ 8,646

(1) Other investments measured at fair value represent real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option using the net asset value practical expedient. These amounts are not required to be categorized in the fair value hierarchy. The investments can never be redeemed

with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital statements received from the general partners, which is generally one quarter prior to our balance sheet date. These values are then analyzed to determine if the NAV represents fair value at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of March 31, 2016 and December 31, 2015. During the three months ended March 31, 2016, no contributions were made and distributions totaling $0.3 million were received from these investments. During the year ended December 31, 2015, no contributions were made and distributions totaling $3.5 million were received from these investments. The amount of unfunded commitments related to the investments was $0.3 million as of March 31, 2016, and $0.6 million as of December 31, 2015.

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Level 3 Assets – Year-to-Date Change:

(in thousands)	Beginning balance at December 31, 2015	Included in earnings (1)	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3	Ending balance at March 31, 2016
Available-for-sale securities:							
Corporate debt securities	$ 69	$ 15	$ 27	$ 3,539	$(55)	$ 1,226	$4,821
Collateralized debt obligations	8,577	4	(12)	3,522	(54)	0	12,037
Total fixed maturities	8,646	19	15	7,061	(109)	1,226	16,858
Total available-for-sale securities	8,646	19	15	7,061	(109)	1,226	16,858
Total Level 3 assets	$ 8,646	$ 19	$ 15	$ 7,061	$(109)	$ 1,226	$16,858

(1) These amounts are reported in the Statement of Operations as net investment income and net realized investment losses for the three months ended March 31, 2016 on Level 3 securities.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in the available market observable inputs. Transfers in and out of level classifications are reported as having occurred at the beginning of the quarter in which the transfers occurred.

There were no transfers between Level 1 and Level 2 for the three months ended March 31, 2016. Level 2 to Level 3 transfers totaled $1.3 million for nine fixed maturity holdings due to the use of unobservable market data to determine the fair value at March 31, 2016. Level 3 to Level 2 transfers totaled $0.1 million for one fixed maturity holding due to the use of observable market data to determine the fair value at March 31, 2016.

Level 3 Assets – Year-to-Date Change:

(in thousands)	Beginning balance at December 31, 2014	Included in earnings	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3	Ending balance at March 31, 2015
Available-for-sale securities:							
Corporate debt securities	$ 0	$ 0	$ 0	$ 110	$ 0	$ 0	$ 110
Total fixed maturities	0	0	0	110	0	0	110
Total available-for-sale securities	0	0	0	110	0	0	110
Total Level 3 assets	$ 0	$ 0	$ 0	$ 110	$ 0	$ 0	$ 110

There were no transfers between Level 1 and Level 2 or between Level 2 and Level 3 for the three months ended March 31, 2015.

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Quantitative and Qualitative Disclosures about Unobservable Inputs

When a non-binding broker quote was the only input available, the security was classified within Level 3. Use of non-binding brokers quotes totaled $16.9 million at March 31, 2016. The unobservable inputs are not reasonably available to us.

The following table presents our fair value measurements on a recurring basis by pricing source:

(in thousands)	At March 31, 2016			
	Total	Level 1	Level 2	Level 3
Fixed maturities:				
Priced via pricing services	$594,244	$ 0	$589,423	$4,821
Priced via market comparables/broker quotes	12,037	0	0	12,037
Total fixed maturities	606,281	0	589,423	16,858
Common stock:				
Priced via pricing services	11,887	11,887	0	0
Total common stock	11,887	11,887	0	0
Other investments:				
Priced via unobservable inputs (1)	4,302	—	—	—
Total other investments	4,302	—	—	