

Edgar Filing: Employers Holdings, Inc. - Form 10-Q

Employers Holdings, Inc.  
Form 10-Q  
November 08, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2012

OR

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

For the transition period from \_\_\_\_ to \_\_\_\_

Commission file number: 001-33245

EMPLOYERS HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction

of incorporation or organization)

04-3850065

(I.R.S. Employer

Identification Number)

10375 Professional Circle, Reno, Nevada 89521

(Address of principal executive offices and zip code)

(888) 682-6671

(Registrant's telephone number, including area code)

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

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

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

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

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

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Class

October 31, 2012

Common Stock, \$0.01 par value per share

30,724,286 shares outstanding

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## PART I – FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements

## Employers Holdings, Inc. and Subsidiaries

## Consolidated Balance Sheets

(in thousands, except share data)

|                                                                                                                                 | As of<br>September 30,<br>2012<br>(unaudited) | As of<br>December 31,<br>2011 |
|---------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------|-------------------------------|
| Assets                                                                                                                          |                                               |                               |
| Available for sale:                                                                                                             |                                               |                               |
| Fixed maturity securities at fair value (amortized cost \$1,737,949 at September 30, 2012 and \$1,706,216 at December 31, 2011) | \$1,905,590                                   | \$1,852,699                   |
| Equity securities at fair value (cost \$80,897 at September 30, 2012 and \$64,962 at December 31, 2011)                         | 128,158                                       | 98,046                        |
| Total investments                                                                                                               | 2,033,748                                     | 1,950,745                     |
| Cash and cash equivalents                                                                                                       | 243,242                                       | 252,300                       |
| Restricted cash and cash equivalents                                                                                            | 5,462                                         | 6,299                         |
| Accrued investment income                                                                                                       | 18,595                                        | 19,537                        |
| Premiums receivable (less bad debt allowance of \$6,380 at September 30, 2012 and \$5,546 at December 31, 2011)                 | 225,064                                       | 160,443                       |
| Reinsurance recoverable for:                                                                                                    |                                               |                               |
| Paid losses                                                                                                                     | 9,299                                         | 10,729                        |
| Unpaid losses                                                                                                                   | 912,877                                       | 940,840                       |
| Funds held by or deposited with reinsureds                                                                                      | 2,677                                         | 1,102                         |
| Deferred policy acquisition costs                                                                                               | 40,343                                        | 37,524                        |
| Federal income taxes recoverable                                                                                                | —                                             | 1,993                         |
| Deferred income taxes, net                                                                                                      | 19,803                                        | 22,140                        |
| Property and equipment, net                                                                                                     | 12,832                                        | 11,360                        |
| Intangible assets, net                                                                                                          | 10,819                                        | 11,728                        |
| Goodwill                                                                                                                        | 36,192                                        | 36,192                        |
| Other assets                                                                                                                    | 16,933                                        | 18,812                        |
| Total assets                                                                                                                    | \$3,587,886                                   | \$3,481,744                   |
| Liabilities and stockholders' equity                                                                                            |                                               |                               |
| Claims and policy liabilities:                                                                                                  |                                               |                               |
| Unpaid losses and loss adjustment expenses                                                                                      | \$2,304,424                                   | \$2,272,363                   |
| Unearned premiums                                                                                                               | 270,843                                       | 194,933                       |
| Policyholders' dividends accrued                                                                                                | 3,364                                         | 3,838                         |
| Total claims and policy liabilities                                                                                             | 2,578,631                                     | 2,471,134                     |
| Commissions and premium taxes payable                                                                                           | 38,485                                        | 28,905                        |
| Accounts payable and accrued expenses                                                                                           | 16,834                                        | 14,994                        |
| Federal income taxes payable                                                                                                    | 61                                            | —                             |
| Deferred reinsurance gain—LPT Agreement                                                                                         | 341,564                                       | 353,194                       |
| Notes payable                                                                                                                   | 122,000                                       | 122,000                       |
| Other liabilities                                                                                                               | 17,095                                        | 17,331                        |
| Total liabilities                                                                                                               | 3,114,670                                     | 3,007,558                     |
| Commitments and contingencies                                                                                                   |                                               |                               |

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Stockholders' equity:

|                                                                                                                                                                                                                   |             |              |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|--------------|
| Common stock, \$0.01 par value; 150,000,000 shares authorized; 54,074,236 and 53,948,442 shares issued and 30,724,086 and 32,996,809 shares outstanding at September 30, 2012 and December 31, 2011, respectively | 541         | 540          |
| Preferred stock, \$0.01 par value; 25,000,000 shares authorized; none issued                                                                                                                                      | —           | —            |
| Additional paid-in capital                                                                                                                                                                                        | 322,739     | 318,989      |
| Retained earnings                                                                                                                                                                                                 | 372,390     | 358,693      |
| Accumulated other comprehensive income, net                                                                                                                                                                       | 139,686     | 116,719      |
| Treasury stock, at cost (23,350,150 shares at September 30, 2012 and 20,951,633 shares at December 31, 2011)                                                                                                      | (362,140    | ) (320,755 ) |
| Total stockholders' equity                                                                                                                                                                                        | 473,216     | 474,186      |
| Total liabilities and stockholders' equity                                                                                                                                                                        | \$3,587,886 | \$3,481,744  |

See accompanying unaudited notes to the consolidated financial statements.

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

|                                                                                                                                                                                                                                                                      | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                                                                                                                                                                                                                                                                      | 2012                                | 2011     | 2012                               | 2011      |
|                                                                                                                                                                                                                                                                      | (unaudited)                         |          | (unaudited)                        |           |
| Revenues                                                                                                                                                                                                                                                             |                                     |          |                                    |           |
| Net premiums earned                                                                                                                                                                                                                                                  | \$131,766                           | \$92,601 | \$360,621                          | \$263,156 |
| Net investment income                                                                                                                                                                                                                                                | 17,506                              | 19,584   | 54,188                             | 60,383    |
| Realized gains on investments, net                                                                                                                                                                                                                                   | 1,838                               | 647      | 4,561                              | 1,983     |
| Other income                                                                                                                                                                                                                                                         | 30                                  | 82       | 225                                | 205       |
| Total revenues                                                                                                                                                                                                                                                       | 151,140                             | 112,914  | 419,595                            | 325,727   |
| Expenses                                                                                                                                                                                                                                                             |                                     |          |                                    |           |
| Losses and loss adjustment expenses                                                                                                                                                                                                                                  | 98,255                              | 67,438   | 267,471                            | 191,009   |
| Commission expense                                                                                                                                                                                                                                                   | 14,865                              | 10,968   | 44,541                             | 32,368    |
| Policyholder dividends                                                                                                                                                                                                                                               | 867                                 | 840      | 2,517                              | 2,766     |
| Underwriting and other operating expenses                                                                                                                                                                                                                            | 29,280                              | 25,334   | 90,935                             | 77,212    |
| Interest expense                                                                                                                                                                                                                                                     | 896                                 | 906      | 2,656                              | 2,731     |
| Total expenses                                                                                                                                                                                                                                                       | 144,163                             | 105,486  | 408,120                            | 306,086   |
| Net income before income taxes                                                                                                                                                                                                                                       | 6,977                               | 7,428    | 11,475                             | 19,641    |
| Income tax benefit                                                                                                                                                                                                                                                   | (1,173)                             | (4,355)  | (7,903)                            | (8,738)   |
| Net income                                                                                                                                                                                                                                                           | \$8,150                             | \$11,783 | \$19,378                           | \$28,379  |
| Comprehensive income                                                                                                                                                                                                                                                 |                                     |          |                                    |           |
| Unrealized gains during the period (net of taxes of \$8,639 and \$9,118 for the three months ended September 30, 2012 and 2011, respectively, and \$13,963 and \$18,382 for the nine months ended September 30, 2012 and 2011, respectively)                         | \$16,045                            | \$16,935 | \$25,933                           | \$32,957  |
| Less: reclassification adjustment for realized gains in net income (net of taxes of \$643 and \$226 for the three months ended September 30, 2012 and 2011, respectively, and \$1,595 and \$694 for the nine months ended September 30, 2012 and 2011, respectively) | 1,195                               | 421      | 2,966                              | 1,289     |
| Other comprehensive income, net of tax                                                                                                                                                                                                                               | 14,850                              | 16,514   | 22,967                             | 31,668    |
| Total comprehensive income                                                                                                                                                                                                                                           | \$23,000                            | \$28,297 | \$42,345                           | \$60,047  |
| Earnings per common share (Note 11):                                                                                                                                                                                                                                 |                                     |          |                                    |           |
| Basic                                                                                                                                                                                                                                                                | \$0.26                              | \$0.31   | \$0.61                             | \$0.74    |
| Diluted                                                                                                                                                                                                                                                              | \$0.26                              | \$0.31   | \$0.61                             | \$0.74    |
| Cash dividends declared per common share                                                                                                                                                                                                                             | \$0.06                              | \$0.06   | \$0.18                             | \$0.18    |
| Realized gains on investments, net                                                                                                                                                                                                                                   |                                     |          |                                    |           |
| Net realized gains on investments before credit related impairments on fixed maturity securities                                                                                                                                                                     | \$1,838                             | \$647    | \$5,090                            | \$1,983   |
|                                                                                                                                                                                                                                                                      | —                                   | —        | (529)                              | —         |

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Other than temporary impairment, credit losses recognized in earnings

Portion of impairment recognized in other comprehensive income

|                                    |         |       |         |         |
|------------------------------------|---------|-------|---------|---------|
| Realized gains on investments, net | \$1,838 | \$647 | \$4,561 | \$1,983 |
|------------------------------------|---------|-------|---------|---------|

See accompanying unaudited notes to the consolidated financial statements.

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

|                                                                                   | Nine Months Ended<br>September 30, |            |
|-----------------------------------------------------------------------------------|------------------------------------|------------|
|                                                                                   | 2012                               | 2011       |
| Operating activities                                                              | (unaudited)                        |            |
| Net income                                                                        | \$ 19,378                          | \$ 28,379  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |            |
| Depreciation and amortization                                                     | 4,193                              | 4,861      |
| Stock-based compensation                                                          | 3,942                              | 2,738      |
| Amortization of premium on investments, net                                       | 5,342                              | 5,791      |
| Allowance for doubtful accounts                                                   | 834                                | (1,396 )   |
| Deferred income tax expense                                                       | (10,031 )                          | (4,756 )   |
| Realized gains on investments, net                                                | (4,561 )                           | (1,983 )   |
| Realized losses on retirement of assets                                           | 314                                | 128        |
| Change in operating assets and liabilities:                                       |                                    |            |
| Accrued investment income                                                         | 942                                | 2,770      |
| Premiums receivable                                                               | (65,455 )                          | (43,331 )  |
| Reinsurance recoverable for paid and unpaid losses                                | 29,393                             | 32,167     |
| Funds held by or deposited with reinsureds                                        | (1,575 )                           | 2,086      |
| Federal income taxes recoverable                                                  | 2,054                              | (4,212 )   |
| Unpaid losses and loss adjustment expenses                                        | 32,061                             | (30,465 )  |
| Unearned premiums                                                                 | 75,910                             | 44,733     |
| Accounts payable, accrued expenses and other liabilities                          | 1,604                              | 9,979      |
| Deferred reinsurance gain – LPT Agreement                                         | (11,630 )                          | (12,984 )  |
| Other                                                                             | 8,167                              | 1,472      |
| Net cash provided by operating activities                                         | 90,882                             | 35,977     |
| Investing activities                                                              |                                    |            |
| Purchase of fixed maturities                                                      | (270,549 )                         | (112,895 ) |
| Purchase of equity securities                                                     | (28,804 )                          | (4,314 )   |
| Proceeds from sale of fixed maturities                                            | 112,704                            | 98,400     |
| Proceeds from sale of equity securities                                           | 14,002                             | 4,490      |
| Proceeds from maturities and redemptions of investments                           | 124,198                            | 104,990    |
| Proceeds from sale of fixed assets                                                | 107                                | —          |
| Capital expenditures and other                                                    | (5,177 )                           | (3,591 )   |
| Restricted cash and cash equivalents provided by investing activities             | 837                                | 10,757     |
| Net cash (used in) provided by investing activities                               | (52,682 )                          | 97,837     |
| Financing activities                                                              |                                    |            |
| Acquisition of treasury stock                                                     | (41,385 )                          | (40,720 )  |
| Cash transactions related to stock-based compensation                             | (209 )                             | 800        |
| Dividends paid to stockholders                                                    | (5,664 )                           | (6,885 )   |
| Net cash used in financing activities                                             | (47,258 )                          | (46,805 )  |
| Net (decrease) increase in cash and cash equivalents                              | (9,058 )                           | 87,009     |
| Cash and cash equivalents at the beginning of the period                          | 252,300                            | 119,825    |
| Cash and cash equivalents at the end of the period                                | \$ 243,242                         | \$ 206,834 |
| See accompanying unaudited notes to the consolidated financial statements.        |                                    |            |





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

1. Basis of Presentation and Summary of Operations

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

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal, recurring adjustments) necessary for a fair presentation of the Company's consolidated financial position and results of operations for the periods presented have been included. The results of operations for an interim period are not necessarily indicative of the results for an entire year. These financial statements have been prepared consistent with the accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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

Use of Estimates

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

At September 30, 2012, the Company changed the estimate of its guaranty fund assessment liability as a result of the application of new information related to historical payment trends and reflected this change in its financial statements for the period ended September 30, 2012. This change in estimate resulted in a \$2.9 million reduction of the accrued liability for guaranty fund assessments, offset by a \$0.7 million reduction in the corresponding premium tax asset and a \$0.8 million reduction in deferred acquisition costs (DAC) that reduced the Company's underwriting and other operating expense by a total of \$1.4 million and reduced the income tax benefit by \$0.2 million. This change in estimate increased net income by \$1.2 million, or \$0.04 per basic and diluted share, for the three and nine months ended September 30, 2012.

Reclassifications

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

2. New Accounting Standards

In July 2012, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2012-02, Intangibles- Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment.

This update simplifies the guidance for impairment testing of indefinite-lived intangible assets other than goodwill and provides the option to assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test. Companies electing to perform a qualitative assessment will no longer be required to calculate the fair value of an indefinite-lived intangible asset unless the company determines, based on a qualitative assessment, that it is more likely than not that the asset is impaired. This update becomes effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012; however, early adoption is permitted. The Company elected to adopt this update for annual and interim impairment tests performed beginning the third

quarter of 2012. The adoption of this new guidance did not have a material impact on the Company's consolidated financial condition or results of operations.

### 3. Deferred Policy Acquisition Costs

In October 2010, the FASB issued Accounting Standard Update Number 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts that became effective in 2012. This guidance changed the definition of acquisition costs which may be capitalized to specify costs that relate directly to the successful acquisition of new or renewal insurance contracts, including underwriting, policy issuance and processing, medical and inspection, and sales force contract selling. It also defines incremental direct costs that must be capitalized as costs that result directly from contract transactions that are essential to contract issuance, which would not have been incurred had the contract transaction not occurred. All other costs are expensed as incurred. Capitalized costs are amortized over the life of the contract.

The Company adopted this standard on a prospective basis on January 1, 2012. Under the new guidance, the Company capitalized acquisition costs totaling \$21.3 million and \$66.5 million for the three and nine months ended September 30, 2012, respectively. Under the previous guidance, the amount capitalized would have been \$25.1 million and \$77.6 million for the same periods. The total effect of implementing this guidance was a \$3.8 million and \$11.1 million decrease in the amount capitalized and a \$2.5 million and \$4.6 million decrease in the amortization expense for the three and nine months ended September 30, 2012, respectively. The total amortization expense was \$21.7 million and \$63.7 million for the three and nine months ended September 30, 2012, respectively. The net effect of implementing this guidance was a \$1.3 million and \$6.5 million increase in underwriting and other operating expense for the three and nine months ended September 30, 2012, respectively. The Company expects that the total impact of this new guidance for 2012 will be approximately \$7 million in increased underwriting and other operating expenses.

### 4. Fair Value of Financial Instruments

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

|                                      | September 30, 2012 |                      | December 31, 2011 |                      |
|--------------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                      | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
|                                      | (in thousands)     |                      |                   |                      |
| Financial assets                     |                    |                      |                   |                      |
| Investments                          | \$2,033,748        | \$2,033,748          | \$1,950,745       | \$1,950,745          |
| Cash and cash equivalents            | 243,242            | 243,242              | 252,300           | 252,300              |
| Restricted cash and cash equivalents | 5,462              | 5,462                | 6,299             | 6,299                |
| Financial liabilities                |                    |                      |                   |                      |
| Notes payable                        | 122,000            | 127,479              | 122,000           | 130,447              |

The Company's estimates of fair value for financial liabilities are based on a combination of the variable interest rates for the Company's existing line of credit and notes with similar durations to discount the projection of future payments on notes payable, and have been determined to be Level 2 fair value measurements, as defined below. Assets and liabilities recorded at fair value on the consolidated balance sheets are categorized based upon the levels of judgment associated with the inputs used to measure their fair value. Level inputs are defined as follows:

Level 1 - Inputs are unadjusted quoted market prices for identical assets or liabilities in active markets at the measurement date.

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

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

The following methods and assumptions were used to determine the fair value of each class of assets and liabilities recorded at fair value in the consolidated balance sheets.

Fair value of available-for-sale fixed maturity and equity securities is based on quoted market prices, where available, and is obtained primarily from third party pricing services, who generally use Level 1 or Level 2 inputs. The Company obtains a quoted price for each security from third party pricing services. The quoted prices are derived through recently reported trades for identical or similar securities. For securities not actively traded, the third party pricing

services may use quoted market prices of similar instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, broker quotes, benchmark yields, credit spreads, default rates, and prepayment speeds. The Company also performs quarterly analysis on the prices received from third party pricing services to determine whether the prices are reasonable estimates of fair value, including confirming the fair values of these securities through observable market prices using an alternative pricing source. If unusual fluctuations are noted in this review, the Company may obtain additional information from other pricing services to validate the quoted price. There were no

adjustments to prices obtained from third party pricing services as of September 30, 2012 or December 31, 2011 that were material to the consolidated financial statements.

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

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

Most estimates of fair value for fixed maturity securities are based on estimates using objectively verifiable information and are included in the amount disclosed in Level 2 of the hierarchy. The fair value estimates for determining Level 3 fair value include the Company's assumptions about risk assessments and market participant assumptions based on the best information available, including quotes from market makers and other broker/dealers recognized as market participants, using standard or trade derived inputs, new issue data, monthly payment information, cash flow generation, prepayment speeds, spread adjustments, or rating updates.

The following table presents the items on the accompanying consolidated balance sheets that are stated at fair value and the fair value measurements.

|                                        | September 30, 2012 |           |         | December 31, 2011 |           |         |
|----------------------------------------|--------------------|-----------|---------|-------------------|-----------|---------|
|                                        | Level 1            | Level 2   | Level 3 | Level 1           | Level 2   | Level 3 |
|                                        | (in thousands)     |           |         |                   |           |         |
| Fixed maturity securities              |                    |           |         |                   |           |         |
| U.S. Treasuries                        | \$—                | \$147,297 | \$—     | \$—               | \$137,365 | \$—     |
| U.S. Agencies                          | —                  | 94,560    | —       | —                 | 108,448   | —       |
| States and municipalities              | —                  | 773,194   | —       | —                 | 789,636   | —       |
| Corporate securities                   | —                  | 583,799   | —       | —                 | 501,669   | —       |
| Residential mortgage-backed securities | —                  | 254,477   | —       | —                 | 281,511   | —       |
| Commercial mortgage-backed securities  | —                  | 38,466    | —       | —                 | 21,665    | —       |
| Asset-backed securities                | —                  | 13,797    | —       | —                 | 12,405    | —       |
| Total fixed maturity securities        | —                  | 1,905,590 | —       | —                 | 1,852,699 | —       |
| Equity securities                      | \$128,158          | \$—       | \$—     | \$98,046          | \$—       | \$—     |

## 5. Investments

The cost or amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of the Company's investments were as follows:

|                                        | Cost or<br>Amortized<br>Cost<br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|----------------------------------------|------------------------------------------------|------------------------------|-------------------------------|-------------------------|
| At September 30, 2012                  |                                                |                              |                               |                         |
| Fixed maturity securities              |                                                |                              |                               |                         |
| U.S. Treasuries                        | \$ 132,747                                     | \$ 14,550                    | \$—                           | \$ 147,297              |
| U.S. Agencies                          | 88,259                                         | 6,301                        | —                             | 94,560                  |
| States and municipalities              | 700,029                                        | 73,165                       | —                             | 773,194                 |
| Corporate securities                   | 531,578                                        | 52,252                       | (31 )                         | 583,799                 |
| Residential mortgage-backed securities | 234,856                                        | 19,731                       | (110 )                        | 254,477                 |
| Commercial mortgage-backed securities  | 36,952                                         | 1,514                        | —                             | 38,466                  |
| Asset-backed securities                | 13,528                                         | 270                          | (1 )                          | 13,797                  |
| Total fixed maturity securities        | 1,737,949                                      | 167,783                      | (142 )                        | 1,905,590               |
| Equity securities                      | 80,897                                         | 48,232                       | (971 )                        | 128,158                 |
| Total investments                      | \$ 1,818,846                                   | \$ 216,015                   | \$ (1,113 )                   | \$ 2,033,748            |
| At December 31, 2011                   |                                                |                              |                               |                         |
| Fixed maturity securities              |                                                |                              |                               |                         |
| U.S. Treasuries                        | \$ 122,144                                     | \$ 15,222                    | \$ (1 )                       | \$ 137,365              |
| U.S. Agencies                          | 101,520                                        | 6,942                        | (14 )                         | 108,448                 |
| States and municipalities              | 719,431                                        | 70,391                       | (186 )                        | 789,636                 |
| Corporate securities                   | 467,470                                        | 35,745                       | (1,546 )                      | 501,669                 |
| Residential mortgage-backed securities | 262,961                                        | 19,154                       | (604 )                        | 281,511                 |
| Commercial mortgage-backed securities  | 20,756                                         | 910                          | (1 )                          | 21,665                  |
| Asset-backed securities                | 11,934                                         | 471                          | —                             | 12,405                  |
| Total fixed maturity securities        | 1,706,216                                      | 148,835                      | (2,352 )                      | 1,852,699               |
| Equity securities                      | 64,962                                         | 34,639                       | (1,555 )                      | 98,046                  |
| Total investments                      | \$ 1,771,178                                   | \$ 183,474                   | \$ (3,907 )                   | \$ 1,950,745            |

The amortized cost and estimated fair value of fixed maturity securities at September 30, 2012, by contractual maturity, are shown below. Expected maturities differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                        | Amortized Cost<br>(in thousands) | Estimated Fair Value |
|----------------------------------------|----------------------------------|----------------------|
| Due in one year or less                | \$ 98,755                        | \$ 100,909           |
| Due after one year through five years  | 613,369                          | 658,752              |
| Due after five years through ten years | 527,068                          | 598,510              |
| Due after ten years                    | 213,421                          | 240,679              |
| Mortgage and asset-backed securities   | 285,336                          | 306,740              |
| Total                                  | \$ 1,737,949                     | \$ 1,905,590         |

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The following is a summary of investments that have been in a continuous unrealized loss position for less than 12 months and for 12 months or greater as of September 30, 2012 and December 31, 2011.

|                                        | September 30, 2012      |                               |                     | December 31, 2011       |                               |                     |
|----------------------------------------|-------------------------|-------------------------------|---------------------|-------------------------|-------------------------------|---------------------|
|                                        | Estimated<br>Fair Value | Gross<br>Unrealized<br>Losses | Number of<br>Issues | Estimated<br>Fair Value | Gross<br>Unrealized<br>Losses | Number of<br>Issues |
|                                        | (dollars in thousands)  |                               |                     |                         |                               |                     |
| Less than 12 months:                   |                         |                               |                     |                         |                               |                     |
| Fixed maturity securities              |                         |                               |                     |                         |                               |                     |
| U.S. Treasuries                        | \$—                     | \$—                           | —                   | \$5,076                 | \$(1                          | ) 2                 |
| U.S. Agencies                          | —                       | —                             | —                   | 11,124                  | (14                           | ) 3                 |
| States and municipalities              | —                       | —                             | —                   | 5,094                   | (185                          | ) 1                 |
| Corporate securities                   | 2,561                   | (31                           | ) 1                 | 64,846                  | (1,481                        | ) 30                |
| Residential mortgage-backed securities | 145                     | (1                            | ) 11                | 4,916                   | (20                           | ) 14                |
| Commercial mortgage-backed securities  | —                       | —                             | —                   | 1,464                   | (1                            | ) 1                 |
| Asset-backed securities                | 1,000                   | (1                            | ) 2                 | —                       | —                             | —                   |
| Total fixed maturity securities        | 3,706                   | (33                           | ) 14                | 92,520                  | (1,702                        | ) 51                |
| Equity securities                      | 10,960                  | (883                          | ) 37                | 12,443                  | (1,462                        | ) 57                |
| Total less than 12 months              | \$14,666                | \$(916                        | ) 51                | \$104,963               | \$(3,164                      | ) 108               |
| 12 months or greater:                  |                         |                               |                     |                         |                               |                     |
| Fixed maturity securities              |                         |                               |                     |                         |                               |                     |
| States and municipalities              | —                       | —                             | —                   | 1,049                   | (1                            | ) 1                 |
| Corporate securities                   | —                       | —                             | —                   | 1,024                   | (65                           | ) 1                 |
| Residential mortgage-backed securities | 2,456                   | (109                          | ) 9                 | 2,692                   | (584                          | ) 5                 |
| Total fixed maturity securities        | 2,456                   | (109                          | ) 9                 | 4,765                   | (650                          | ) 7                 |
| Equity securities                      | 300                     | (88                           | ) 6                 | 452                     | (93                           | ) 4                 |
| Total 12 months or greater             | \$2,756                 | \$(197                        | ) 15                | \$5,217                 | \$(743                        | ) 11                |
| Total available-for-sale:              |                         |                               |                     |                         |                               |                     |
| Fixed maturity securities              |                         |                               |                     |                         |                               |                     |
| U.S. Treasuries                        | \$—                     | \$—                           | —                   | \$5,076                 | \$(1                          | ) 2                 |
| U.S. Agencies                          | —                       | —                             | —                   | 11,124                  | (14                           | ) 3                 |
| States and municipalities              | —                       | —                             | —                   | 6,143                   | (186                          | ) 2                 |
| Corporate securities                   | 2,561                   | (31                           | ) 1                 | 65,870                  | (1,546                        | ) 31                |
| Residential mortgage-backed securities | 2,601                   | (110                          | ) 20                | 7,608                   | (604                          | ) 19                |
| Commercial mortgage-backed securities  | —                       | —                             | —                   | 1,464                   | (1                            | ) 1                 |
| Asset-backed securities                | 1,000                   | (1                            | ) 2                 | —                       | —                             | —                   |
| Total fixed maturity securities        | 6,162                   | (142                          | ) 23                | 97,285                  | (2,352                        | ) 58                |
| Equity securities                      | 11,260                  | (971                          | ) 43                | 12,895                  | (1,555                        | ) 61                |
| Total available-for-sale               | \$17,422                | \$(1,113                      | ) 66                | \$110,180               | \$(3,907                      | ) 119               |

Based on reviews of the fixed maturity securities, the Company determined that unrealized losses as of September 30, 2012 were primarily the result of changes in prevailing interest rates and not the credit quality of the issuers. The fixed maturity securities whose total fair value was less than amortized cost were not determined to be



other-than-temporarily impaired given the severity and duration of the impairment, the credit quality of the issuers, the Company's intent to not sell the securities, and a determination that it is not more likely than not that the Company will be required to sell the securities until fair value recovers to above cost, or to maturity.

Based on reviews of the equity securities as of September 30, 2012, the Company recognized total impairments of \$0.5 million in the fair values of seven equity securities as a result of the severity and duration of the change in fair values of those securities.

Realized gains on investments, net and the change in unrealized gains (losses) on fixed maturity and equity securities are determined on a specific-identification basis and were as follows:

|                                                  | Three Months Ended<br>September 30,<br>2012 |          | Nine Months Ended<br>September 30,<br>2012 |          |
|--------------------------------------------------|---------------------------------------------|----------|--------------------------------------------|----------|
|                                                  | 2011                                        |          | 2011                                       |          |
|                                                  | (in thousands)                              |          |                                            |          |
| Realized gains on investments, net               |                                             |          |                                            |          |
| Fixed maturity securities                        |                                             |          |                                            |          |
| Gross gains                                      | \$1,138                                     | \$185    | \$3,433                                    | \$1,117  |
| Gross losses                                     | —                                           | —        | (5                                         | ) (148   |
| Realized gains on fixed maturity securities, net | \$1,138                                     | \$185    | \$3,428                                    | \$969    |
| Equity securities                                |                                             |          |                                            |          |
| Gross gains                                      | \$731                                       | \$479    | \$1,891                                    | \$1,034  |
| Gross losses                                     | (31                                         | ) (17    | ) (758                                     | ) (20    |
| Realized gains on equity securities, net         | \$700                                       | \$462    | \$1,133                                    | \$1,014  |
| Total                                            | \$1,838                                     | \$647    | \$4,561                                    | \$1,983  |
| Change in unrealized gains (losses)              |                                             |          |                                            |          |
| Fixed maturity securities                        | \$17,600                                    | \$36,444 | \$21,158                                   | \$55,902 |
| Equity securities                                | 5,246                                       | (11,038  | ) 14,177                                   | (6,546   |
| Total                                            | \$22,846                                    | \$25,406 | \$35,335                                   | \$49,356 |

Net investment income was as follows:

|                                      | Three Months Ended<br>September 30,<br>2012 |          | Nine Months Ended<br>September 30,<br>2012 |          |
|--------------------------------------|---------------------------------------------|----------|--------------------------------------------|----------|
|                                      | 2011                                        |          | 2011                                       |          |
|                                      | (in thousands)                              |          |                                            |          |
| Fixed maturity securities            | \$17,243                                    | \$19,726 | \$53,532                                   | \$60,665 |
| Equity securities                    | 856                                         | 449      | 2,280                                      | 1,367    |
| Cash equivalents and restricted cash | 52                                          | 46       | 275                                        | 196      |
|                                      | 18,151                                      | 20,221   | 56,087                                     | 62,228   |
| Investment expenses                  | (645                                        | ) (637   | ) (1,899                                   | ) (1,845 |
| Net investment income                | \$17,506                                    | \$19,584 | \$54,188                                   | \$60,383 |

The Company is required by various state laws and regulations to keep securities or letters of credit in depository accounts with certain states in which it does business. As of September 30, 2012 and December 31, 2011, securities having a fair value of \$532.7 million and \$522.6 million, respectively, were on deposit. These laws and regulations govern not only the amount, but also the types of securities that are eligible for deposit. The deposits are limited to fixed maturity securities in all states. Additionally, certain reinsurance contracts require Company funds to be held in trust for the benefit of the ceding reinsurer to secure the outstanding liabilities assumed by the Company. The fair value of fixed maturity securities held in trust for the benefit of ceding reinsurers at September 30, 2012 and December 31, 2011 was \$33.2 million and \$40.3 million, respectively. Pursuant to the Amended Credit Facility, a portion of the Company's debt was secured by fixed maturity securities and restricted cash and cash equivalents that had a fair value of \$115.9 million and \$126.7 million at September 30, 2012 and December 31, 2011, respectively.

## 6. Income Taxes

Income tax expense for interim periods is measured using an estimated effective tax rate for the annual period. The following is a reconciliation of the federal statutory income tax rate to the Company's effective tax rates for the periods presented.

|                                                      | Nine Months Ended<br>September 30, |    |        |    |
|------------------------------------------------------|------------------------------------|----|--------|----|
|                                                      | 2012                               |    | 2011   |    |
| Expense computed at statutory rate                   | 35.0                               | %  | 35.0   | %  |
| Dividends received deduction and tax-exempt interest | (64.1)                             | )  | (47.4) | )  |
| LPT Agreement                                        | (38.2)                             | )  | (26.7) | )  |
| Pre-privatization reserve adjustments                | —                                  |    | (6.6)  | )  |
| Other                                                | (1.6)                              | )  | 1.2    |    |
| Effective tax rate                                   | (68.9)                             | )% | (44.5) | )% |

## 7. Liability for Unpaid Losses and Loss Adjustment Expenses

The following table represents a reconciliation of changes in the liability for unpaid losses and LAE.

|                                                                     | Nine Months Ended<br>September 30, |             |
|---------------------------------------------------------------------|------------------------------------|-------------|
|                                                                     | 2012                               | 2011        |
|                                                                     | (in thousands)                     |             |
| Unpaid losses and LAE, gross of reinsurance, at beginning of period | \$2,272,363                        | \$2,279,729 |
| Less reinsurance recoverables for unpaid losses and LAE             | 940,840                            | 956,043     |
| Net unpaid losses and LAE at beginning of period                    | 1,331,523                          | 1,323,686   |
| Losses and LAE, net of reinsurance, related to:                     |                                    |             |
| Current period                                                      | 277,821                            | 203,362     |
| Prior periods                                                       | 1,281                              | 631         |
| Total net losses and LAE incurred during the period                 | 279,102                            | 203,993     |
| Deduct payments for losses and LAE, net of reinsurance, related to: |                                    |             |
| Current period                                                      | 40,991                             | 33,477      |
| Prior periods                                                       | 178,087                            | 172,608     |
| Total net payments for losses and LAE during the period             | 219,078                            | 206,085     |
| Ending unpaid losses and LAE, net of reinsurance                    | 1,391,547                          | 1,321,594   |
| Reinsurance recoverable for unpaid losses and LAE                   | 912,877                            | 927,670     |
| Unpaid losses and LAE, gross of reinsurance, at end of period       | \$2,304,424                        | \$2,249,264 |

Total net losses and LAE included in the above table excludes the impact of the amortization of the deferred reinsurance gain—LPT Agreement (Deferred Gain) (Note 8).

The increase in the estimates of incurred losses and LAE attributable to insured events for prior periods was entirely related to the Company's assigned risk business.

## 8. LPT Agreement

The Company is party to a 100% quota share retroactive reinsurance agreement (LPT Agreement) under which \$1.5 billion in liabilities for losses and LAE related to claims incurred by EICN prior to July 1, 1995 were reinsured for consideration of \$775.0 million. The LPT Agreement provides coverage up to \$2.0 billion. The initial Deferred Gain resulting from the LPT Agreement was recorded as a liability in the accompanying consolidated balance sheets and is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries. The Company amortized \$11.6 million and \$13.0 million of the Deferred Gain for the nine months ended September 30, 2012 and 2011, respectively. Any adjustments to the Deferred Gain are recorded in losses and LAE incurred in the accompanying consolidated statements of comprehensive income. No adjustments occurred in the current period. The remaining Deferred Gain was \$341.6 million and \$353.2 million as of September 30, 2012 and December 31, 2011, respectively, and is included in the accompanying consolidated balance sheets. The estimated remaining liabilities subject to the LPT Agreement were

\$780.9 million and \$807.5 million as of September 30, 2012 and December 31, 2011, respectively. Losses and LAE paid with respect to the LPT Agreement totaled \$596.5 million and \$569.9 million through September 30, 2012 and December 31, 2011, respectively.

# 9. Accumulated Other Comprehensive Income, net

Accumulated other comprehensive income is comprised of unrealized gains on investments classified as available-for-sale, net of deferred tax expense. The following table summarizes the components of accumulated other comprehensive income, net:

|                                                   | September 30, 2012<br>(in thousands) | December 31, 2011 |
|---------------------------------------------------|--------------------------------------|-------------------|
| Net unrealized gain on investments, before taxes  | \$214,902                            | \$179,567         |
| Deferred tax expense on net unrealized gains      | (75,216)                             | (62,848)          |
| Total accumulated other comprehensive income, net | \$139,686                            | \$116,719         |

# 10. Stock-Based Compensation

The Company awarded stock options, restricted stock units (RSUs) and performance share awards (PSAs) to certain officers and Directors of the Company as follows:

|                              | Number<br>Awarded | Fair Value on<br>Date of Grant | Exercise Price | Aggregate Fair Value<br>on Date of Grant<br>(in millions) |
|------------------------------|-------------------|--------------------------------|----------------|-----------------------------------------------------------|
| March 2012                   |                   |                                |                |                                                           |
| Stock options <sup>(1)</sup> | 242,300           | \$5.64                         | \$17.02        | \$1.4                                                     |
| RSUs <sup>(1)</sup>          | 79,450            | 17.02                          | —              | 1.4                                                       |
| PSAs <sup>(2)</sup>          | 158,900           | 17.02                          | —              | 2.7                                                       |
| May 2012                     |                   |                                |                |                                                           |
| RSUs <sup>(1)</sup>          | 36,355            | 17.40                          | —              | 0.6                                                       |

The stock options and RSUs were awarded to certain officers of the Company and have a service vesting period of four years after the date awarded and vest 25% on each of the subsequent four anniversaries of the grant date. The stock options and RSUs are subject to accelerated vesting in certain circumstances, such as: death or disability, or in connection with change of control of the Company. The stock options expire seven years from the date of grant. The RSUs awarded in May 2012 include 27,584 RSUs granted to non-employee Directors of the Company that have a service vesting period of one year from the date awarded.

The PSAs have a performance period of three years and are subject to certain performance goals, based on the Company's statutory combined ratio, with payouts that range from 0% to 200% of the target awards.

A total of 31,044 and 92,646 stock options were exercised during the nine months ended September 30, 2012 and the year ended December 31, 2011, respectively.

## 11. Earnings Per Share

Basic earnings per share includes no dilution and is computed by dividing income applicable to stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilutive impact of all convertible securities on earnings per share. Diluted earnings per share includes shares assumed issued under the “treasury stock method,” which reflects the potential dilution that would occur if outstanding options were to be exercised. The following table presents the net income and the weighted average shares outstanding used in the earnings per common share calculations.

|                                                        | Three Months Ended<br>September 30,<br>2012 |            | Nine Months Ended<br>September 30,<br>2011 |            |
|--------------------------------------------------------|---------------------------------------------|------------|--------------------------------------------|------------|
|                                                        | 2012                                        | 2011       | 2012                                       | 2011       |
|                                                        | (in thousands, except share data)           |            |                                            |            |
| Net income available to stockholders—basic and diluted | \$8,150                                     | \$11,783   | \$19,378                                   | \$28,379   |
| Weighted average number of shares outstanding—basic    | 30,891,648                                  | 37,623,935 | 31,689,844                                 | 38,251,561 |
| Effect of dilutive securities:                         |                                             |            |                                            |            |
| PSAs                                                   | 43,241                                      | —          | 20,562                                     | —          |
| Stock options                                          | 114,390                                     | —          | 99,782                                     | 61,055     |
| RSUs                                                   | 46,827                                      | 12,577     | 60,183                                     | 67,751     |
| Dilutive potential shares                              | 204,458                                     | 12,577     | 180,527                                    | 128,806    |
| Weighted average number of shares outstanding—diluted  | 31,096,106                                  | 37,636,512 | 31,870,371                                 | 38,380,367 |

Diluted earnings per share exclude outstanding options and other common stock equivalents in periods where the inclusion of such options and common stock equivalents would be anti-dilutive. The following table presents options and RSUs that were excluded from diluted earnings per share.

|                                                                                                                                                              | Three Months Ended<br>September 30,<br>2012 |           | Nine Months Ended<br>September 30,<br>2011 |           |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|-----------|--------------------------------------------|-----------|
|                                                                                                                                                              |                                             |           |                                            |           |
| Options excluded as the exercise price was greater than the average market price                                                                             | 934,597                                     | 1,449,821 | 934,597                                    | 1,122,986 |
| Options and RSUs excluded under the treasury method, as the potential proceeds on settlement or exercise price was greater than the value of shares acquired | 242,300                                     | 659,729   | 554,484                                    | 479,723   |

**Item 2. Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations**

You should read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes thereto included in Item 1 of Part I. Unless otherwise indicated, all references to "we," "us," "our," "the Company," or similar terms refer to Employers Holdings, Inc. (EHI), together with its subsidiaries. The information contained in this quarterly report is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this quarterly report and in our other reports filed with the Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K for the year ended December 31, 2011 (Annual Report).

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements if accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those discussed. You should not place undue reliance on these statements, which speak only as of the date of this report. Forward-looking statements include those related to our expected financial position, business, financing plans, litigation, future premiums, revenues, earnings, pricing, investments, business relationships, expected losses, loss reserves, acquisitions, competition, rate increases with respect to our business, response to regulatory changes and changes in laws, and the insurance industry in general. Statements including words such as "expect," "intend," "plan," "believe," "estimate," "may," "anticipate," "will" or similar statements of a future or forward-looking nature identify forward-looking statements.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by law. All forward-looking statements address matters that involve risks and uncertainties that could cause actual results to differ materially from historical or anticipated results, depending on a number of factors. These risks and uncertainties include, but are not limited to, those described in our Annual Report and other documents that we have filed with the SEC.

**Overview**

We are a Nevada holding company. Through our insurance subsidiaries, we provide workers' compensation insurance coverage to select, small businesses in low to medium hazard industries. Workers' compensation insurance is provided under a statutory system wherein most employers are required to provide coverage for their employees' medical, disability, vocational rehabilitation, and/or death benefit costs for work-related injuries or illnesses. We provide workers' compensation insurance in 31 states and the District of Columbia, with a concentration in California, where over one-half of our business is generated. Our revenues are primarily comprised of net premiums earned, net investment income, and net realized gains on investments.

We target small businesses, as we believe that this market is traditionally characterized by fewer competitors, more attractive pricing, and stronger persistency when compared to the U.S. workers' compensation insurance industry in general. We believe we are able to price our policies at levels that are competitive and profitable over the long-term. Our underwriting approach is to consistently underwrite small business accounts at appropriate and competitive prices without sacrificing long-term profitability and stability for short-term top-line revenue growth.

Our goal is to maintain our focus on disciplined underwriting and to continue to pursue profitable growth opportunities across market cycles; however, we continue to be affected by persistently low investment yields and continuing high levels of unemployment nationally. We do not believe overall economic conditions will change significantly in the near-term.

We market and sell our workers' compensation insurance products through independent local, regional, and national agents and brokers; through our strategic partnerships and alliances, including our principal partners ADP, Inc. and Anthem Blue Cross of California; and through relationships with national and regional trade groups and associations, including the National Federation of Independent Business.

**Results of Operations**

Overall, net income was \$8.2 million and \$19.4 million for the three and nine months ended September 30, 2012, respectively, compared to \$11.8 million and \$28.4 million for the corresponding periods of 2011. We recognized underwriting losses of \$11.5 million and \$44.8 million for the three and nine months ended September 30, 2012, respectively, compared to underwriting losses of \$12.0 million and \$40.2 million for the same periods of 2011. Underwriting income or loss is determined by deducting losses and LAE, commission expense, policyholder

dividends, and underwriting and other operating expenses from net premiums earned. Key factors that affected our financial performance during the three and nine months ended September 30, 2012, compared to the same period of 2011, include:

• Gross premiums written increased 41% and 40%;

• Net premiums earned increased 42% and 37%;

• Losses and LAE increased 46% and 40%;

• Underwriting and other operating expenses increased 16% and 18%; and



Income tax benefit decreased to \$1.2 million and \$7.9 million during the three and nine months ended September 30, 2012, respectively, compared to \$4.4 million and \$8.7 million for the corresponding periods of 2011.

Additionally, the Financial Accounting Standards Board issued guidance that, beginning in 2012, changed the definition of policy acquisition costs which may be capitalized. Our underwriting and other operating expenses increased \$1.3 million and \$6.5 million during the three and nine months ended September 30, 2012 as a result of this change (see Note 3 in the Notes to Consolidated Financial Statements for additional information). We expect that the total impact of this guidance for 2012 will be approximately \$7 million in increased underwriting and other operating expenses.

We measure our performance by our ability to increase stockholders' equity, including the impact of the deferred reinsurance gain—LPT Agreement (Deferred Gain), over the long-term. The following table shows our stockholders' equity including the Deferred Gain, stockholders' equity on a GAAP basis, and number of common shares outstanding at:

|                                                                 | September 30, 2012<br>(in thousands, except share data) | December 31, 2011 |
|-----------------------------------------------------------------|---------------------------------------------------------|-------------------|
| Stockholders' equity including the Deferred Gain <sup>(1)</sup> | \$814,780                                               | \$827,380         |
| GAAP stockholders' equity                                       | \$473,216                                               | \$474,186         |
| Common shares outstanding                                       | 30,724,086                                              | 32,996,809        |

(1) Stockholders' equity, including the Deferred Gain, is a non-GAAP measure that is defined as total stockholders' equity plus the Deferred Gain, which we believe is an important supplemental measure of our capital position.

The comparative components of net income are set forth in the following table:

|                                                              | Three Months Ended<br>September 30,<br>2012      2011<br>(in thousands) |           | Nine Months Ended<br>September 30,<br>2012      2011 |           |
|--------------------------------------------------------------|-------------------------------------------------------------------------|-----------|------------------------------------------------------|-----------|
| Gross premiums written                                       | \$147,032                                                               | \$104,514 | \$442,920                                            | \$315,571 |
| Net premiums written                                         | \$144,353                                                               | \$102,557 | 435,081                                              | 309,249   |
| Net premiums earned                                          | \$131,766                                                               | \$92,601  | \$360,621                                            | \$263,156 |
| Net investment income                                        | 17,506                                                                  | 19,584    | 54,188                                               | 60,383    |
| Realized gains on investments, net                           | 1,838                                                                   | 647       | 4,561                                                | 1,983     |
| Other income                                                 | 30                                                                      | 82        | 225                                                  | 205       |
| Total revenues                                               | 151,140                                                                 | 112,914   | 419,595                                              | 325,727   |
| Losses and LAE                                               | 98,255                                                                  | 67,438    | 267,471                                              | 191,009   |
| Commission expense                                           | 14,865                                                                  | 10,968    | 44,541                                               | 32,368    |
| Policyholder dividends                                       | 867                                                                     | 840       | 2,517                                                | 2,766     |
| Underwriting and other operating expenses                    | 29,280                                                                  | 25,334    | 90,935                                               | 77,212    |
| Interest expense                                             | 896                                                                     | 906       | 2,656                                                | 2,731     |
| Income tax benefit                                           | (1,173)                                                                 | (4,355)   | (7,903)                                              | (8,738)   |
| Total expenses                                               | 142,990                                                                 | 101,131   | 400,217                                              | 297,348   |
| Net income                                                   | \$8,150                                                                 | \$11,783  | \$19,378                                             | \$28,379  |
| Less impact of the Deferred Gain                             | \$3,646                                                                 | \$4,203   | \$11,630                                             | \$12,984  |
| Net income before impact of the Deferred Gain <sup>(1)</sup> | \$4,504                                                                 | \$7,580   | \$7,748                                              | \$15,395  |

(1) We define net income before impact of the Deferred Gain as net income less: (a) amortization of Deferred Gain and (b) adjustments to LPT Agreement ceded reserves. Deferred Gain reflects the unamortized gain from our LPT Agreement. Under GAAP, this gain is deferred and is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries, and the amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement. Our reevaluation results in corresponding adjustments, if needed, to reserves, ceded reserves,

reinsurance recoverables, and the Deferred Gain, with the net effect being an increase or decrease, as the case may be, to net income. Net income before impact of the Deferred Gain is not a measurement of financial performance under GAAP, but rather reflects the difference in accounting treatment between statutory and GAAP, and should not be considered in isolation or as an alternative to net income before income taxes, net income, or any other measure of performance derived in accordance with GAAP.

We present net income before impact of the Deferred Gain because we believe that it is an important supplemental measure of operating performance to be used by analysts, investors and other interested parties in evaluating us. The LPT Agreement was a non-recurring transaction and the Deferred Gain does not result in ongoing cash benefits. Consequently, we believe this presentation is useful in providing a meaningful understanding of our operating performance. In addition, we believe this non-GAAP measure, as we have defined it, is helpful to our management in identifying trends in our performance because the excluded item has limited significance on our current and ongoing operations.

#### Net Premiums Earned

Net premiums earned increased 42.3% and 37.0% for the three and nine months ended September 30, 2012, compared to the corresponding periods in 2011. These increases are primarily due to increasing policy count as we continue to execute our strategy.

The following table shows the percentage change in our in-force premium, policy count, average policy size, payroll exposure upon which our premiums are based, and net rate.

|                              | As of September 30, 2012 |                         |
|------------------------------|--------------------------|-------------------------|
|                              | Year-to-Date Increase    | Year-Over-Year Increase |
| In-force premiums            | 29.7                     | % 38.6                  |
| In-force policy count        | 25.7                     | 34.7                    |
| Average in-force policy size | 3.2                      | 2.9                     |
| In-force payroll exposure    | 21.9                     | 29.1                    |
| Net rate <sup>(1)</sup>      | 6.4                      | 7.4                     |

Net rate, defined as total premium in-force divided by total insured payroll exposure, is a function of a variety of (1) factors, including rate changes, underwriting risk profiles and pricing, and changes in business mix related to economic and competitive pressures.

Our in-force premiums and number of policies in-force by select states were as follows:

| State      | September 30, 2012     |          | December 31, 2011 |          | September 30, 2011 |          | December 31, 2010 |          |
|------------|------------------------|----------|-------------------|----------|--------------------|----------|-------------------|----------|
|            | Premiums               | Policies | Premiums          | Policies | Premiums           | Policies | Premiums          | Policies |
|            | In-force               | In-force | In-force          | In-force | In-force           | In-force | In-force          | In-force |
|            | (dollars in thousands) |          |                   |          |                    |          |                   |          |
| California | \$299,272              | 44,766   | \$221,910         | 36,867   | \$206,272          | 35,139   | \$172,621         | 29,244   |
| Illinois   | 29,291                 | 3,235    | 24,744            | 2,433    | 23,041             | 2,045    | 18,617            | 932      |
| Georgia    | 21,971                 | 2,915    | 16,393            | 2,050    | 14,530             | 1,716    | 10,772            | 757      |
| Florida    | 17,332                 | 2,805    | 15,226            | 2,399    | 14,993             | 2,309    | 15,071            | 1,963    |
| Nevada     | 15,281                 | 3,890    | 14,639            | 3,718    | 14,675             | 3,630    | 16,940            | 3,596    |
| Other      | 127,683                | 18,653   | 101,009           | 13,226   | 95,080             | 11,762   | 87,116            | 8,069    |
| Total      | \$510,830              | 76,264   | \$393,921         | 60,693   | \$368,591          | 56,601   | \$321,137         | 44,561   |

Our strategic partnerships and alliances generated \$114.5 million and \$87.9 million, or 22.4% and 23.8%, of our in-force premiums as of September 30, 2012 and 2011, respectively. We believe that the bundling of products and services through these relationships contributes to higher retention rates than business generated by our independent agents. These relationships also allow us to access new customers that we may not have access to through our independent agent distribution channel. We continue to expand our existing relationships and actively seek new partnerships and alliances.

In April 2011, the Workers' Compensation Insurance Rating Bureau (WCIRB) of California provided an informational filing highlighting the cost drivers that indicated a cumulative 39.8% increase in the claims cost benchmark since January 1, 2009 based on an analysis of December 31, 2010 loss experience. This included deterioration of more than 12 percentage points in the claims cost benchmark since the WCIRB's previous recommendation for a 27.7% increase based on an analysis of June 30, 2010 loss experience. The WCIRB indicated that this further deterioration was due to: (a) continued adverse loss development on the 2009 accident year; (b) high emerging costs on the 2010 accident year, primarily due to increased claims frequency; (c) less optimistic forecasts for statewide wage growth in

California; and (d) increased LAE that is likely as a result of certain Workers' Compensation Appeals Board decisions. In August 2011, the WCIRB modified its benchmark for pure premium rates. The WCIRB's pure premium rate filings are now based on the industry average filed pure premium rate, rather than the pure premium rate approved by the California Commissioner of Insurance. The WCIRB submitted its benchmark for the proposed advisory pure premium rate to be effective January 1, 2012. The WCIRB noted that while 2012 projected claims costs continue to be below pre-reform highs and the proposed pure premium

rate was slightly less than the industry average filed rate, these rates reflected significant deterioration in projected losses and LAE and less optimistic economic forecasts, compared to the prior year.

In April 2012, the WCIRB submitted its pure premium rate filing recommending an increase in advisory pure premium rates to be effective July 1, 2012. That filing proposed a 4.1% increase over the industry average filed pure premium rate as of January 1, 2012. The filing was based on an analysis of December 31, 2011 experience and reflects increased loss development on the 2010 and 2011 accident years, increased LAE, and lower forecasts of wage growth in California for 2012 and 2013.

In August 2012, the WCIRB submitted its pure premium rate filing recommending an increase in advisory pure premium rates to be effective January 1, 2013. That filing proposed a 12.6% increase over the industry average filed pure premium rate as of July 1, 2012. The WCIRB indicated that the proposed rate increase was due to deterioration in loss experience attributable to continued adverse loss development, elevated indemnity claim frequency, an increase in the projection of future loss inflation, an increase in allocated loss adjustment expense, and lower wage growth forecasts.

In September 2012, the California legislature passed Senate Bill No. 863 (SB 863), which was subsequently signed into law. SB 863 includes a number of reforms to California's workers' compensation system, including increases to permanent disability benefits offset by reforms designed to reduce costs in the system. According to the WCIRB, the cost savings are expected to be achieved through a number of measures, including: the creation of a new dispute resolution process outside of the Workers' Compensation Appeals Board for medical treatments and billing issues; new controls on liens; and calls for new fee schedules for physicians, interpreters, ambulatory surgery centers, and home health care.

In October 2012, the WCIRB amended its January 1, 2013 rate filing, noting that loss development continued to deteriorate in the second quarter of 2012, and to account for the provisions of SB 863 that could be evaluated at the time. This new data indicated a pure premium rate that was 9.3% higher than the industry average filed pure premium rate as of July 1, 2012; however, due to the uncertainty surrounding SB 863 and the potential for additional cost savings beyond what was then quantifiable, the WCIRB's amended rate filing proposed no increase above the industry average filed pure premium rate as of July 1, 2012.

Any cost savings associated with SB 863 will be dependent on the implementation of the provisions of the bill and are not included in our current rate filings. We will evaluate SB 863's mandated regulations as they are adopted and will adjust our rate filings as indicated.

We set our own premium rates in California based upon actuarial analyses of current and anticipated loss trends with a goal of maintaining underwriting profitability. Due to increasing loss costs, primarily medical cost inflation, we have increased our filed premium rates in California by a cumulative 41.3% since February 1, 2009.

The following table sets forth the percentage increases to our filed California rates effective for new and renewal policies incepting on or after the dates shown.

| Effective Date     | Premium Rate Change<br>Filed in California | % |
|--------------------|--------------------------------------------|---|
| February 1, 2009   | 10.0                                       |   |
| August 15, 2009    | 10.5                                       |   |
| March 15, 2010     | 3.0                                        |   |
| March 15, 2011     | 2.5                                        |   |
| September 15, 2011 | 3.9                                        |   |
| June 15, 2012      | 6.0                                        |   |

We expect that total premiums in 2012 across our markets will continue to reflect:

- overall rate increases;
- increasing policy count as we continue to execute our strategy;
- increasing average policy size; and
- lessened competitive pressures.

Net Investment Income and Realized Gains on Investments, Net

We invest our holding company assets, statutory surplus, and the funds supporting our insurance liabilities, including unearned premiums and unpaid losses and LAE. We invest in fixed maturity securities, equity securities, and cash equivalents. Net investment income includes interest and dividends earned on our invested assets and amortization of premiums and discounts on our fixed maturity securities, less bank service charges and custodial and portfolio management fees. We have established a high quality/short duration bias in our investment portfolio.

Net investment income decreased 10.6% and 10.3% for the three and nine months ended September 30, 2012, respectively, compared to the corresponding periods of 2011. The decrease was primarily related to decreases in the average pre-tax book yield

on invested assets to 3.6% and 3.7% for the three and nine months ended September 30, 2012, compared to 4.0% and 4.1% for the same periods of 2011. The tax-equivalent yield on invested assets decreased to 4.7% at September 30, 2012, compared to 5.2% at September 30, 2011.

Realized gains and losses on our investments are reported separately from our net investment income. Realized gains and losses on investments include the gain or loss on a security at the time of sale compared to its original or adjusted cost (equity securities) or amortized cost (fixed maturity securities). Realized losses are also recognized when securities are written down as a result of an other-than-temporary impairment.

Net realized gains on investments were \$1.8 million and \$4.6 million for the three and nine months ended September 30, 2012, respectively, compared to \$0.6 million and \$2.0 million for the corresponding periods of 2011. Additional information regarding our Investments is set forth under “—Liquidity and Capital Resources—Investments.”

#### Combined Ratio

The combined ratio, expressed as a percentage, is a key measurement of underwriting profitability. The combined ratio is the sum of the loss and LAE ratio, the commission expense ratio, policyholder dividends ratio, and underwriting and other operating expenses ratio. When the combined ratio is below 100%, we have recorded underwriting income, and conversely, when the combined ratio is greater than 100%, we cannot be profitable without investment income. Because we only have one operating segment, holding company expenses are included in our calculation of the combined ratio.

The following table provides the calculation of our calendar year combined ratios.

|                                                 | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |   |
|-------------------------------------------------|-------------------------------------|---------|------------------------------------|---------|---|
|                                                 | 2012                                | 2011    | 2012                               | 2011    |   |
| Loss and LAE ratio                              | 74.6                                | % 72.8  | % 74.2                             | % 72.6  | % |
| Underwriting and other operating expenses ratio | 22.2                                | 27.4    | 25.2                               | 29.3    |   |
| Commission expense ratio                        | 11.3                                | 11.8    | 12.3                               | 12.3    |   |
| Policyholder dividends ratio                    | 0.6                                 | 0.9     | 0.7                                | 1.1     |   |
| Combined ratio                                  | 108.7                               | % 112.9 | % 112.4                            | % 115.3 | % |

**Loss and LAE Ratio.** Expressed as a percentage, this is the ratio of losses and LAE to net premiums earned.

Losses and LAE represents our largest expense item and includes claim payments made, amortization of the Deferred Gain, estimates for future claim payments and changes in those estimates for current and prior periods, and costs associated with investigating, defending, and adjusting claims. The quality of our financial reporting depends in large part on accurately predicting our losses and LAE, which are inherently uncertain as they are estimates of the ultimate cost of individual claims based on actuarial estimation techniques.

In California, we are experiencing an increase in indemnity claims frequency (the number of claims expressed as a percentage of payroll) year-over-year. Our loss experience also indicates an upward trend in medical and indemnity costs that are reflected in our current accident year loss estimate. These increases are partially offset by continuing favorable loss cost trends in Nevada and several of our other states. We believe our current accident year loss estimate is adequate; however, ultimate losses will not be known with any certainty for many years. We assume that increasing medical and indemnity cost trends will continue to impact our long-term claims costs and current accident year loss estimate, which may be offset by rate increases.

Overall, losses and LAE increased 45.7% and 40.0% for the three and nine months ended September 30, 2012, respectively, compared to the corresponding periods of 2011. These increases were primarily due to increases in net earned premiums. Prior accident year loss development in both periods was entirely related to our assigned risk business. Our current accident year loss estimate was 77.2% and 77.0% for the three and nine months ended September 30, 2012, compared to 77.2% and 77.3% for the same periods of 2011.

Excluding the impact from the LPT Agreement, losses and LAE would have been \$101.9 million and \$71.6 million, or 77.3% and 77.4% of net premiums earned, for the three months ended September 30, 2012 and 2011, respectively. For the nine months ended September 30, 2012 and 2011, losses and LAE would have been \$279.1 million and \$204.0 million, or 77.4% and 77.5% of net premiums earned, respectively.





The table below reflects the losses and LAE reserve adjustments.

|                                                   | Three Months Ended<br>September 30,<br>2012 |   | September 30,<br>2011 |   | Nine Months Ended<br>September 30,<br>2012 |   | 2011          |   |
|---------------------------------------------------|---------------------------------------------|---|-----------------------|---|--------------------------------------------|---|---------------|---|
|                                                   | (in millions)                               |   | (in millions)         |   | (in millions)                              |   | (in millions) |   |
| Prior accident year loss development, net         | \$ (0.2                                     | ) | \$ (0.2               | ) | \$ (1.3                                    | ) | \$ (0.6       | ) |
| LPT amortization of the deferred reinsurance gain | \$ 3.6                                      |   | \$ 4.2                |   | \$ 11.6                                    |   | \$ 13.0       |   |

**Underwriting and Other Operating Expenses Ratio.** The underwriting and other operating expenses ratio is the ratio (expressed as a percentage) of underwriting and other operating expenses to net premiums earned and measures an insurance company's operational efficiency in producing, underwriting, and administering its insurance business. Underwriting and other operating expenses are those costs that we incur to underwrite and maintain the insurance policies we issue, excluding commission. These expenses include premium taxes and certain other general expenses that vary with, and are primarily related to, producing new or renewal business. Other underwriting expenses include changes in estimates of future write-offs of premiums receivable, general administrative expenses such as salaries and benefits, rent, office supplies, depreciation, and all other operating expenses not otherwise classified separately. Policy acquisition costs are variable based on premiums earned; however, other operating costs are more fixed in nature and become a smaller percentage of net premiums earned as premiums increase.

Our underwriting and other operating expenses ratio decreased 5.2 percentage points and 4.1 percentage points for the three and nine months ended September 30, 2012, compared to the same periods of 2011, primarily due to net premiums earned increasing at a faster rate than our expenses during these periods.

Underwriting and other operating expenses increased 15.6% for the three months ended September 30, 2012, compared to the same period of 2011. During the three months ended September 30, 2012, compensation related expenses increased \$1.9 million, and bad debt expense increased \$0.9 million, partially offset by a \$1.1 million decrease in professional services fees, compared to the same period of 2011.

Our underwriting and other operating expenses increased 17.8% for the nine months ended September 30, 2012, compared to the same period of 2011. During the nine months ended September 30, 2012, compensation related expenses increased \$3.7 million, bad debt expense increased \$2.2 million, and our premium taxes and assessments increased \$1.3 million, partially offset by a \$1.2 million decrease in professional services fees, compared to the same period of 2011.

Additionally, implementation of the new accounting guidance for deferred policy acquisition costs (DAC) resulted in a \$1.3 million and \$6.5 million increase in our underwriting and other operating expenses for the three and nine months ended September 30, 2012, respectively. These increases were partially offset by a \$1.4 million net reduction in underwriting and other operating expenses for the three and nine months ended September 30, 2012, related to a change in estimate for guarantee fund assessments.

Excluding the impact of the new DAC guidance and the change in estimate for guarantee fund assessments, underwriting and other operating expenses would have increased 16.1% and 11.2% for the three and nine months ended September 30, 2012, respectively, compared to the same periods of 2011.

**Commission Expense Ratio.** The commission expense ratio is the ratio (expressed as a percentage) of commission expense to net premiums earned and measures the cost of compensating agents and brokers for the business we have underwritten.

Commission expense includes direct commissions to our agents and brokers for the premiums that they produce for us, as well as incentive payments, other marketing costs, and fees. Commission expense is net of contingent profit commission income related to the LPT Agreement.

Commission expense increased 35.5% and 37.6% for the three and nine months ended September 30, 2012, respectively, compared to the corresponding periods of 2011, primarily due to higher net premiums earned in 2012 and higher agency incentive commissions due to increased agent production through the third quarter of 2012 compared to the same period of 2011.

**Policyholder Dividends Ratio.** The policyholder dividends ratio is the ratio (expressed as a percentage) of the policyholder dividends to net premiums earned and measures the cost of returning premium to policyholders in the

form of dividends.

In administered pricing states such as Florida and Wisconsin, insurance rates are set by state insurance regulators. Rate competition generally is not permitted and policyholder dividend programs are an important competitive factor in these states. We offer dividend programs to eligible policyholders, under which a portion of the policyholders' premium may be returned in the form of dividends.

Policyholder dividends were \$0.9 million and \$2.5 million for the three and nine months ended September 30, 2012, respectively, compared to \$0.8 million and \$2.8 million for the corresponding periods of 2011. Policyholder dividends may fluctuate from time to time due to changes in premium levels on dividend policies and the eligibility of policyholders to receive dividend payments.

#### Income Tax Benefit

Income tax benefit was \$1.2 million and \$7.9 million for the three and nine months ended September 30, 2012, respectively, compared to \$4.4 million and \$8.7 million for the corresponding periods of 2011. The effective tax rates were (16.8)% and (68.9)% for the three and nine months ended September 30, 2012, respectively, compared to (58.6)% and (44.5)% for the same periods of 2011. The decreased tax benefit for the three months ended September 30, 2012, compared to the same period of 2011, was primarily due to a decrease in tax exempt income as a percentage of pretax net income to approximately 173%, from 236%. The decreased tax benefit for the nine months ended September 30, 2012, compared to the same period of 2011, was primarily due to decreased pretax net income.

#### Liquidity and Capital Resources

##### Parent Company

**Operating Cash and Cash Equivalents.** We are a holding company and our ability to fund our operations is contingent upon existing capital and our insurance subsidiaries and their ability to pay dividends up to the holding company. Payment of dividends by our insurance subsidiaries is restricted by state insurance laws, including laws establishing minimum solvency and liquidity thresholds. We require cash to pay stockholder dividends, repurchase common stock, make interest and principal payments on our outstanding debt obligations, provide additional surplus to our insurance subsidiaries, and fund our operating expenses.

In September 2012, EHI made a cash capital contribution totaling \$70.0 million to its operating subsidiaries to support future growth and maintain the subsidiaries' financial strength ratings.

The holding company had \$90.2 million of cash and cash equivalents and fixed maturity securities maturing within the next 24 months at September 30, 2012. Ten million dollars of our line of credit is payable on each of December 31, 2012 and 2013. We believe that the liquidity needs of the holding company over the next 24 months will be met with cash, maturing investments, and dividends from our insurance subsidiaries.

**Share Repurchases.** In November 2010, the EHI Board of Directors (Board of Directors) authorized a share repurchase program for repurchases of up to \$100 million of the Company's common stock from November 8, 2010 through June 30, 2012 (the 2011 Program). In November 2011, the Board of Directors authorized a \$100 million expansion of the 2011 Program, to \$200 million, and extended the repurchase authority pursuant to the 2011 Program through June 30, 2013. Repurchases under the 2011 Program may be commenced or suspended from time-to-time without prior notice, and the 2011 Program may be suspended or discontinued at any time. From inception of the 2011 Program through September 30, 2012, we repurchased a total of 9,403,307 shares of common stock at an average price of \$15.78 per share, including commissions, for a total of \$148.4 million.

**Outstanding Debt.** In December 2010, we entered into the Third Amended and Restated Credit Agreement with Wells Fargo (Amended Credit Facility) under which we were provided with: (a) \$100.0 million line of credit through December 31, 2011; (b) \$90.0 million line of credit from January 1, 2012 through December 31, 2012; (c) \$80.0 million line of credit from January 1, 2013 through December 31, 2013; (d) \$70.0 million line of credit from January 1, 2014 through December 31, 2014; and (e) \$60.0 million line of credit from January 1, 2015 through December 31, 2015. Amounts outstanding bear interest at a rate equal to, at our option: (a) a fluctuating rate of 1.75% above prime rate or (b) a fixed rate that is 1.75% above the LIBOR rate then in effect. The Amended Credit Facility is secured by fixed maturity securities and restricted cash and cash equivalents that had a fair value of \$115.9 million and \$126.7 million at September 30, 2012 and December 31, 2011, respectively. The Amended Credit Facility contains customary non-financial covenants and requires us to maintain \$5.0 million of cash and cash equivalents at all times at the holding company. We are currently in compliance with all applicable covenants.

Our capital structure is comprised of outstanding debt and stockholders' equity. As of September 30, 2012, our capital structure consisted of \$90.0 million principal balance on our Amended Credit Facility, \$32.0 million in surplus notes maturing in 2034, and \$814.8 million of stockholders' equity, including the Deferred Gain. Outstanding debt was 13.0% of total capitalization, including the Deferred Gain, as of September 30, 2012.

##### Operating Subsidiaries

**Operating Cash and Cash Equivalents.** The primary sources of cash for our insurance operating subsidiaries are funds generated from underwriting operations, investment income, maturities and sales of investments, and capital contributions from the parent holding company. The primary uses of cash are payments of claims and operating

expenses, purchases of investments, and payments of dividends to the parent holding company, which are subject to state insurance laws and regulations.

Our insurance subsidiaries had \$392.8 million of cash and cash equivalents and fixed maturity securities maturing within the next 24 months at September 30, 2012. We believe that our subsidiaries' liquidity needs over the next 24 months will be met with cash from operations, investment income, and maturing investments.

We purchase reinsurance to protect us against the costs of severe claims and catastrophic events. On July 1, 2012, we entered into a new reinsurance program that is effective through June 30, 2013. The reinsurance program consists of one treaty covering excess

of loss and catastrophic loss events in five layers of coverage. Our reinsurance coverage is \$195 million in excess of our \$5.0 million retention on a per occurrence basis, subject to a \$2.0 million annual aggregate deductible and certain exclusions. We believe that our reinsurance program meets our needs and that we are sufficiently capitalized.

Various state regulations require us to keep securities or letters of credit on deposit with certain states in which we do business. Securities having a fair value of \$532.7 million and \$522.6 million were on deposit at September 30, 2012 and December 31, 2011, respectively. These laws and regulations govern both the amount and types of fixed maturity securities that are eligible for deposit. Additionally, certain reinsurance contracts require Company funds to be held in trust for the benefit of the ceding reinsurer to secure the outstanding liabilities we assumed. The fair value of fixed maturity securities held in trust for the benefit of ceding reinsurers was \$33.2 million and \$40.3 million at September 30, 2012 and December 31, 2011, respectively.

#### Cash Flows

We monitor cash flows at both the consolidated and subsidiary levels. We use trend and variance analyses to project future cash needs, making adjustments to our forecasts as appropriate.

The table below shows our net cash flows for the nine months ended:

|                                                  | September 30,<br>2012 | 2011       |
|--------------------------------------------------|-----------------------|------------|
|                                                  | (in thousands)        |            |
| Cash and cash equivalents provided by (used in): |                       |            |
| Operating activities                             | \$90,882              | \$35,977   |
| Investing activities                             | (52,682               | ) 97,837   |
| Financing activities                             | (47,258               | ) (46,805  |
| (Decrease) increase in cash and cash equivalents | \$ (9,058             | ) \$87,009 |

**Operating Activities.** Major components of net cash provided by operating activities for the nine months ended September 30, 2012 included net premiums received of \$371.1 million, investment income received of \$60.5 million, and amounts recovered from reinsurers of \$29.2 million. These were partially offset by claims payments of \$246.8 million, underwriting and other operating expenses paid of \$82.0 million (including premium taxes paid of \$12.7 million), and commissions paid of \$35.7 million.

Major components of net cash provided by operating activities for the nine months ended September 30, 2011 included net premiums received of \$263.2 million and investment income received of \$68.9 million. These were partially offset by claims payments of \$202.3 million and underwriting and other operating expenses paid of \$93.8 million.

**Investing Activities.** The major sources of net cash used in investing activities for the nine months ended September 30, 2012 were the purchases of fixed maturity and equity securities.

The major sources of net cash provided by investing activities for the nine months ended September 30, 2011 included the sales, maturities, and redemptions of certain fixed maturity securities.

**Financing Activities.** The majority of cash used in financing activities for the nine months ended September 30, 2012 and 2011 was to repurchase \$41.4 million and \$40.7 million, respectively, of our common stock, and to pay dividends to stockholders.

#### Investments

The cost or amortized cost of our investment portfolio was \$1.8 billion and the fair value was \$2.0 billion as of September 30, 2012.

We employ an investment strategy that emphasizes asset quality and considers the durations of fixed maturity securities against anticipated claim payments and expenditures, other liabilities, and capital needs. Our investment portfolio is structured so that investments mature periodically in reasonable relation to current expectations of future claim payments. Currently, we make claim payments from positive cash flow from operations and use excess cash to invest in operations, invest in marketable securities, return capital to our stockholders (through dividends and share repurchases), and fund growth.

As of September 30, 2012, our investment portfolio, which is classified as available-for-sale, consisted of 93.7% fixed maturity securities whose fair values may fluctuate due to interest rate changes. We strive to limit interest rate risk by

managing the duration of our fixed maturity securities. Our fixed maturity securities (excluding cash and cash equivalents) had a duration of 4.1 at September 30, 2012. To minimize interest rate risk, our portfolio is weighted toward short-term and intermediate-term bonds; however, our investment strategy balances consideration of duration, yield, and credit risk. Our investment guidelines require that the minimum weighted average quality of our fixed maturity securities portfolio be "AA-." Our fixed maturity securities portfolio had a weighted average quality of "AA" as of September 30, 2012, with 66.0% of the portfolio rated "AA" or better, based on market value.

We carry our portfolio of equity securities on our balance sheet at fair value. We minimize our exposure to equity price risk by investing primarily in the equity securities of mid-to-large capitalization issuers and by diversifying our equity holdings across several industry sectors. Equity securities represented 6.3% of our investment portfolio at September 30, 2012.

Given current economic uncertainty and continuing market volatility, we believe that our current asset allocation best meets our strategy to preserve capital for policyholders, to provide sufficient income to support insurance operations, and to effectively grow book value over a long-term investment horizon.

The following table shows the estimated fair value, the percentage of the fair value to total invested assets, and the average tax equivalent yield based on the fair value of each category of invested assets as of September 30, 2012.

| Category                               | Estimated Fair Value | Percentage of Total | Yield |   |
|----------------------------------------|----------------------|---------------------|-------|---|
| (in thousands, except percentages)     |                      |                     |       |   |
| U.S. Treasuries                        | \$147,297            | 7.2                 | % 2.5 | % |
| U.S. Agencies                          | 94,560               | 4.7                 | 3.2   |   |
| States and municipalities              | 773,194              | 38.0                | 5.8   |   |
| Corporate securities                   | 583,799              | 28.7                | 4.2   |   |
| Residential mortgage-backed securities | 254,477              | 12.5                | 4.5   |   |
| Commercial mortgage-backed securities  | 38,466               | 1.9                 | 3.5   |   |
| Asset-backed securities                | 13,797               | 0.7                 | 2.4   |   |
| Equity securities                      | 128,158              | 6.3                 | 5.3   |   |
| Total                                  | \$2,033,748          | 100.0               | %     |   |
| Weighted average yield                 |                      |                     | 4.7   | % |

The following table shows the percentage of total estimated fair value of our fixed maturity securities as of September 30, 2012 by credit rating category, using the lower of ratings assigned by Moody's Investor Services and/or Standard & Poor's.

| Rating                 | Percentage of Total Estimated Fair Value |   |
|------------------------|------------------------------------------|---|
| "AAA"                  | 9.7                                      | % |
| "AA"                   | 56.3                                     |   |
| "A"                    | 22.0                                     |   |
| "BBB"                  | 11.9                                     |   |
| Below investment grade | 0.1                                      |   |
| Total                  | 100.0                                    | % |

Investments that we currently own could be subject to default by the issuer or could suffer declines in fair value that become other-than-temporary. We regularly assess individual securities as part of our ongoing portfolio management, including the identification of other-than-temporary declines in fair value. Our other-than-temporary assessment includes reviewing the extent and duration of declines in fair value of investments below amortized cost, historical and projected financial performance and near-term prospects of the issuer, the outlook for industry sectors, credit rating, and macro-economic changes. We also make a determination as to whether it is not more likely than not that we will be required to sell the security before its fair value recovers above cost, or to maturity.

Based on our review of fixed maturity and equity securities, we believe that we appropriately identified the declines in the fair values of our unrealized losses at September 30, 2012. We determined that the unrealized losses on fixed maturity securities were primarily the result of prevailing interest rates and not the credit quality of the issuers. The fixed maturity securities whose fair value was less than amortized cost were not determined to be other-than-temporarily impaired given the severity and duration of the impairment, the credit quality of the issuers, the Company's intent to not sell the securities, and a determination that it is not more likely than not that the Company will be required to sell the securities until fair value recovers to above cost, or to maturity.

Based on reviews of the equity securities as of September 30, 2012, the Company recognized total impairments of \$0.5 million in the fair values of seven equity securities as a result of the severity and duration of the change in fair

values of those securities.

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The cost or amortized cost, gross unrealized gains, gross unrealized losses, and estimated fair value of our investments were as follows:

|                                         | Cost or<br>Amortized<br>Cost<br>(in thousands) | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|-----------------------------------------|------------------------------------------------|------------------------------|-------------------------------|-------------------------|
| At September 30, 2012                   |                                                |                              |                               |                         |
| Fixed maturity securities               |                                                |                              |                               |                         |
| U.S. Treasuries                         | \$ 132,747                                     | \$ 14,550                    | \$ —                          | \$ 147,297              |
| U.S. Agencies                           | 88,259                                         | 6,301                        | —                             | 94,560                  |
| States and municipalities               | 700,029                                        | 73,165                       | —                             | 773,194                 |
| Corporate securities                    | 531,578                                        | 52,252                       | (31)                          | 583,799                 |
| Residential mortgaged-backed securities | 234,856                                        | 19,731                       | (110)                         | 254,477                 |
| Commercial mortgaged-backed securities  | 36,952                                         | 1,514                        | —                             | 38,466                  |
| Asset-backed securities                 | 13,528                                         | 270                          | (1)                           | 13,797                  |
| Total fixed maturity securities         | 1,737,949                                      | 167,783                      | (142)                         | 1,905,590               |
| Equity securities                       | 80,897                                         | 48,232                       | (971)                         | 128,158                 |
| Total investments                       | \$ 1,818,846                                   | \$ 216,015                   | \$ (1,113)                    | \$ 2,033,748            |

#### Contractual Obligations and Commitments

The following table identifies our long-term debt and contractual obligations as of September 30, 2012:

|                                           | Payment Due By Period |                     |           |           |                      |
|-------------------------------------------|-----------------------|---------------------|-----------|-----------|----------------------|
|                                           | Total                 | Less Than<br>1-Year | 1-3 Years | 4-5 Years | More Than<br>5-Years |
|                                           | (in thousands)        |                     |           |           |                      |
| Operating leases                          | \$25,559              | \$1,742             | \$13,345  | \$8,007   | \$2,465              |
| Purchased liabilities                     | 117                   | 117                 | —         | —         | —                    |
| Notes payable <sup>(1)</sup>              | 156,461               | 10,705              | 25,172    | 63,836    | 56,748               |
| Capital leases                            | 2,129                 | 316                 | 902       | 799       | 112                  |
| Losses and LAE reserves <sup>(2)(3)</sup> | 2,304,424             | 272,807             | 337,167   | 220,969   | 1,473,481            |
| Total contractual obligations             | \$2,488,690           | \$285,687           | \$376,586 | \$293,611 | \$1,532,806          |

Notes payable obligations reflect payments for the principal and estimated interest expense based on LIBOR rates (1) plus a margin. The estimated interest expense was based on the contractual obligations of the debt outstanding as of September 30, 2012. The interest rates range from 1.5% to 4.7%.

Estimated losses and LAE reserve payment patterns have been computed based on historical information. Our calculation of loss and LAE reserve payments by period is subject to the same uncertainties associated with determining the level of reserves and to the additional uncertainties arising from the difficulty of predicting when (2) claims (including claims that have not yet been reported to us) will be paid. Actual payments of losses and LAE by period will vary, perhaps materially, from the above table to the extent that current estimates of losses and LAE reserves vary from actual ultimate claims amounts due to variations between expected and actual payout patterns.

The losses and LAE reserves are presented gross of reinsurance recoverables for unpaid losses, which are as (3) follows for each of the periods presented above:

|                          | Recoveries By Period |                     |           |           |                      |
|--------------------------|----------------------|---------------------|-----------|-----------|----------------------|
|                          | Total                | Less Than<br>1-Year | 1-3 Years | 4-5 Years | More Than<br>5-Years |
|                          | (in thousands)       |                     |           |           |                      |
| Reinsurance recoverables | \$912,877            | \$44,506            | \$86,992  | \$83,725  | \$697,654            |

#### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.



### Critical Accounting Policies

These unaudited interim consolidated financial statements include amounts based on the use of estimates and judgments of management for those transactions that are not yet complete. We believe that the estimates and judgments that were most critical to the preparation of the consolidated financial statements involved the following: (a) reserves for losses and LAE; (b) reinsurance recoverables; (c) recognition of premium income; (d) deferred income taxes; (e) valuation of investments; and (f) goodwill and intangible asset impairment. These estimates and judgments require the use of assumptions about matters that are highly uncertain and therefore are subject to change as facts and circumstances develop. Our accounting policies are discussed under "Critical Accounting Policies" in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report.

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

Market risk is the risk of potential economic loss principally arising from adverse changes in the fair value of financial instruments. The major components of market risk affecting us are credit risk, interest rate risk, and equity price risk, and are described in detail in our Annual Report. We have not experienced any material changes in market risk since December 31, 2011.

The primary market risk exposure to our investment portfolio, which consists primarily of fixed maturity securities, is interest rate risk. We have the ability to hold fixed maturity securities to maturity and we strive to limit interest rate risk by managing duration. As of September 30, 2012, our fixed maturity securities portfolio had a duration of 4.1. We continually monitor the impact of interest rate changes on our investment portfolio and liquidity obligations. Changes to our market risk, if any, since December 31, 2011 are reflected in Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements contained in this Form 10-Q.

### Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report. There have not been any changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

From time-to-time, the Company is involved in pending and threatened litigation in the normal course of business in which claims for monetary damages are asserted. In the opinion of management, the ultimate liability, if any, arising from such pending or threatened litigation is not expected to have a material effect on our results of operations, liquidity, or financial position.

## Item 1A. Risk Factors

We have disclosed in our Annual Report the most significant risk factors that can impact year-to-year comparisons and that may affect the future performance of the Company's business. On a quarterly basis, we review these disclosures and update the risk factors, as appropriate. As of the date of this report, there have been no material changes to the risk factors contained in our Annual Report.

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

The following table summarizes the repurchases of our common stock for the three months ended September 30, 2012:

| Period                           | Total Number of Shares Purchased | Average Price Paid Per Share <sup>(1)</sup> | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet be Purchased Under the Program <sup>(2)</sup><br>(in millions) |
|----------------------------------|----------------------------------|---------------------------------------------|------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
| July 1 – July 31, 2012           | 136,137                          | \$17.81                                     | 136,137                                                                | \$53.2                                                                                                         |
| August 1 – August 31, 2012       | 92,427                           | 17.73                                       | 92,427                                                                 | 51.6                                                                                                           |
| September 1 – September 30, 2012 | —                                | —                                           | —                                                                      | 51.6                                                                                                           |
| Total                            | 228,564                          | \$17.77                                     | 228,564                                                                |                                                                                                                |

(1) Includes fees and commissions paid on stock repurchases.

On November 3, 2010, the Board of Directors authorized a share repurchase program for repurchases of up to \$100 million of the Company's common stock (the 2011 Program). On November 2, 2011, the Board of Directors

(2) authorized a \$100 million expansion of the 2011 Program, to \$200 million. We expect that shares may be purchased at prevailing market prices through June 30, 2013 through a variety of methods, including open market or private transactions, in accordance with applicable laws and regulations and as determined by management.

The timing and actual number of shares repurchased will depend on a variety of factors, including the share price, corporate and regulatory requirements, and other market and economic conditions. Repurchases under the 2011 Program may be commenced, modified, or suspended from time to time without prior notice, and the program may be suspended or discontinued at any time.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit No. | Description of Exhibit                                    | Included Herewith | Incorporated by Reference Herein |         |             |
|-------------|-----------------------------------------------------------|-------------------|----------------------------------|---------|-------------|
|             |                                                           |                   | Form                             | Exhibit | Filing Date |
| 31.1        | Certification of Douglas D. Dirks Pursuant to Section 302 | X                 |                                  |         |             |
| 31.2        | Certification of William E. Yocke Pursuant to Section 302 | X                 |                                  |         |             |
| 32.1        | Certification of Douglas D. Dirks Pursuant to Section 906 | X                 |                                  |         |             |
| 32.2        | Certification of William E. Yocke Pursuant to Section 906 | X                 |                                  |         |             |
| *101.INS    | XBRL Instance Document                                    | X                 |                                  |         |             |
| *101.SCH    | XBRL Taxonomy Extension Schema Document                   | X                 |                                  |         |             |
| *101.CAL    | XBRL Taxonomy Extension Calculation Linkbase Document     | X                 |                                  |         |             |
| *101.DEF    | XBRL Taxonomy Extension Definition Linkbase Document      | X                 |                                  |         |             |
| *101.LAB    | XBRL Taxonomy Extension Label Linkbase Document           | X                 |                                  |         |             |
| *101.PRE    | XBRL Taxonomy Extension Presentation Linkbase Document    | X                 |                                  |         |             |

\*XBRL (eXtensible Business Reporting Language) information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

SIGNATURES

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

EMPLOYERS HOLDINGS, INC.

Date: November 8, 2012

/s/ Douglas D. Dirks  
Douglas D. Dirks  
President and Chief Executive Officer  
Employers Holdings, Inc.

Date: November 8, 2012

/s/ William E. Yocke  
William E. Yocke  
Executive Vice President and Chief Financial Officer  
Employers Holdings, Inc.  
(Principal Financial and Accounting Officer)