

National Interstate CORP
Form 11-K
June 20, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 11-K

ANNUAL REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES
AND EXCHANGE ACT OF 1934

ANNUAL REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934 *(No fee required, effective October 7, 1996)*
For the fiscal year ended December 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934 *(No fee required)*
For the transition period from _____ to _____

Commission file number _____

A. Full title of the plan and the address of the plan, if different from that of the issuer named below:

National Interstate Savings and Profit Sharing Plan

**B. Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:
National Interstate Corporation**

3250 Interstate Drive

Richfield, Ohio 44286-9000

Table of Contents

NATIONAL INTERSTATE
SAVINGS AND PROFIT SHARING PLAN
FINANCIAL STATEMENTS
WITH
REPORT OF INDEPENDENT
REGISTERED PUBLIC ACCOUNTING FIRM
December 31, 2007

Table of Contents

INDEX

	Page
<u>Report of Independent Registered Public Accounting Firm</u>	
Financial Statements:	
<u>Statement of Net Assets Available for Benefits</u>	2
<u>Statement of Changes in Net Assets Available for Benefits</u>	3
<u>Notes to Financial Statements</u>	4 - 11
<u>Supplemental Schedule:</u>	
<u>Schedule of Assets Held for Investment Purposes at End of Year</u>	12

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Plan Administrator

National Interstate Savings and Profit Sharing Plan

Richfield, Ohio

We have audited the accompanying Statement of Net Assets Available for Benefits of the NATIONAL INTERSTATE SAVINGS AND PROFIT SHARING PLAN and the related Statement of Changes in Net Assets Available for Benefits for the years ended December 31, 2007 and 2006. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes the consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of National Interstate Savings and Profit Sharing Plan as of December 31, 2007 and 2006, and the changes in its net assets available for benefits for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying supplemental schedule of assets held (at end of year) as of December 31, 2007, is presented for the purposes of additional analysis and is not a required part of the financial statements but is supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedule is the responsibility of the Plan's management. The supplemental information has been subjected to the auditing procedures applied in our audits of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

/s/ MEADEN & MOORE, LTD.

Certified Public Accountants

June 12, 2008

Cleveland, Ohio

Table of Contents

STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS

National Interstate

Savings and Profit Sharing Plan

	December 31	
	2007	2006
ASSETS		
Receivable - Employer contributions	\$ 436,906	\$ 375,102
Receivable - Employee contributions		28,442
Total Receivables	436,906	403,544
Investments (at fair value):		
Thornburg International Value	1,186,207	
Victory Special Value	63,784	
Oppenheimer Main St Small Cap	700,434	
American Funds Growth Fund of America	824,120	
Franklin Strategic Income	386,134	
MFS Value	384,870	
MFS Conservative Allocation	184,293	
MFS Lifetime Retirement Income	982	
MFS Lifetime 2010	144,532	
MFS Lifetime 2020	425,082	
MFS Lifetime 2030	470,389	
MFS Lifetime 2040	451,494	
T. Rowe Price Equity Income	945,767	
Franklin Total Return Fund-A	4,532	
National Interstate Corp Stock Fund	50,335	
MFS Fixed Fund	901,731	
Guaranteed Investment Contracts		1,347,071
Mass Mutual Blue Chip Growth		607,425
Mass Mutual Core Bond		348,562
Mass Mutual Core Equity		287,685
Mass Mutual D-Aggressive		344,586
Mass Mutual D-Conservative		109,925
Mass Mutual D-Moderate		546,529
Mass Mutual D-Ultra Aggressive		373,925
Mass Mutual Discovery		567,263
Mass Mutual Equity Income		488,086
Mass Mutual Indexed Equity		328,411
Mass Mutual International Equity		740,254
Participant Loans	127,228	116,425
Total Investments	7,251,914	6,206,147
Total Assets	7,688,820	6,609,691
LIABILITIES		
Net Assets Reflecting all Investments at Fair Value	7,688,820	6,609,691
Adjustment from fair value to contract value for fully benefit- responsive investment contracts	8,889	20,874
Net Assets Available for Benefits	\$ 7,697,709	\$ 6,630,565

See accompanying notes.

Table of Contents

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

National Interstate

Savings and Profit Sharing Plan

	Year Ended December 31	
	2007	2006
Additions to Net Assets Attributed to:		
Contributions:		
Employer	\$ 436,906	\$ 375,102
Employee	771,886	660,205
Other (including rollovers)	113,324	202,504
	1,322,116	1,237,811
Interest and dividend income	9,998	52,241
Net unrealized/realized appreciation	588,059	484,800
Total Additions	1,920,173	1,774,852
Deductions from Net Assets Attributed to:		
Benefits paid to participants	851,192	944,036
Administrative expenses	1,837	25,807
Total Deductions	853,029	969,843
Net Increase	1,067,144	805,009
Net Assets Available for Benefits:		
Beginning of Year	6,630,565	5,825,556
End of Year	\$ 7,697,709	\$ 6,630,565

See accompanying notes.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

1 Description of Plan

The following description of The National Interstate Savings and Profit Sharing Plan (the Plan) provides only general information. Participants should refer to the Plan document for a complete description of the Plan's provisions.

General:

The Plan, which began March 30, 1989, is a defined contribution plan covering all employees of National Interstate Corporation and its Subsidiaries (the Company) who meet the hour and age requirements. Effective January 1, 2007, employees from our United States Virgin Islands office, Hudson Management Group, are also included in the Plan.

The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

Eligibility:

Any employee who has completed 3 months of service and has attained age 18 shall be eligible to participate in the Plan.

Contributions:

Cash or Deferred Option - Participants may elect to contribute to the Plan 1% to 100% of their compensation by the Company, subject to the dollar limit which is set by law.

Employer Contributions - The Company may make discretionary profit sharing contributions. These contributions are allocated to participants who meet the eligibility requirements to share in the contribution for the plan year. Employees must complete a year of service during the Plan year and be actively employed on the last day of the Plan year to share in this discretionary profit sharing contribution. Employees will have completed a year of service for purposes of receiving a discretionary profit sharing contribution if they are credited with at least 1,000 hours of service during a Plan year.

The contribution is an amount equal to a specified percentage of employees' compensation as determined by the Company. The Company made contributions of \$436,907 and \$375,102 for the years ended 2007 and 2006, respectively.

Rollover contributions from other Plans are also accepted, providing certain specified conditions are met.

Contributions are subject to limitations on annual additions and other limitations imposed by the Internal Revenue Code as defined in the Plan agreement.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

1 Description of Plan, Continued

Participants Accounts:

401(k) Accounts - Each participant's account is credited with the participant's elective contributions, employer discretionary contributions, earnings and losses thereon.

Vesting:

All participants are 100% vested in elective deferrals and rollover contributions made to the Plan. Participants become 100% vested in Company contributions made prior to December 31, 2006, after five years of service and contributions made subsequent to December 31, 2006, after three years of service.

Forfeitures:

Forfeited non-vested accounts totaled \$132,053 and \$251,670 as of December 31, 2007 and 2006, respectively. The Company utilizes forfeiture amounts to pay Plan administrative expenses and employer contributions.

Participants Loans:

Loans are permitted under certain circumstances and are subject to limitations. Participants may have no more than four outstanding loans borrowed from their fund accounts up to a maximum equal to the lesser of \$50,000 or 50% of their vested account balance. Loans are repaid over a period not to exceed 5 years with exceptions for the purchase of a primary residence.

The loans are secured by the balance in the participant's account and bear interest. The Administrator determines a reasonable rate of interest. Principal and interest are paid ratably through payroll deductions.

Other Plan Provisions:

Normal retirement age is 65; however, a participant may elect early retirement on or after age 55. The Plan also provides for early payment of benefits after reaching age 59- 1/12.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

1 Description of Plan, Continued

Payment of Benefits:

Upon termination of service by reason of retirement, death or total and permanent disability, a participant receives a lump sum amount equal to the vested value of his or her account unless another form of payment is elected.

Hardship Withdrawals:

Hardship withdrawals are permitted in accordance with Internal Revenue Service guidelines.

Investment Options:

Upon enrollment in the Plan, a participant may direct his or her contributions in any of the investment options offered by the Plan.

Company Shares:

On August 7, 2007, the Company filed a Form S-8 registration statement with the Securities and Exchange Commission registering 250,000 shares to be offered in the Plan. Effective August 2007, participants in the Plan can now choose to invest in the Company Stock Fund, which is invested in shares of National Interstate Corporation common stock.

2 Summary of Significant Accounting Policies

Basis of Accounting:

The Plan's transactions are reported on the accrual basis of accounting. Registered investment companies and pooled separate accounts are reported at fair market value as of the balance sheet date. Fair market values represent quoted market prices or, if quoted market prices are not available, estimated fair values as determined by a registered broker or investment banker. The fair value of the common collective trust, or investment contracts, in 2007 and guaranteed investment contracts in 2006 are calculated by discounting the related cash flows based on current yields of similar instruments with comparable durations. Loans are valued at cost, which approximates fair value.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

2 Summary of Significant Accounting Policies, Continued

As described in Financial Accounting Standards Board Staff Position, FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Contracts Held by Certain Investment Companies subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans (the FSP)*, investment contracts held by a defined contribution plan are required to be reported at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined contribution plan attributable to fully benefit-responsive investment contracts because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan. As required by the FSP, the Statements of Net Assets Available for Benefits presents the fair value of the investment contracts as well as the adjustment of the fully benefit-responsive investment contracts from fair value to contract value. The Statement of Changes in Net Assets Available for Benefits is prepared on a contract value basis.

Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions to net assets during the reporting period. Actual results could differ from those estimates.

Administrative Fees:

Substantially all administrative fees are paid by the Company.

Plan Termination:

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts. Upon full termination of the plan, the Employer shall direct the distribution of the assets of the Trust Fund to Participants in a manner which is consistent with and satisfies the Distribution of Benefits provision of the Plan. Distributions to a participant shall be made in cash or through the purchase of irrevocable nontransferable deferred commitments from an insurer.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

2 Summary of Significant Accounting Policies, Continued

Risks and Uncertainties:

The Plan's investments include investments in registered investment companies and a common collective trust in 2007 and pooled separate accounts and an insurance company general account in 2006 that have varying degrees of risk, such as interest rate, credit and overall market volatility risks. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and such changes could materially affect the amounts reported in the statement of net assets available for Plan benefits.

Reclassifications:

Certain prior year amounts have been reclassified to conform with the current year's presentation.

3 Tax Status

The Plan sponsor has obtained an opinion letter dated March 10, 1993, in which the Internal Revenue Service stated that the Plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code. The Plan has been amended; however, the Plan Administrator and the Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, they believe that the Plan was qualified and the related trust was tax-exempt as of the financial statement date.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

4 Investments

The Plan's funds are invested in the various registered investment companies and a common collective trust in 2007 and pooled separate accounts and guaranteed investment contracts in 2006 through Sun Life Retirement Services and Mass Mutual, respectively. Investments which constitute more than 5% of the Plan's net assets are:

	2007	2006
Thornburg International Value	\$ 1,186,207	\$
Oppenheimer Main St Small Cap	700,434	
American Funds Growth Fund of America	824,120	
Franklin Strategic Income	386,134	
MFS Value	384,870	
MFS Lifetime 2020	425,082	
MFS Lifetime 2030	470,389	
MFS Lifetime 2040	451,494	
T. Rowe Price Equity Income	945,767	
MFS Fixed Fund	901,731	
Guaranteed Investment Contracts		1,367,071
Mass Mutual Blue Chip Growth		607,425
Mass Mutual Core Bond		348,562
Mass Mutual D-Aggressive		344,586
Mass Mutual D-Moderate		546,529
Mass Mutual D-Ultra Aggressive		373,925
Mass Mutual Discovery		567,263
Mass Mutual Equity Income		488,086
Mass Mutual International Equity	\$	\$ 740,254

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

5 Party-in-Interest Transactions

Certain Plan investments in 2007 are registered investment companies managed by MFS Heritage Trust, the Trustee, and in 2006 were pooled separate accounts managed by Mass Mutual, the Trustee, as defined by the Plan, and therefore, these transactions qualify as party-in-interest. Usual and customary fees were paid by the mutual fund for the investment management and administrative services.

6 Investment Contract with Insurance Company

Effective December 21, 2006, and August 1, 2000, the Plan entered into benefit-responsive investment contracts with Sun Life Retirement Services and Massachusetts Mutual (Mass Mutual), respectively. Sun Life Retirement Services and Mass Mutual maintain the contributions in a general account. The account represents contributions and reinvested income, less any withdrawals plus accrued interest because the investments have fully benefit-responsive features. For example, participants may ordinarily direct the withdrawal or transfer of all or a portion of their investments at contract value. However, withdrawals influenced by Company-initiated events, such as in connection with the sale of a business, may result in a distribution other than at contract value.

As described in Note 2, because the contract is fully benefit-responsive, contract value is the relevant measurement attribute for that portion of the net assets available for benefits attributable to the stable value investment contract. Contract value, as reported by Sun Life Retirement Services and Mass Mutual, represent contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value.

There are no reserves against contract value for credit risk of the contract issuer or otherwise. The crediting interest rate is based on a formula agreed upon with the issuer. In 2007, the crediting interest rate with Sun Life Retirement for the common collective trust was a rate not less than 0%. The interest rate is reviewed periodically for resetting. In 2006, such interest rates with Mass Mutual were a rate not less than 3% and were reviewed twice annually for resetting.

Certain events limit the ability of the Plan to transact at contract value with the issuer. The Plan Administrator does not believe that the occurrence of any such value event that would limit the Plan's ability to transact at contract value with participants is probable.

Table of Contents

NOTES TO FINANCIAL STATEMENTS

National Interstate

Savings and Profit Sharing Plan

6 Investment Contract with Insurance Company, Continued

The average yield and crediting interest rate of the contract with Sun Life Retirements Services was 4.9% during the year ended December 31, 2007. The average yield and crediting interest rate of the contracts with Mass Mutual were 3.0% to 4.0% during the year ended December 31, 2006.

	Investments at Fair Value	2007 Adjustment to Contract Value	Investments at Contract Value
MFS Fixed Fund	\$ 901,731	\$ 8,889	\$ 910,620

	Investments at Fair Value	2006 Adjustment to Contract Value	Investments at Contract Value
Guaranteed Investment Contracts	\$ 1,347,071	\$ 20,874	\$ 1,367,945

7 Recently Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (FAS 157). This standard clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of FAS 157 will not impact the amounts reported in the financial statements; however, additional disclosures will be required to describe the inputs used to develop the measurements of fair value and the effect of certain measurements reported in the statement of operations for a fiscal period.

Table of Contents

SCHEDULE OF ASSETS HELD FOR INVESTMENT PURPOSES AT END OF YEAR

Form 5500, Schedule H, Part IV, Line 4i

National Interstate

Savings and Profit Sharing Plan

34-1607396

Plan Number 001

December 31, 2007

(a)	(b)	(c)	(d)	(e)
or Similar Party	Identity of Issue, Borrower, Lessor,	Description of Investment Including Maturity Date, Rate of Interest, Collateral, Par or Maturity Value	Cost	Current Value
*	Thornburg International Value	Registered Investment Company	N/A	\$ 1,186,207
*	Victory Special Value	Registered Investment Company	N/A	63,784
*	Oppenheimer Main St Small Cap	Registered Investment Company	N/A	700,434
*	American Funds Growth Fund of America	Registered Investment Company	N/A	824,120
*	Franklin Strategic Income	Registered Investment Company	N/A	386,134
*	MFS Value	Registered Investment Company	N/A	384,870
*	MFS Conservative Allocation	Registered Investment Company	N/A	184,293
*	MFS Lifetime Retirement Income	Registered Investment Company	N/A	982
*	MFS Lifetime 2010	Registered Investment Company	N/A	144,532
*	MFS Lifetime 2020	Registered Investment Company	N/A	425,082
*	MFS Lifetime 2030	Registered Investment Company	N/A	470,389
*	MFS Lifetime 2040	Registered Investment Company	N/A	451,494
*	T. Rowe Price Equity Income	Registered Investment Company	N/A	945,767
*	Franklin Total Return Fund-A	Registered Investment Company	N/A	4,532
*	National Interstate Corp Stock Fund	Common Stock	N/A	50,335
*,^^	MFS Fixed Fund	Common Collective Trust	N/A	910,620
*	Participant Loans	Notes Receivable (8.25%-9.25%, at various maturity dates)		127,228
				\$ 7,260,803

* Party-in-interest to the Plan. 41,312

Receipt of advance payments on purchase contracts	2,645,154	1,674,403
Recognition of advance payments on	(1,915,247)	(796,094)

Edgar Filing: National Interstate CORP - Form 11-K

purchase contracts		
Deferred income taxes	(4,108,000)	(5,780,000)
Changes in operating assets and liabilities:		
Receivables	821,684	(2,538,159)
Inventory	(13,534,677)	(3,507,715)
Other assets	5,789,269	(2,475,994)
Accounts payable and accrued expenses	8,268,120	(2,726,619)
Net Cash Provided by Operating Activities	52,760,003	30,563,672
Cash Flows from Investing Activities:		
Proceeds from sales of property and equipment	510,809	623,321
Capital expenditures	(42,727,205)	(43,703,702)
Net Cash Used in Investing Activities	(42,216,396)	(43,080,381)
Cash Flows from Financing Activities:		
Proceeds from short-term borrowings	216,580,400	
Payments on short-term borrowings	(218,885,400)	
Principal payments on long-term debt	(5,933,601)	(8,786,030)
Proceeds from exercise of stock options	212,242	515,853
Dividends paid	(7,716,659)	(7,698,131)

Edgar Filing: National Interstate CORP - Form 11-K

Net Cash Used in Financing Activities		(15,743,018)		(15,968,308)
Net Decrease in Cash and Cash Equivalents		(5,199,411)		(28,485,017)
Cash and cash equivalents at beginning of period		17,540,306		50,626,448
Cash and Cash Equivalents at End of Period	\$	12,340,895	\$	22,141,431

See notes to unaudited interim financial statements.

Table of Contents

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED INTERIM FINANCIAL STATEMENTS

Six Months Ended March 31, 2007 and March 25, 2006

A. BASIS OF PREPARATION

In the opinion of management, the accompanying unaudited interim financial statements contain all adjustments necessary to present fairly the Company's financial position as of March 31, 2007, the results of operations for the three-month and six-month periods ended March 31, 2007 and March 25, 2006, and the changes in stockholders' equity and cash flows for the six-month periods ended March 31, 2007 and March 25, 2006. The adjustments made are of a normal recurring nature. Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission for Form 10-Q. It is suggested that these unaudited interim financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Annual Report on Form 10-K for the year ended September 30, 2006 and the Form 10-Q for the fiscal quarter ended March 25, 2006, filed by the Company under the Securities Exchange Act of 1934 on December 1, 2006 and May 2, 2006, respectively.

The results of operations for the three-month and six-month periods ended March 31, 2007 are not necessarily indicative of the results to be expected for the full fiscal year.

Certain amounts for the three-month and six-month periods ended March 25, 2006 have been reclassified to conform to the current year presentation in the accompanying financial statements.

B. NEW ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FAS 109, Accounting for Income Taxes (FIN 48), to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition of tax provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN 48 as of September 30, 2007, as required. The Company is currently evaluating the impact of FIN 48 on its consolidated financial statements.

C. ALLOWANCE FOR DOUBTFUL ACCOUNTS

Receivables are presented net of an allowance for doubtful accounts of \$944,000 and \$845,000 at March 31, 2007 and September 30, 2006, respectively.

D. ACCRUED EXPENSES AND CURRENT PORTION OF OTHER LONG-TERM LIABILITIES

Accrued expenses and current portion of other long-term liabilities consist of the following:

	MARCH 31,	SEPTEMBER 30,
	2007	2006
Property, payroll, and other taxes payable	\$ 11,478,827	\$ 17,865,518
Salaries, wages and bonuses payable	16,261,276	19,602,902
Self-insurance reserves	8,348,405	8,524,499
Interest	11,815,819	11,855,031
Income taxes	9,975,446	2,175,447
Other	12,150,516	12,902,174

\$ 70,030,289 \$ 72,925,571

Self-insurance liabilities are established for workers compensation and employee group medical and dental benefits based on claims filed and estimates of claims incurred but not reported. The Company is insured for covered costs in excess of \$750,000 per occurrence for workers compensation and \$250,000 per covered person for medical care benefits for a policy year. Employee insurance expense, including workers compensation and medical care benefits, net of employee contributions, totaled \$6.2 million and \$5.0 million for the three-month periods ended March 31, 2007 and March 25, 2006, respectively. For the six-month periods ended March 31, 2007 and March 25, 2006, employee insurance expense, net of employee contributions, totaled \$11.7 million and \$11.3 million, respectively.

Table of Contents

E. LONG-TERM DEBT

At March 31, 2007, the Company had lines of credit with six banks totaling \$150.0 million, of which \$1.6 million was outstanding at March 31, 2007. The lines of credit mature between October 2007 and February 2010. At March 31, 2007, the Company had issued \$15.7 million in unused letters of credit that reduced the amounts available to be drawn under its lines of credit. The letters of credit mature from May 2007 to February 2008. The lines provide the Company with various interest rate options generally at rates less than prime. The Company is not required to maintain compensating balances in connection with these lines of credit. The lines of credit contain provisions that under certain circumstances would permit lending institutions to terminate or withdraw their respective extensions of credit to the Company. Included among the triggering factors permitting the termination or withdrawal of lines of credit to the Company are certain events of default, including both monetary and non-monetary defaults, the initiation of bankruptcy or insolvency proceedings, and the failure of the Company to meet certain financial covenants designated in its respective loan documents. The Company was in compliance with all financial covenants related to these lines of credit at March 31, 2007.

Long-term debt and lines of credit agreements contain various restrictive covenants requiring, among other things, minimum levels of net worth and maintenance of certain financial ratios. One of the covenants has the effect of restricting funds available for dividends to approximately \$113.9 million, based on tangible net worth at March 31, 2007. As of March 31, 2007, the Company was in compliance with these covenants.

F. DIVIDENDS

The Company paid cash dividends of \$0.165 for each share of Class A Common Stock and \$0.15 for each share of Class B Common Stock on January 30, 2007 and October 26, 2006 to stockholders of record on January 16, 2007 and October 12, 2006, respectively.

G. COMMON STOCK AND CALCULATION OF EARNINGS PER COMMON SHARE

The Company has two classes of common stock: Class A which is publicly traded, and Class B, which has no public market. The Class B Common Stock has restrictions on transfer; however, each share is convertible into one share of Class A Common Stock at any time. During the six months ended March 31, 2007, 151,298 shares of Class B Common Stock were converted to Class A Common Stock, including 125,000 shares of Class B Common Stock owned by the Ingles Investment/Profit Sharing Plan (the Plan). The Plan then sold the Class A Common Stock to meet distribution and asset diversification requests from Plan participants. Each share of Class A Common Stock has one vote per share and each share of Class B Common Stock has ten votes per share. Each share of Class A Common Stock is entitled to receive cash dividends equal to 110% of any cash dividend paid on Class B Common Stock.

The Company has determined that, under Emerging Issues Task Force (EITF) Issue 03-6, Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings per Share, the two-class method of computing earnings per share is required.

The two-class method of computing basic earnings per share for each period reflects the cash dividends paid per share for each class of stock, plus the amount of allocated undistributed earnings per share computed using the participation percentage, which reflects the dividend rights of each class of stock. Diluted earnings per share is calculated assuming the exercise of dilutive stock options outstanding and the conversion of all shares of Class B Common Stock to shares of Class A Common Stock on a share-for-share basis. The tables below reconcile the numerators and denominators of basic and diluted earnings per share for current periods.

	Three Months Ended		Six Months Ended	
	March 31, 2007		March 31, 2007	
	Class A	Class B	Class A	Class B
<i>Numerator: Allocated net income</i>				
Net income allocated, basic	\$ 7,052,497	\$ 6,454,247	\$ 12,871,083	\$ 11,803,246
Conversion of Class B to Class A shares	6,453,566		11,802,121	
Effect of assumed stock options exercised on allocated net income	681	(681)	1,125	(1,125)
Net income allocated, diluted	\$ 13,506,744	\$ 6,453,566	\$ 24,674,329	\$ 11,802,121

Edgar Filing: National Interstate CORP - Form 11-K

Denominator: Weighted average shares outstanding

Weighted average shares outstanding, basic	12,213,914	12,294,512	12,200,473	12,303,667
Conversion of Class B to Class A shares	12,294,512		12,303,667	
Assumed stock options exercised	3,458		3,243	

Weighted average shares outstanding, diluted	24,511,884	12,294,512	24,507,383	12,303,667
--	------------	------------	------------	------------

Earnings per share

Basic	\$ 0.58	\$ 0.53	\$ 1.06	\$ 0.96
-------	---------	---------	---------	---------

Diluted	\$ 0.55	\$ 0.53	\$ 1.01	\$ 0.96
---------	---------	---------	---------	---------

Table of Contents

	Three Months Ended		Six Months Ended	
	March 25, 2006		March 25, 2006	
	Class A	Class B	Class A	Class B
<i>Numerator: Allocated net income</i>				
Net income allocated, basic	\$ 4,897,006	\$ 4,544,062	\$ 8,922,158	\$ 8,289,297
Conversion of Class B to Class A shares	4,541,572		8,284,022	
Effect of assumed stock options exercised on allocated net income	2,490	(2,490)	5,275	(5,275)
Net income allocated, diluted	\$ 9,441,068	\$ 4,541,572	\$ 17,211,455	\$ 8,284,022
<i>Denominator: Weighted average shares outstanding</i>				
Weighted average shares outstanding, basic	12,114,025	12,350,715	12,101,623	12,357,830
Conversion of Class B to Class A shares	12,350,715		12,357,830	
Assumed stock options exercised	21,632		21,175	
Weighted average shares outstanding, diluted	24,486,372	12,350,715	24,480,628	12,357,830
Earnings per share				
Basic	\$ 0.41	\$ 0.37	\$ 0.74	\$ 0.67
Diluted	\$ 0.38	\$ 0.37	\$ 0.70	\$ 0.67

H. LINES OF BUSINESS

The Company operates three lines of business: retail grocery sales, shopping center rentals, and a fluid dairy processing plant. All of the Company's operations are domestic. Information about the Company's operations by lines of business (in thousands) is as follows:

	Three Months Ended		Six Months Ended	
	MARCH 31,	MARCH 25,	MARCH 31,	MARCH 25,
	2007	2006	2007	2006
Revenues from unaffiliated customers:				
Grocery sales	\$ 652,050	\$ 579,155	\$ 1,310,433	\$ 1,174,978
Shopping center rentals	3,198	3,164	6,393	6,369
Fluid dairy	29,115	27,494	56,430	55,065
Total revenues from unaffiliated customers	\$ 684,363	\$ 609,813	\$ 1,373,256	\$ 1,236,412
Income from operations:				
Grocery sales	\$ 23,639	\$ 23,756	\$ 49,103	\$ 44,362
Shopping center rentals	1,281	1,300	2,304	2,584
Fluid dairy	3,430	2,751	6,365	5,218
Total income from operations	\$ 28,350	\$ 27,807	\$ 57,772	\$ 52,164
	MARCH 31,	SEPTEMBER 30,		
	2007	2006		

Edgar Filing: National Interstate CORP - Form 11-K

Assets:

Grocery sales	\$ 940,698	\$ 927,510
Shopping center rentals	120,626	121,083
Fluid dairy	27,186	28,125
Elimination of intercompany receivable	(1,046)	(1,744)
Total assets	\$ 1,087,464	\$ 1,074,974

Revenue from shopping center rentals is reported on the rental income, net line of the Condensed Consolidated Statements of Income. Grocery and fluid dairy revenues comprise net sales on the Condensed Consolidated Statements of Income.

For the three-month periods ended March 31, 2007 and March 25, 2006, respectively, the fluid dairy segment had \$13.4 million and \$12.2 million in sales to the grocery sales segment. The fluid dairy segment had \$26.2 million and \$24.5 million in sales to the grocery sales segment for the six-month periods ended March 31, 2007 and March 25, 2006, respectively. These sales have been eliminated in consolidation and are excluded from the amounts in the table above.

Table of Contents

I. TAX CONTINGENCY SETTLEMENT

During the quarter ended March 31, 2007 the Company settled a tax position under an initiative offered by one of the states in which the Company conducts its operations. As a result of this settlement, the Company reduced its reserve for contingent income tax liabilities by \$3.2 million. This reduction is reflected as a reduction of income tax expense for the three- and six-month periods ended March 31, 2007. Without this reduction, the effective tax rate would have been 38.1% for the six months ended March 31, 2007.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Ingles, a leading supermarket chain in the Southeast, operates 196 supermarkets in Georgia (73), North Carolina (65), South Carolina (35), Tennessee (20), Virginia (2) and Alabama (1). The Company locates its supermarkets primarily in suburban areas, small towns and rural communities. Ingles supermarkets offer customers a wide variety of nationally advertised food products, including grocery, meat and dairy products, produce, frozen foods and other perishables and non-food products, including health and beauty care products and general merchandise, as well as quality private label items. In addition, the Company focuses on selling high-growth, high-margin products to its customers through the development of book sections, media centers, floral departments, premium coffee kiosks, certified organic products, bakery departments and prepared foods including delicatessen sections. During fiscal 2000, the Company began adding fuel centers and pharmacies at select store locations. As of March 31, 2007, the Company operated 47 in-store pharmacies and 39 fuel centers.

Ingles also operates two other lines of business, fluid dairy processing and shopping center rentals. The fluid dairy processing segment sells approximately 32% of its products to the retail grocery segment and approximately 68% of its products to third parties. Real estate ownership (including the shopping center rental segment) is an important component of the Company's operations, providing both operational and economic benefit.

Critical Accounting Policies

Critical accounting policies are those accounting policies that management believes are important to the portrayal of Ingles' financial condition and results of operations, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Self-Insurance

The Company is self-insured for workers' compensation and group medical and dental benefits. Risks and uncertainties are associated with self-insurance; however, the Company has limited its exposure by maintaining excess liability coverages. Self-insurance liabilities are established based on claims filed and estimates of claims incurred but not reported. The estimates are based on data provided by the respective claims administrators. These estimates can fluctuate if historical trends are not predictive of the future. The majority of the Company's properties are self-insured for casualty losses and business interruption; however, liability coverage is maintained.

Asset Impairments

The Company accounts for the impairment of long-lived assets in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. For assets to be held and used, the Company tests for impairment using undiscounted cash flows and calculates the amount of impairment using discounted cash flows. For assets held for sale, impairment is recognized based on the excess of remaining book value over expected recovery value. The recovery value is the fair value as determined by independent quotes or expected sales prices developed by internal associates. Estimates of future cash flows and expected sales prices are judgments based upon the Company's experience and knowledge of local operations and cash flows that are projected for several years into the future. These estimates can fluctuate significantly due to changes in real estate market conditions, the economic environment, capital spending decisions and inflation. The Company monitors the carrying value of long-lived assets for potential impairment each quarter based on whether any indicators of impairment have occurred.

Closed Store Accrual

Edgar Filing: National Interstate CORP - Form 11-K

For properties closed prior to December 31, 2002 that were under long-term lease agreements, the present value of any remaining liability under the lease, discounted using risk-free rates and net of expected sublease recovery, is recognized as a liability and expensed. For all store closures subsequent to the adoption of Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities, effective December 31, 2002, the liability is recognized and expensed based on the difference between the present value of any remaining liability under the lease and the present value of the estimated market rate at which the Company expects to be able to sublease the properties. The Company's estimates of market rates are based on its experience, knowledge and typical third-party advice or market data. If the real estate and leasing markets change, sublease recovery

could vary significantly from the recoveries originally assumed, resulting in a material change in the Company's recorded liability. The closed store accrual is included in accrued expenses on the consolidated balance sheet.

Table of Contents

Vendor Allowances

The Company receives funds for a variety of merchandising activities from the many vendors whose products the Company buys for resale in its stores. These incentives and allowances are primarily comprised of volume or purchase based incentives, advertising allowances, slotting fees, and promotional discounts. The purpose of these incentives and allowances is generally to help defray the costs incurred by the Company for stocking, advertising, promoting and selling the vendor's products. These allowances generally relate to short term arrangements with vendors, often relating to a period of a month or less, and are negotiated on a purchase-by-purchase or transaction-by-transaction basis. Whenever possible, vendor discounts and allowances that relate to buying and merchandising activities are recorded as a component of item cost in inventory and recognized in merchandise costs when the item is sold. Due to system constraints and the nature of certain allowances, it is sometimes not practicable to apply allowances to the item cost of inventory. In those instances, the allowances are applied as a reduction of merchandise costs using a rational and systematic methodology, which results in the recognition of these incentives when the inventory related to the vendor consideration received is sold. Vendor allowances applied as a reduction of merchandise costs totaled \$24.3 million and \$24.9 million for the fiscal quarters ended March 31, 2007 and March 25, 2006, respectively. For the six-month periods ended March 31, 2007 and March 25, 2006, vendor allowances applied as a reduction of merchandise costs totaled \$45.9 million and \$46.3 million, respectively. Vendor advertising allowances that represent a reimbursement of specific identifiable incremental costs of advertising the vendor's specific products are recorded as a reduction to the related expense in the period that the related expense is incurred. Vendor advertising allowances recorded as a reduction of advertising expense totaled \$2.4 million for each of the fiscal quarters ended March 31, 2007 and March 25, 2006, respectively. For the six-month periods ended March 31, 2007 and March 25, 2006, vendor advertising allowances recorded as a reduction of advertising expense totaled \$4.8 million and \$4.6 million, respectively.

If vendor advertising allowances were substantially reduced or eliminated, the Company would likely consider other methods of advertising as well as the volume and frequency of its product advertising, which could increase or decrease our expenditures.

Similarly, the Company is not able to assess the impact of vendor advertising allowances on the creation of additional revenues, as it has no way to measure whether such allowances directly generate revenue for its stores.

Tax Contingencies

Despite the Company's belief that its tax positions are consistent with applicable tax laws, the Company believes that certain positions it has taken are likely to be challenged by taxing authorities. Settlement of any challenge can result in no change, a complete disallowance, or some partial adjustment reached through negotiations or litigation. Significant judgment is required in evaluating the Company's tax contingencies. The Company's contingencies are adjusted in light of changing facts and circumstances, such as the progress of its tax audits as well as evolving case law. Income tax expense includes the impact of contingency provisions and changes to contingencies that the Company considers appropriate. Unfavorable settlement of any particular issue would require use of cash. Favorable resolution would be recognized as a reduction to income tax expense at the time of resolution.

During the quarter ended March 31, 2007 the Company settled a tax position under an initiative offered by one of the states in which the Company conducts its operations. As a result of this settlement, the Company reduced its reserve for contingent income tax liabilities by \$3.2 million. This reduction is reflected as a reduction of income tax expense for the three- and six-month periods ended March 31, 2007.

Results of Operations

Ingles operates on a 52- or 53-week fiscal year ending on the last Saturday in September. There are 13 and 26 weeks of operations included in the unaudited condensed consolidated statements of income for the three- and six-month periods ended March 31, 2007 and March 25, 2006. Comparable store sales are defined as sales by grocery stores in operation for the entire duration of the previous and current fiscal periods. Sales from replacement stores, major remodels, minor remodels and the addition of fuel stations to existing stores are included in the comparable store sales calculation from the date thereof. A replacement store is a new store that is opened to replace an existing nearby store that is closed. A major remodel entails substantial remodeling of an existing store and may include additional retail square footage. A minor remodel includes repainting, remodeling and updating the lighting and equipment throughout an existing store. For the three- and six-month periods ended March 31, 2007 and March 25, 2006, comparable store sales include 194 and 193 stores, respectively.

Table of Contents

The following table sets forth, for the periods indicated, selected financial information as a percentage of net sales. For information regarding the various segments of the business, see Note H Lines of Business to the Unaudited Consolidated Financial Statements.

	Three Months Ended		Six Months Ended	
	MARCH 31,	MARCH 25,	MARCH 31,	MARCH 25,
	2007	2006	2007	2006
Net sales	100.0%	100.0%	100.0%	100.0%
Gross profit	24.5%	25.7%	24.2%	25.2%
Operating and administrative expenses	20.5%	21.3%	20.2%	21.2%
Rental income, net	0.2%	0.2%	0.2%	0.2%
Income from operations	4.2%	4.6%	4.2%	4.2%
Other income, net	0.1%	0.0%	0.1%	0.1%
Interest expense	1.8%	2.0%	1.8%	2.0%
Income before income taxes	2.5%	2.6%	2.5%	2.3%
Income taxes	0.5%	1.0%	0.7%	0.9%
Net income	2.0%	1.6%	1.8%	1.4%

Three Months Ended March 31, 2007 Compared to the Three Months Ended March 25, 2006

Net income for the second quarter of fiscal 2007 totaled \$13.5 million, 43.1% higher than net income of \$9.4 million earned for the second quarter of fiscal 2006. Total and comparable store sales increases were strong and gross profit dollars grew despite a decrease in gross profit as a percentage of sales. Settlement of a state income tax position decreased income tax expense by approximately \$3.2 million during the second quarter of fiscal 2007.

Net Sales. Net sales increased 12.3% to \$681.2 million for the three months ended March 31, 2007 from \$606.6 million for the three months ended March 25, 2006. Ingles operated 196 stores at March 31, 2007, compared to 197 stores at March 25, 2006. Retail square footage was approximately 9.6 million at March 31, 2007 and 9.5 million at March 25, 2006. Sales improved in each department except video, with the largest percentage increases in the gasoline, pharmacy, deli and bakery departments. The Company operated six additional pharmacy departments and eight additional fuel centers at March 31, 2007 compared to March 25, 2006. Pharmacy sales increased due to an increase in the number of prescriptions. Increases in the Company's deli and bakery departments reflect its customers' desire for convenience and quality in prepared foods.

Grocery segment comparable store sales grew \$71.9 million, or 12.4%, in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006. Excluding gasoline sales, comparable store sales increased \$48.1 million, or 8.9%, for the three months ended March 31, 2007. Total gasoline gallons sold increased approximately 62% while the average price per gas gallon was somewhat level comparing the March fiscal 2007 quarter to the same period of fiscal 2006.

Changes in grocery segment sales for the quarter ended March 31, 2007 are summarized as follows (in thousands):

Total grocery sales for the three months ended March 25, 2006	\$ 579,155
Comparable store sales increase (including gasoline)	71,875
Impact of stores opened in fiscal 2006 and 2007	2,827
Impact of stores closed in fiscal 2006 and 2007	(1,980)
Other	173
Total grocery sales for the three months ended March 31, 2007	\$ 652,050

Net sales to outside parties for the Company's milk processing subsidiary increased \$1.6 million or 5.9% in the March 2007 quarter compared to the March 2006 quarter. The sales increase is primarily attributable to an increase in the case volume of products sold which offset lower raw milk costs, which are generally passed on to customers in the pricing of milk products.

Edgar Filing: National Interstate CORP - Form 11-K

Gross Profit. Gross profit for the three-month period ended March 31, 2007 increased \$11.0 million, or 7.1%, to \$166.6 million, or 24.5% of sales, compared to \$155.6 million, or 25.7% of sales, for the three-month period ended March 25, 2006.

Gross profit dollars increased due to the higher sales volume in the grocery segment. Gross profit as a percentage of sales decreased primarily due to higher relative sales growth in the gasoline and pharmacy departments, which generally have lower gross margins. Excluding gasoline sales, grocery segment gross profit as a percentage of sales was 27.0% for the three months ended March 31, 2007 compared to 27.5% for the same quarter of last fiscal year. Increased competitive pressures, especially in gasoline, and food cost increases also contributed to lower grocery segment margins. The Company elected to accept lower margins in order to increase sales, maintain market share and keep prices low for its customers.

Gross profit for the Company's milk processing subsidiary for the March 2007 quarter increased \$1.1 million, or 21.5%, to \$6.3 million, or 14.8% of sales, compared to \$5.2 million, or 13.0% of sales, for the March 2006 quarter. Gross profit dollars increased due to higher case sales volume. Gross profit as a percentage of sales increased due to relatively level per-gallon margins applied to a lower per-gallon sales price.

Table of Contents

In addition to the direct product cost, cost of goods sold line for the grocery segment includes inbound freight charges. The milk processing segment is a manufacturing process; therefore, the inbound freight charges as well as purchasing and receiving costs, production costs, inspection costs, warehousing costs, internal transfer costs, and other costs of distribution incurred by the milk processing segment are included in the cost of sales line item, while these items are included in operating and administrative expenses by the grocery segment.

The Company's gross margins may not be comparable to those of other retailers, since some retailers include all of the costs related to their distribution network in cost of goods sold and others, like the Company, exclude a portion of the costs from gross profit, characterizing the costs as operating and administrative expenses.

Operating and Administrative Expenses. Operating and administrative expenses increased \$10.4 million, or 8.1%, to \$139.5 million for the three months ended March 31, 2007, from \$129.1 million for the three months ended March 25, 2006. As a percentage of sales, operating and administrative expenses decreased to 20.5% for the three months ended March 31, 2007 compared to 21.3% for the three months ended March 25, 2006. A variety of factors contributed to the dollar increase.

A breakdown of the major increases (decreases) in operating and administrative expenses is as follows:

	Increase	Increase
	(decrease)	(decrease)
	(decrease)	as a %
	in millions	of sales
Salaries and wages	\$ 5.0	(0.26)%
Warehouse expense	\$ 1.1	0.01%
Repairs and maintenance	\$ 0.9	0.01%
Bank charges	\$ 0.8	0.05%
Advertising and promotions	\$ 0.8	0.04%
Insurance	\$ 0.7	0.01%

Salaries and wages increased in dollars due to additional labor hours required for the increased sales volume, but decreased as a percentage of sales due to the allocation of management salaries over higher sales dollars and sales growth in less labor-intensive departments such as gasoline.

Warehouse expense increased due to additional labor costs needed to process increased volume of both incoming and outgoing product shipments.

Repairs and maintenance increased due to the replacement and upgrade of refrigeration equipment, product display and other store fixtures.

Bank charges rose primarily due to increased fees for processing debit and credit cards. The increase is a result of both increased usage of cards and increased transaction fees related to the usage.

Advertising and promotion costs increased in the frequency of print advertising and in additional promotions to targeted holders of the Company's Ingles Advantage Savings and Reward customer loyalty card.

Insurance expense increased due to increased employee health insurance costs.

Rental Income, Net. Rental income, net totaled \$1.3 million for both the quarters ended March 31, 2007 and March 25, 2006. Overall tenant activity and shopping center expenses have been relatively stable over the past twelve months.

Other Income, Net. Other income, net increased \$0.1 million to \$0.2 million for the three-month period ended March 31, 2007 from \$0.1 million for the three-month period ended March 25, 2006. The increase was due primarily to increased sales of waste paper and packaging, offset by decreased interest income.

Edgar Filing: National Interstate CORP - Form 11-K

Interest Expense. Interest expense decreased \$0.3 million for the three-month period ended March 31, 2007 to \$11.9 million from \$12.2 million for the three-month period ended March 25, 2006. Total debt at March 31, 2007 was \$548.1 million compared to \$560.6 million at March 25, 2006.

Income Taxes. Income tax expense as a percentage of pre-tax income decreased to 18.9% in the quarter ended March 31, 2007 compared to 39.7% in the quarter ended March 25, 2006 due to the settlement of a tax position under an initiative offered by one of the states in which the Company conducts its operations. As a result of this settlement the Company reduced its reserve for contingent income taxes by \$3.2 million and reduced income tax expense by the same amount during the three months ended March 31, 2007. Without this reduction, the effective tax rate would have been 38.3% for the three months ended March 31, 2007.

Net Income. Net income increased \$4.1 million, or 43.1%, for the three-month period ended March 31, 2007 to \$13.5 million compared to \$9.4 million for the three-month period ended March 25, 2006. Net income, as a percentage of sales, was 2.0% for the

Table of Contents

quarter ended March 31, 2007 and 1.6% for the quarter ended March 25, 2006. Basic and diluted earnings per share for Class A Common Stock were \$0.58 and \$0.55 for the quarter ended March 31, 2007 compared to \$0.41 and \$0.38, respectively, for the quarter ended March 25, 2006. Basic and diluted earnings per share for Class B Common Stock were each \$0.53 for the quarter ended March 31, 2007 compared to \$0.37 of basic and diluted earnings per share for the quarter ended March 25, 2006.

Six Months Ended March 31, 2007 Compared to the Six Months Ended March 25, 2006

Net income for the first six months of fiscal 2007 totaled \$24.7 million, 43.4% higher than net income of \$17.2 million earned for the first six months of fiscal 2006. Total and comparable store sales increases were strong and gross profit dollars grew despite a decrease in gross profit as a percentage of sales. Gross profit dollar growth exceeded operating expense growth by approximately \$5.9 million. Settlement of a state income tax position decreased income tax expense by approximately \$3.2 million during the second quarter of fiscal 2007.

Net Sales. Net sales for the six months ended March 31, 2007 increased 11.1% to \$1.37 billion, compared to \$1.23 billion for the six months ended March 25, 2006. Sales improved in each department except video, with the largest percentage increases in the gasoline, pharmacy, and deli departments, as noted above in the three-month discussion.

Grocery segment comparable store sales for the period grew \$133.7 million, or 11.4%. Excluding gasoline sales, comparable store sales increased \$89.2 million, or 8.1%, for the six months ended March 31, 2007. Total gasoline gallons sold increased approximately 66% while the average price per gallon decreased approximately 4% comparing the March fiscal 2007 six months to the same period of fiscal 2006.

Changes in grocery segment sales for the six months ended March 31, 2007 are summarized as follows (in thousands):

Total grocery sales for the six months ended March 25, 2006	\$ 1,174,978
Comparable store sales increase (including gasoline)	133,701
Impact of stores opened in fiscal 2006 and 2007	4,523
Impact of stores closed in fiscal 2006 and 2007	(3,043)
Other	274
 Total grocery sales for the six months ended March 31, 2007	 \$ 1,310,433

Net sales to outside parties for the Company's milk processing subsidiary increased \$1.4 million, or 2.5%, in the six-month period ended March 31, 2007 compared to the six-month period ended March 25, 2006. The sales increase is primarily attributable to an increase in the case volume of products sold which offset lower raw milk costs in the six-month period ended March 31, 2007 compared to the six-month period ended March 25, 2006. Raw milk cost decreases are typically passed on to customers in the pricing of milk products.

The Company expects sales growth for the remainder of fiscal 2007 to approximate the rate of growth experienced in the first six months of this fiscal year. Sales growth for the remainder of fiscal year 2007 will be influenced to some extent by market fluctuations in the per gallon price of gasoline, and by the success of promotional efforts to retain and grow its customer base. The Company also expects that the maturation of new and expanded stores will contribute to sales growth.

In addition to the factors discussed above, the Company expects to accelerate the completion of new, remodeled or replacement stores and add additional fuel centers during the last six months of fiscal 2007.

Gross Profit. Gross profit for the six months ended March 31, 2007 increased \$21.3 million, or 6.9%, to \$331.4 million compared to \$310.1 million, for the six months ended March 25, 2006. As a percent of sales, gross profit decreased to 24.2% for the six months ended March 31, 2007 from 25.2% for the six months ended March 25, 2006.

Gross profit dollars increased due to the higher sales volume in the grocery segment. Gross profit as a percentage of sales decreased primarily due to higher relative sales growth in the gasoline and pharmacy departments, which generally have lower gross margins. Excluding gasoline sales, grocery segment gross profit as a percentage of sales was 26.6% for the six months ended March 31, 2007 compared to 26.9% for the same period of last fiscal year. Gasoline gross profit margin was lower in fiscal 2007 following historically higher margins experienced following the fall 2005 hurricanes. Increased competitive pressures and food cost increases also contributed to lower grocery segment margins. The Company elected to accept lower margins in order to increase sales, maintain market share and keep prices low for its customers.

Edgar Filing: National Interstate CORP - Form 11-K

Gross profit for the Company's milk processing subsidiary for the six-month period ended March 31, 2007 increased \$1.8 million, or 18.4%, to \$11.6 million, or 14.1%, of sales compared to \$9.8 million, or 12.4%, of sales for the six-month period ended March 25, 2006. Gross profit dollars increased due to higher case sales volume. Gross profit as a percentage of sales increased due to relatively level per-gallon margins applied to a lower per gallon sales price.

Table of Contents

Operating and Administrative Expenses. Operating and administrative expenses increased \$15.5 million, or 5.9%, to \$276.0 million for the six months ended March 31, 2007, from \$260.5 million for the six months ended March 25, 2006. As a percentage of sales, operating and administrative expenses decreased to 20.2% for the six-month period ended March 31, 2007 from 21.2% for the six-month period ended March 25, 2006. A variety of factors contributed to the dollar increase.

A breakdown of the major increases (decreases) in operating and administrative expenses is as follows:

	Increase	(decrease)
	(decrease)	as a %
	in millions	of sales
Salaries and wages	\$ 9.5	(0.20)%
Equipment rent expense	\$ (1.8)	(0.15)%
Repairs and maintenance	\$ 1.8	0.03%
Warehouse expenses	\$ 1.6	(0.02)%
Bank charges	\$ 1.3	0.04%
Professional fees	\$ (1.3)	(0.12)%

Salaries and wages increased in dollars due to additional labor hours required for the increased sales volume, but decreased as a percentage of sales due to the allocation of management salaries over higher sales dollars and sales growth in less labor-intensive departments such as gasoline.

Equipment rent expense decreased due to the expiration of operating leases on equipment used in the Company's distribution facility and in its stores. Much of this equipment was purchased by the Company at the expiration of the lease term.

Repairs and maintenance increased due to the replacement and upgrade of refrigeration equipment, product display and other store fixtures.

Warehouse expenses increased due to additional labor costs needed to process increased volume of both incoming and outgoing product shipments.

Bank charges rose primarily due to increased fees for processing debit and credit cards. The increase is a result of both increased usage of cards and increased transaction fees related to the usage.

Professional fees decreased due to reduced audit and compliance costs associated with the implementation of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 that occurred late in fiscal 2005 and the first six months of fiscal 2006.

Rental Income, Net. Rental income, net decreased \$0.3 million to \$2.3 million for the six-month period ended March 31, 2007 from \$2.6 million in the March 2006 comparable period due to an increase in shopping center expenses. Tenant activity has been relatively stable over the past twelve months.

Other Income, Net. Other income, net totaled \$0.9 million and \$0.8 million for the six-month periods ended March 31, 2007 and March 25, 2006, respectively. Losses on assets taken out of service were offset by increased sales of waste paper and packaging.

Interest Expense. Interest expense decreased \$0.7 million to \$23.9 million for the six months ended March 31, 2007 from \$24.6 million for the six months ended March 25, 2006 due primarily to \$12.5 million of principal debt repayment during the twelve months ended March 31, 2007.

Income Taxes. Income tax expense as a percentage of pre-tax income decreased to 28.9% for the six-month period ended March 31, 2007 compared to 39.5% for the six-month period ended March 25, 2006 due to the settlement of a tax position under an initiative offered by one of the states in which the Company conducts its operations. As a result of this settlement the Company reduced its reserve for contingent income taxes by \$3.2 million and reduced income tax expense by the same amount during the six months ended March 31, 2007. Without this reduction, the effective tax rate would have been 38.1% for the six months ended March 31, 2007.

Edgar Filing: National Interstate CORP - Form 11-K

Net Income. Net income increased \$7.5 million, or 43.4%, for the six-month period ended March 31, 2007 to \$24.7 million compared to \$17.2 million for the six-month period ended March 25, 2006. Net income, as a percentage of sales, was 1.8% for the six-month period ended March 2007 and 1.4% for the March 2006 comparable period. Basic and diluted earnings per share for Class A Common Stock were \$1.06 and \$1.01 for the six-month period ended March 31, 2007 compared to \$0.74 and \$0.70, respectively, for the March 2006 comparable period. Basic and diluted earnings per share for Class B Common Stock were each \$0.96 for the fiscal period ended March 31, 2007 compared to \$0.67 of basic and diluted earnings per share for the March 2006 comparable period.

Table of Contents

Liquidity and Capital Resources

Capital Expenditures

The Company believes that a key to its ability to continue to develop a loyal customer base is providing conveniently located, clean and modern stores which provide customers with good service and a broad selection of competitively priced products. Therefore, the Company has invested and will continue to invest significant amounts of capital toward the modernization of its store base. The Company's modernization program includes the opening of new stores, the completion of major remodels and expansion of selected existing stores, the relocation of selected existing stores to larger, more convenient locations and the completion of minor remodeling of its remaining existing stores. The Company will also add fuel centers and other products complementary to grocery sales where market conditions and real estate considerations warrant.

Capital expenditures totaled \$42.7 million for the six-month period ended March 31, 2007, including the completion of one new store, one remodeled store, one convenience store/fuel center, the purchase of six future store sites, and the addition of two fuel centers and pharmacies to existing store locations. Capital expenditures also included the costs of upgrading and replacing store equipment, technology investments, capital expenditures related to the Company's distribution operation and its milk processing plant, and expenditures for stores to open later in fiscal 2007 and in fiscal 2008.

Ingles' capital expenditure plans for all of fiscal 2007 include investments of approximately \$100 million. For the balance of fiscal 2007, the Company plans to open two remodeled and three replacement stores, and add approximately three new fuel stations at existing stores. Expenditure plans will also include investments in stores expected to open in fiscal 2008, as well as technology improvements, upgrading and replacing existing store equipment, warehouse and transportation equipment, and improvements to the Company's milk processing plant.

The Company expects that its net annual capital expenditures will be in the range of approximately \$90 to \$100 million going forward in order to maintain a modern store base. In general, the Company is increasing the average size of stores being built, which could affect both the number of projects pursued at any given time and the cost of these projects. The number of projects may also fluctuate due to the varying costs of the types of projects pursued including new stores, major remodel/expansions or minor remodels. The Company makes decisions on the allocation of capital expenditure dollars based on many factors, including the competitive environment, other Company capital initiatives and its financial condition.

The Company does not generally enter into commitments for capital expenditures other than on a store-by-store basis at the time it begins construction on a new store or begins a major or minor remodeling project. The Company generally engages in major remodeling and new store development in no more than three or four locations at a time. Construction commitments at March 31, 2007 totaled \$26.0 million.

Liquidity

The Company generated net cash from operations of \$52.8 million for the six months ended March 31, 2007 compared to \$30.6 million for the comparable 2006 period. In addition to the \$7.5 million increase in net income over the comparative six-month periods, inventory increased \$13.5 million during the six months ended March 31, 2007 to support increased growth.

Cash used by investing activities for the six-month period ended March 31, 2007 totaled \$42.2 million, comprised primarily of \$42.7 million of capital expenditures during the period, partially offset by \$0.5 million of proceeds from the sale of assets.

Cash used by financing activities during the six-month period ended March 31, 2007 totaled \$15.7 million, including principal payments on long-term debt of \$5.9 million, dividend payments of \$7.7 million and net repayments on line of credit borrowings of \$2.3 million.

At March 31, 2007, the Company had committed lines of credit with six banks totaling \$150.0 million. \$1.6 million was borrowed under the lines of credit at March 31, 2007; in addition, unused letters of credit totaling \$15.7 million reduced the amount available to be drawn under these lines to \$132.7 million at March 31, 2007. The lines of credit mature in October 2007 and February 2010. The lines provide the Company with various interest rate options generally at rates less than prime. The Company is not required to maintain compensating balances in connection with these lines of credit. The Company was in compliance with all financial covenants related to these lines of credit at March 31, 2007.

Table of Contents

At March 31, 2007, the Company had \$349.8 million principal amount of senior subordinated notes (the Notes) outstanding to mature in December 2011. The indenture governing the Notes contains certain restrictive covenants relating to, among other things, the issuance of indebtedness and the payment of dividends. The Notes are currently redeemable by the Company at a redemption premium of 104.438%. The redemption premium decreases to 102.903% on December 1, 2007 and to 101.369% on December 1, 2008. Beginning December 1, 2009 the Notes can be redeemed at par. The Company was in compliance with all financial covenants related to the Notes at December 30, 2006.

The Company's principal sources of liquidity are expected to be cash flow from operations, borrowings under its lines of credit and long-term financing. As of March 31, 2007, the Company had unencumbered real property and equipment with a net book value of approximately \$497.3 million. The Company believes, based on its current results of operations and financial condition, that its financial resources, including existing bank lines of credit, short- and long-term financing expected to be available to it and internally generated funds, will be sufficient to meet planned capital expenditures and working capital requirements for the foreseeable future, including any debt service requirements of additional borrowings. However, there can be no assurance that any such sources of financing will be available to the Company on acceptable terms, or at all.

It is possible that, in the future, the Company's results of operations and financial condition will be different from that described in this report based on a number of factors. These factors may include, among others, increased competition, changing regional and national economic conditions, adverse climatic conditions affecting food production and delivery and changing demographics as well as the additional factors discussed below under Forward Looking Statements. It is also possible, for such reasons, that the results of operations from the new, expanded, remodeled and/or replacement stores will not meet or exceed the results of operations from existing stores that are described in this report.

Contractual Obligations and Commercial Commitments

There have been no material changes in contractual obligations and commercial commitments subsequent to September 30, 2006.

Off Balance Sheet Arrangements

The Company is not a party to any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on the Company's financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

Quarterly Cash Dividends

Since December 27, 1993, the Company has paid regular quarterly cash dividends of \$0.165 (sixteen and one-half cents) per share on its Class A Common Stock and \$0.15 (fifteen cents) per share on its Class B Common Stock for an annual rate of \$0.66 and \$0.60 per share, respectively.

The Company expects to continue paying regular cash dividends on a quarterly basis. However, the Board of Directors periodically reconsiders the declaration of dividends. The Company pays these dividends at the discretion of the Board of Directors, and the continuation of these payments, the amount of such dividends, and the form in which the dividends are paid (cash or stock) depends upon the results of operations, the financial condition of the Company and other factors which the Board of Directors deems relevant. In addition, certain loan agreements containing provisions outlining minimum tangible net worth requirements restrict the ability of the Company to pay additional dividends to approximately \$113.9 million based on tangible net worth at March 31, 2007. Further, the Company is prevented from declaring dividends at any time that it is in default under the indenture governing the Company's senior subordinated debt. In addition, the terms of the indenture may restrict the ability of the Company to pay additional dividends based on certain financial parameters.

Seasonality

Sales in the grocery segment of the Company's business are subject to a slight seasonal variance due to holiday related sales and due to sales in areas where seasonal homes are located. Sales are traditionally higher in the Company's first fiscal quarter due to the inclusion of sales related to Thanksgiving and Christmas. The Company's second fiscal quarter traditionally has the lowest sales of the year. In the third and fourth quarter, sales are affected by the return of customers to seasonal homes in our market area. The fluid dairy segment of the Company's business has slight seasonal variation to the extent of its sales into the grocery industry. The Company's real estate segment is not subject to seasonal variations.

Table of Contents*Impact of Inflation*

The following table from the United States Bureau of Labor Statistics lists changes in the Consumer Price Index that could have an effect on the Company's operations. One of the Company's significant costs is labor, which increases with general inflation. Inflation in energy costs affects both the Company's gasoline sales and distribution expenses.

	Three Months Ended		Twelve Months Ended	
	MARCH 31,	MARCH 25,	MARCH 31,	MARCH 25,
	2007	2006	2007	2006
All items	4.7%	4.3%	2.8%	3.4%
Food and beverages	7.4%	2.7%	3.3%	2.6%
Energy	22.9%	21.8%	4.4%	17.3%

Forward Looking Statements

This Quarterly Report contains certain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. The words expect, anticipate, intend, plan, believe, seek and similar expressions are intended to identify forward-looking statements. When forward-looking statements and the related assumptions are made in good faith and reflect the Company's current judgment regarding the direction of the Company's business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, assumptions or other future performance suggested herein. Such statements are based upon a number of assumptions and estimates which are inherently subject to significant risks and uncertainties many of which are beyond the Company's control. Some of these assumptions inevitably will not materialize, and unanticipated events will occur which will affect the Company's results. Some important factors (but not necessarily all factors) that affect the Company's revenues, growth strategies, future profitability and operating results, or that otherwise could cause actual results to differ materially from those expressed in or implied by any forward-looking statement, include business and economic conditions generally in the Company's operating area; the Company's ability to successfully implement its expansion and operating strategies and to manage rapid expansion; pricing pressures and other competitive factors; reduction in per gallon retail gasoline prices; the maturation of new and expanded stores; the Company's ability to reduce costs and achieve improvements in operating results; the availability and terms of financing; increases in labor and utility costs; success or failure in the ownership and development of real estate; changes in the laws and government regulations applicable to the Company; and changes in accounting policies, standards, guidelines or principles as may be adopted by regulatory agencies as well as the Financial Accounting Standards Board.

Consequently, actual events affecting the Company and the impact of such events on the Company's operations may vary significantly from those described in this report or contemplated or implied by statements in this report.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market interest rates subsequent to September 30, 2006.

Item 4. CONTROLS AND PROCEDURES**(a) Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures designed to provide reasonable assurance of achieving the objective that information in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified and pursuant to the regulations of the Securities and Exchange Commission. Disclosure controls and procedures, as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act, include controls and procedures designed to ensure the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. It should be noted that the Company's system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met.

Edgar Filing: National Interstate CORP - Form 11-K

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with participation of its management including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as of March 31, 2007, the end of the period covered by this report. In making this evaluation, it considered matters previously identified and disclosed in connection with the filing of its Form 10-K for fiscal 2006. After consideration of the matters discussed above, the Company has concluded that its controls and procedures were effective as of March 31, 2007.

(b) Changes in Internal Control over Financial Reporting

No other change in internal control over financial reporting occurred during the Company's last fiscal quarter that materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Table of Contents

Part II. Other Information

Item 5. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders of Ingles Markets, Incorporated was held Tuesday, February 13, 2007. At this meeting, the Company's stockholders voted on the following proposals:

1. Elect nine members of the Board of Directors by holders of Class A Common Stock and Class B Common Stock to serve until the 2008 Annual Meeting of Stockholders:

Name	Common Stock	Votes For	Votes Withheld
Fred D. Ayers	Class A	11,026,042	185,985
John O. Pollard	Class A	10,651,481	560,546
Ronald B. Freeman	Class B	12,114,709	
Charles L. Gaither, Jr.	Class B	12,114,709	
Robert P. Ingle	Class B	12,114,709	
Robert P. Ingle, II	Class B	12,114,709	
James W. Lanning	Class B	12,114,559	150
Charles E. Russell	Class B	12,114,709	
Laura Ingle Sharp	Class B	12,114,709	

2. Consider and vote on a stockholder proposal for the Board of Directors to establish a policy requiring each independent director to invest at least 20% of his Ingles compensation in shares of the Company:

	Class A	Class B
For	550,893	195,209
Against	8,018,216	11,919,500
Abstain	67,764	
Broker non-votes	2,575,154	

Item 6. EXHIBITS

- (a) Exhibits.

- 1) Exhibit 31.1 Rule 13a-14(a) Certificate
- 2) Exhibit 31.2 Rule 13a-14(a) Certificate
- 3) Exhibit 32.1 Certification Pursuant to 18 U.S.C. Section 1350

Edgar Filing: National Interstate CORP - Form 11-K

- 4) Exhibit 32.2 Certification Pursuant to 18 U.S.C. Section 1350

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Form 10-Q to be signed on its behalf by the undersigned thereunto duly authorized.

INGLES MARKETS, INCORPORATED

Date: May 4, 2007

/s/ Robert P. Ingle
Robert P. Ingle
Chief Executive Officer

Date: May 4, 2007

/s/ Ronald B. Freeman
Ronald B. Freeman
Vice President-Finance and Chief Financial Officer