Employers Holdings, Inc.
Form 10-Q
October 25, 2018

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, 2018

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	04-3850065
(State or other jurisdiction of incorporation or organization)	(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, a smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "non-accelerated filer," "smaller reporting company," and "emerging growth 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
Emerging growth company o
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 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

Class	October 18, 2018
Common Stock, $0.01 par value per share	32,799,666 shares outstanding

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PART I – FINANCIAL INFORMATION
Item 1. Consolidated Financial Statements
Employers Holdings, Inc. and Subsidiaries
Consolidated Balance Sheets
(in millions, except share data)

Assets	As of September 30, 2018 (unaudited)	As of December 31, 2017
Investments:		
Fixed maturity securities at fair value (amortized cost $2,423.0 at September 30, 2018 and $2,421.0 at December 31, 2017)	$ 2,394.6	$ 2,463.4
Equity securities at fair value (cost $94.2 at September 30, 2018 and $116.7 at December 31, 2017)	189.6	210.3
Equity securities at cost	6.4	—
Short-term investments at fair value (amortized cost $4.0 at December 31, 2017)	—	4.0
Total investments	2,590.6	2,677.7
Cash and cash equivalents	203.0	73.3
Restricted cash and cash equivalents	2.0	1.0
Accrued investment income	19.0	19.6
Premiums receivable (less bad debt allowance of $7.9 at September 30, 2018 and $10.0 at December 31, 2017)	352.7	326.7
Reinsurance recoverable for:		
Paid losses	7.9	7.2
Unpaid losses	511.8	537.0
Deferred policy acquisition costs	50.8	45.8
Deferred income taxes, net	20.6	28.7
Property and equipment, net	16.5	13.9
Intangible assets, net	7.7	7.9
Goodwill	36.2	36.2
Contingent commission receivable—LPT Agreement	32.0	31.4
Cloud computing arrangements	21.8	—
Other assets	25.9	33.7
Total assets	$ 3,898.5	$ 3,840.1
Liabilities and stockholders' equity		
Unpaid losses and loss adjustment expenses	$ 2,233.7	$ 2,266.1
Unearned premiums	356.0	318.3
Commissions and premium taxes payable	59.8	55.3
Accounts payable and accrued expenses	24.6	23.7
Deferred reinsurance gain—LPT Agreement	152.1	163.6
Notes payable	20.0	20.0
Non-cancellable obligations	18.2	2.7
Other liabilities	42.9	42.7
Total liabilities	$ 2,907.3	$ 2,892.4
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.01 par value; 150,000,000 shares authorized; 56,904,018 and 56,695,174 shares issued and 32,796,666 and 32,597,819 shares outstanding at September 30, 2018 and December 31, 2017, respectively	$ 0.6	$ 0.6

Preferred stock, $0.01 par value; 25,000,000 shares authorized; none issued	—	—
Additional paid-in capital	385.2	381.2
Retained earnings	1,011.9	842.2
Accumulated other comprehensive (loss) income, net of tax	(22.5)	107.4
Treasury stock, at cost (24,107,352 shares at September 30, 2018 and 24,097,355 shares at December 31, 2017)	(384.0)	(383.7)
Total stockholders’ equity	991.2	947.7
Total liabilities and stockholders’ equity	$ 3,898.5	$ 3,840.1

See accompanying unaudited notes to the consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues	(unaudited)		(unaudited)	
Net premiums earned	$192.9	$187.9	$547.5	$535.0
Net investment income	20.2	18.5	59.9	55.4
Net realized and unrealized gains on investments	15.6	4.1	13.2	7.4
Gain on redemption of notes payable	—	—	—	2.1
Other income	0.2	0.4	0.4	0.5
Total revenues	228.9	210.9	621.0	600.4
Expenses				
Losses and loss adjustment expenses	106.6	116.9	289.7	332.0
Commission expense	24.8	23.7	73.1	66.7
Underwriting and other operating expenses	38.8	33.6	118.1	102.1
Interest and financing expenses	0.4	0.3	1.1	1.1
Other expenses	—	7.5	—	7.5
Total expenses	170.6	182.0	482.0	509.4
Net income before income taxes	58.3	28.9	139.0	91.0
Income tax expense	10.7	7.0	23.3	21.1
Net income	$47.6	$21.9	$115.7	$69.9
Comprehensive income				
Unrealized AFS investment (losses) gains arising during the period (net of taxes of $(2.4) and $1.6 for the three months ended September 30, 2018 and 2017, respectively, and $(15.0) and $11.3 for the nine months ended September 30, 2018 and 2017, respectively)	$(9.2)	$3.0	$(56.3)	$20.9
Reclassification adjustment for realized AFS investment losses (gains) in net income (net of taxes of $(1.4) for the three months ended September 30, 2017, and $0.1 and $(2.6) for the nine months ended September 30, 2018 and 2017, respectively)	—	(2.7)	0.4	(4.8)
Other comprehensive (loss) income, net of tax	(9.2)	0.3	(55.9)	16.1
Total comprehensive income	$38.4	$22.2	$59.8	$86.0
Net realized and unrealized gains on investments				
Net realized and unrealized gains on investments before impairments	$15.6	$4.1	$15.2	$7.6
Other than temporary impairment recognized in earnings	—	—	(2.0)	(0.2)
Net realized and unrealized gains on investments	$15.6	$4.1	$13.2	$7.4
Earnings per common share (Note 12):				
Basic	$1.45	$0.67	$3.52	$2.15
Diluted	$1.43	$0.66	$3.48	$2.12
Cash dividends declared per common share and eligible RSUs and PSUs	$0.20	$0.15	$0.60	$0.45

See accompanying unaudited notes to the consolidated financial statements.

Employers Holdings, Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity
For the Three Months Ended September 30, 2018 and 2017
(Unaudited)

	Common Stock						
	Shares Issued	Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Treasury Stock at Cost	Total Stockholders' Equity
	(in millions, except share data)						
Balance, July 1, 2018	56,866,727	$ 0.6	$ 382.4	$970.8	$ (13.3)	$(384.0)	$ 956.5
Stock-based obligations	—	—	2.0	—	—	—	2.0
Stock options exercised	37,291	—	0.8	—	—	—	0.8
Dividends declared	—	—	—	(6.6)	—	—	(6.6)
Net income for the period	—	—	—	47.6	—	—	47.6
Change in net unrealized losses on investments, net of taxes of $2.4	—	—	—	—	(9.2)	—	(9.2)
Balance, September 30, 2018	56,904,018	$ 0.6	$ 385.2	$1,011.9	$ (22.5)	$(384.0)	$ 991.2
Balance, July 1, 2017	56,510,352	$ 0.6	$ 376.6	$815.4	$ 90.3	$(383.7)	$ 899.2
Stock-based obligations	—	—	0.8	—	—	—	0.8
Stock options exercised	1,998	—	—	—	—	—	—
Vesting of RSUs and PSUs, net of shares withheld to satisfy tax withholdings	8,934	—	(0.2)	—	—	—	(0.2)
Dividends declared	—	—	—	(4.9)	—	—	(4.9)
Net income for the period	—	—	—	21.9	—	—	21.9
Change in net unrealized gains on investments, net of taxes of $0.2	—	—	—	—	0.3	—	0.3
Balance, September 30, 2017	56,521,284	$ 0.6	$ 377.2	$832.4	$ 90.6	$(383.7)	$ 917.1

See accompanying unaudited notes to the consolidated financial statements.

Employers Holdings, Inc. and Subsidiaries
Consolidated Statements of Stockholders' Equity
For the Nine Months Ended September 30, 2018 and 2017
(Unaudited)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net	Treasury Stock at Cost	Total Stockholders' Equity
	Shares Issued	Amount					
	(in millions, except share data)						
Balance, January 1, 2018	56,695,174	$ 0.6	$ 381.2	$ 842.2	$ 107.4	$ (383.7)	$ 947.7
Stock-based obligations	—	—	5.9	—	—	—	5.9
Stock options exercised	51,091	—	1.0	—	—	—	1.0
Vesting of RSUs and PSUs, net of shares withheld to satisfy tax withholdings	157,753	—	(2.9)	—	—	—	(2.9)
Acquisition of common stock	—	—	—	—	—	(0.3)	(0.3)
Dividends declared	—	—	—	(19.9)	—	—	(19.9)
Net income for the period	—	—	—	115.7	—	—	115.7
Reclassification adjustment for adoption of ASU No. 2016-01	—	—	—	74.0	(74.0)	—	—
Change in net unrealized losses on investments, net of taxes of $14.9	—	—	—	—	(55.9)	—	(55.9)
Balance, September 30, 2018	56,904,018	$ 0.6	$ 385.2	$ 1,011.9	$ (22.5)	$ (384.0)	$ 991.2
Balance, January 1, 2017	56,226,277	$ 0.6	$ 372.0	$ 777.2	$ 74.5	$ (383.7)	$ 840.6
Stock-based obligations	—	—	4.0	—	—	—	4.0
Stock options exercised	169,024	—	3.3	—	—	—	3.3
Vesting of RSUs and PSUs, net of shares withheld to satisfy tax withholdings	125,983	—	(2.1)	—	—	—	(2.1)
Dividends declared	—	—	—	(14.7)	—	—	(14.7)
Net income for the period		—	—	69.9	—	—	69.9
Change in net unrealized gains on investments, net of taxes of $8.7		—	—	—	16.1	—	16.1
Balance, September 30, 2017	56,521,284	$ 0.6	$ 377.2	$ 832.4	$ 90.6	$ (383.7)	$ 917.1

See accompanying unaudited notes to the consolidated financial statements.

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

	Nine Months Ended September 30,	
	2018	2017
Operating activities	(unaudited)	
Net income	$115.7	$69.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5.1	6.2
Stock-based compensation	5.9	3.9
Amortization of premium on investments, net	6.4	11.2
Allowance for doubtful accounts	(2.1)	0.1
Deferred income tax expense	23.0	7.9
Net realized and unrealized (gains) on investments	(13.2)	(7.4)
Gain on redemption of notes payable	—	(2.1)
Write-off of previously capitalized costs	—	7.5
Change in operating assets and liabilities:		
Premiums receivable	(23.9)	(26.9)
Reinsurance recoverable on paid and unpaid losses	24.5	27.8
Cloud computing arrangements	(21.8)	—
Current federal income taxes	(2.9)	(5.2)
Unpaid losses and loss adjustment expenses	(32.4)	(2.1)
Unearned premiums	37.7	20.8
Accounts payable, accrued expenses and other liabilities	3.8	(9.8)
Deferred reinsurance gain—LPT Agreement	(11.5)	(8.5)
Non-cancellable obligations	15.5	—
Other	3.3	10.5
Net cash provided by operating activities	133.1	103.8
Investing activities		
Purchases of fixed maturity securities	(472.9)	(403.7)
Purchases of equity securities	(31.2)	(13.8)
Purchases of short-term investments	(34.9)	(8.2)
Proceeds from sale of fixed maturity securities	169.8	181.8
Proceeds from sale of equity securities	58.1	14.6
Proceeds from maturities and redemptions of fixed maturity securities	294.7	159.3
Proceeds from maturities of short-term investments	38.9	18.7
Net change in unsettled investment purchases and sales	5.0	(21.4)
Capital expenditures and other	(7.6)	(7.8)
Net cash provided by (used in) investing activities	19.9	(80.5)
Financing activities		
Acquisition of common stock	(0.3)	—
Cash transactions related to stock-based compensation	(1.9)	1.2
Dividends paid to stockholders	(19.9)	(14.7)
Redemption of notes payable	—	(9.9)
Payments on capital leases	(0.2)	(0.2)
Net cash used in financing activities	(22.3)	(23.6)
Net increase (decrease) in cash, cash equivalents and restricted cash	130.7	(0.3)

Cash, cash equivalents and restricted cash at the beginning of the period	74.3	70.8
Cash, cash equivalents and restricted cash at the end of the period	$205.0	$70.5

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The following table presents our cash, cash equivalents and restricted cash by category within the Consolidated Balance Sheets:

	As of September 30, 2018	As of December 31, 2017
	(in millions)	
Cash and cash equivalents	$ 203.0	$ 73.3
Restricted cash and cash equivalents supporting reinsurance obligations	2.0	1.0
Total cash, cash equivalents and restricted cash	$ 205.0	$ 74.3

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.

In 1999, the Nevada State Industrial Insurance System (the Fund) entered into a retroactive 100% quota share reinsurance agreement (the LPT Agreement) through a loss portfolio transfer transaction with third party reinsurers. The LPT Agreement commenced on June 30, 1999 and will remain in effect until all claims under the covered policies have closed, the LPT Agreement is commuted or terminated, upon the mutual agreement of the parties, or the reinsurers' aggregate maximum limit of liability is exhausted, whichever occurs first. The LPT Agreement does not provide for any additional termination terms. On January 1, 2000, EICN assumed all of the assets, liabilities and operations of the Fund, including the Fund's rights and obligations associated with the LPT Agreement (See Note 8).

The Company accounts for the LPT Agreement as retroactive reinsurance. Upon entry into the LPT Agreement, an initial deferred reinsurance gain (the Deferred Gain) was recorded as a liability on the Company’s Consolidated Balance Sheets. The Company is entitled to receive a contingent profit commission under the LPT Agreement. The contingent profit commission is estimated based on both actual paid results to date and projections of expected paid losses under the LPT Agreement and is recorded as an asset on the Company's Consolidated Balance Sheets.

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 Form 10-K for the year ended December 31, 2017 (Annual Report).

The Company operates as a single operating segment, workers' compensation insurance, through its wholly owned subsidiaries. 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 maker to make decisions about resources to be allocated to the segment and assess its performance based on discrete financial information.

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 and 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 the estimate of unpaid losses and loss adjustment expenses (LAE), evaluation of reinsurance recoverables, recognition of premium revenue, recoverability of deferred income taxes, and valuation of investments.

Reclassifications

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

The Company reclassified $14.0 million of service contract fees associated with hosting arrangements from Other assets to Cloud computing arrangements on the Company's Consolidated Balance Sheets as of September 30, 2018. Additionally, $4.8 million of implementation costs for these hosting arrangements were reclassified from Property and equipment to Cloud computing arrangements on the Company's Consolidated Balance Sheets as a result of the early adoption of ASU Number 2018-15 (See Note 3).

Pending Acquisition

On August 11, 2017, the Company entered into a stock purchase agreement (Purchase Agreement), as amended, with Partner Reinsurance Company of the U.S. (PRUS) with respect to the acquisition (Acquisition) of all of the outstanding shares of capital stock of PartnerRe Insurance Company of New York (PRNY). The purchase price is equal to the sum of: (i) the amount of statutory capital and surplus of PRNY at closing (which is currently estimated to be approximately $40.0 million); and (ii) $5.8 million. The Company expects to fund the Acquisition with cash on hand.

Pursuant to the Purchase Agreement, all liabilities and obligations of PRNY existing as of the closing date, whether known or unknown, will be indemnified by PRUS. In addition, PartnerRe Ltd., the parent company of PRUS, has provided the Company with a Guaranty that unconditionally, absolutely and irrevocably guarantees the full and prompt payment and performance by PRUS of all of its obligations, liabilities, and indemnities under the Purchase Agreement and the transactions contemplated thereby.

The Company will not be acquiring any employees or ongoing business operations pursuant to the Acquisition. The Acquisition is subject to certain closing conditions, including, among other things, approval from the Department of Financial Services of the State of New York.

2. Change in Estimates

The Company reduced its estimated loss and LAE reserves ceded under the Loss Portfolio Transfer Agreement (LPT Reserve Adjustment) as a result of the determination that an adjustment was necessary to reflect observed favorable paid loss trends during the second quarter of 2018. The following table shows the financial statement impact related to the LPT Reserve Adjustment.

	Nine Months Ended September 30, 2018 (in millions, except per share data)
LPT Reserve Adjustment	$ (6.3)
Cumulative adjustment to the Deferred Gain[1]	(2.2)
Net income impact from this change in estimate	2.2
Earnings per common share impact from this change in estimate:	
Basic and Diluted	0.07

(1) The cumulative adjustment to the Deferred reinsurance gain–LPT Agreement (Deferred Gain) was also recognized in losses and LAE incurred in the Company's Consolidated Statement of Comprehensive Income, so that the Deferred Gain reflects the balance that would have existed had the revised loss and LAE reserves been recognized at the inception of the LPT Agreement.

The Company increased its estimate of Contingent commission receivable – LPT Agreement (LPT Contingent Commission Adjustment) as a result of the determination that an adjustment was necessary to reflect observed favorable paid loss trends during the second quarter of 2018. The following table shows the financial statement impact related to the LPT Contingent Commission Adjustment.

	Nine Months Ended September 30, 2018 (in millions, except per share data)
LPT Contingent Commission Adjustment	$ 0.5

Net income impact from this change in estimate	0.5
Earnings per common share impact from this change in estimate:	
Basic and Diluted	0.02

3. New Accounting Standards

Recently Issued Accounting Standards

In August 2018, the FASB issued ASU Number 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement. This update removes the disclosure requirements for the amounts of and the reasons for transfers between Level 1 and Level 2 and disclosure of the policy for timing of transfers between levels. This update also removes disclosure requirements for the valuation processes for Level 3 fair value measurements. Additionally, this update adds disclosure requirements for the changes in unrealized gains and losses for recurring Level 3 fair value measurements and quantitative information for certain unobservable inputs in Level 3 fair value measurements. This update becomes effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company does not expect that this update will have a material impact on its consolidated financial condition and results of operations.

In July 2018, the FASB issued ASU Number 2018-09, Codification Improvements. This update provides clarification, corrects errors in and makes minor improvements to the Codification within various ASC topics. Many of the amendments in this update have transition guidance with effective dates for annual periods beginning after December 15, 2018 and some amendments in this update do not require transition guidance and are effective upon issuance of this update. The Company will adopt amendments as they become applicable and has determined that the impact of these improvements will not be material to its consolidated financial condition and results of operations.

In February 2016, the FASB issued ASU Number 2016-02, Leases (Topic 842). This update provides guidance on a new lease model that includes the recognition of assets and liabilities arising from lease transactions on the balance sheet. Additionally, the update provides clarity on the definition of a lease and the distinction between finance and operating leases. Furthermore, the update requires certain qualitative and quantitative disclosures pertaining to the amounts recorded in the financial statements. This update becomes effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2018 and early adoption is permitted. The Company has determined that the impact of this new standard will be equal to the present value of the Company's lease obligations under various non-cancellable operating lease contracts, which amounted to approximately $21.1 million at September 30, 2018, and will be recognized as lease assets and liabilities on the Company's Consolidated Balance Sheets upon adoption.

In July 2018, the FASB issued ASU Number 2018-11, Leases (Topic 842): Targeted Improvements. This update provides entities with an additional and optional transition method to adopt ASU Number 2016-02 with a cumulative-effect adjustment in the period of adoption. This update also provides guidance for a practical expedient that permits lessors to not separate non-lease components from the associated lease components. Additionally, in July 2018, the FASB issued ASU Number 2018-10, Codification Improvements to Topic 842, Leases. This update provides additional guidance on the new lease model with improvements in numerous aspects of the guidance in ASC 842 including, but not limited to, implicit rates, reassessment of lease classification, terms and purchase options, investment tax credits, and various other transition guidance. These updates will be adopted concurrently with ASU Number 2016-02. The Company has determined that the impact of these new standards will not be material to the Company's financial statements.

Recently Adopted Accounting Standards

In August 2018, the FASB issued ASU Number 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. This update clarifies certain aspects of ASU 2015-05 and aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software and hosting arrangements that include an internal-use software license. This update becomes effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years and early adoption is permitted. The Company early adopted this standard as of July 1, 2018 using the retrospective method of adoption. Prior to adoption, the Company's accounting policy for capitalization of implementation costs followed the existing guidance for internal use software and therefore this update had no impact on the amounts previously capitalized. In accordance with ASU Number 2018-15, $4.8 million of capitalized costs included in the Company's June 30, 2018 Consolidated Balance Sheets were reclassified from Property and equipment to Cloud computing arrangements on the date of adoption. Amortization under the new guidance will commence once the module or component is ready for its intended use, regardless of whether the hosting arrangement has been placed into service and will be recognized over the remaining life of the service contract.

In March 2018, the FASB issued ASU Number 2018-05, Income Taxes (Topic 740). This update provides guidance regarding the application of ASC Topic 740 for the income tax effects of the Tax Cuts and Jobs Act. This update allowed companies to report provisional amounts of the effects of the Tax Cuts and Jobs Act in their financial statements in the first reporting period they are able to determine a reasonable estimate and any adjustments to provisional amounts should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined. The Company adopted this update in the fourth quarter of 2017 and included an estimate of the income tax effects in its financial statements for the year ended December 31, 2017. The Company does not expect the amounts of any future income tax adjustments related to the effects of the Tax Cuts and Jobs Act to be material.

In January 2016, the FASB issued ASU Number 2016-01, Financial Instruments - Overall (Subtopic 825-10). This update replaces the guidance to classify equity securities with readily determinable fair values into different categories

(trading or available-for-sale) and requires those equity securities to be measured at fair value with changes in fair value recognized through net income. Additionally, this update eliminates the disclosure of the method and significant assumptions used to estimate the fair value of financial instruments measured at amortized cost. It requires financial instruments to be measured at fair value using the exit price notion. Furthermore, this update clarifies that an evaluation of deferred tax assets related to available-for-sale securities is needed, in combination with an evaluation of other deferred tax assets, to determine if a valuation allowance is required.
This update did not apply to the Company’s investment in Federal Home Loan Bank (FHLB) stock. Rather, it specified that FHLB stock shall be carried at cost and evaluated periodically for impairment; furthermore, it specified that, beginning January 1, 2018, FHLB stock shall not be shown with securities accounted for under ASC 321, which provides detailed guidance on, among other things, accounting and reporting of investments in equity securities that have readily determinable fair values. As a result, the Company’s investment in FHLB stock is presented within Equity securities at cost on the Company's Consolidated Balance Sheet

at March 31, 2018. In all periods prior to January 1, 2018, the Company's investment in FHLB stock is presented within Equity securities at fair value on the Company's Consolidated Balance Sheets.
This update became effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this update effective January 1, 2018. Adoption of this accounting standard resulted in a $74.0 million reclassification adjustment, net of tax, from accumulated other comprehensive income to retained earnings.
4. Fair Value of Financial Instruments
The carrying value and the estimated fair value of the Company’s financial instruments at fair value were as follows:

	September 30, 2018		December 31, 2017	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(in millions)			
Financial assets				
Total investments at fair value	$2,584.2	$2,584.2	$2,677.7	$2,677.7
Cash and cash equivalents	203.0	203.0	73.3	73.3
Restricted cash and cash equivalents	2.0	2.0	1.0	1.0
Financial liabilities				
Notes payable	$20.0	$23.4	$20.0	$23.6

Assets and liabilities recorded at fair value on the Company's 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 willing market participants would use in pricing the assets or liabilities at the measurement date.

The Company uses third party pricing services to assist it with its investment accounting function. The ultimate pricing source varies depending on the investment security and pricing service used, but investment securities valued on the basis of observable inputs (Levels 1 and 2) are generally assigned values on the basis of actual transactions. Securities valued on the basis of pricing models with significant unobservable inputs or non-binding broker quotes are classified as Level 3. The Company performs quarterly analyses on the prices it receives from third parties 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, as it is ultimately management’s responsibility to ensure that the fair values reflected in the Company’s consolidated financial statements are appropriate. If differences are noted in these analyses, the Company may obtain additional information from other pricing services to validate the quoted price.
The Company bases all of its estimates of fair value for assets on the bid prices, when available, as they represent what a third-party market participant would be willing to pay in an arm's length transaction.
For securities not actively traded, 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 speed assumptions. There were no material adjustments made to the prices obtained from third party pricing services as of September 30, 2018 and December 31, 2017.
These methods of valuation only produce an estimate of fair value if there is objectively verifiable information to produce a valuation. When objectively verifiable information is not available, the Company produces an estimate of fair value using some of the same methodologies, making assumptions for market-based inputs that are unavailable.

The Company's estimates of fair value for its notes payable are based on a combination of the variable interest rates for notes with similar durations to discount the projection of future payments on notes payable. The fair value measurements for notes payable have been determined to be Level 2 at each of the periods presented.
Each of the Company's insurance operating subsidiaries is a member of the FHLB of San Francisco. Members are required to purchase stock in the FHLB in addition to maintaining collateral deposits that back any funds advanced. The Company's investment in FHLB stock is recorded at cost, which approximates fair value, as purchases and sales of these securities are at par value with

the issuer. FHLB stock is considered a restricted security and is periodically evaluated by the Company for impairment based on the ultimate recovery of par value.

The following table presents the Company's investments at fair value and the corresponding fair value measurements.

	September 30, 2018			December 31, 2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
	(in millions)					
Fixed maturity securities:						
U.S. Treasuries	$—	$111.3	$ —	$—	$137.0	$—
U.S. Agencies	—	11.4	—	—	11.8	—
States and municipalities	—	527.4	—	—	642.5	—
Corporate securities	—	1,110.9	—	—	1,118.0	—
Residential mortgage-backed securities	—	423.9	—	—	389.3	—
Commercial mortgage-backed securities	—	95.1	—	—	106.0	—
Asset-backed securities	—	66.5	—	—	58.8	—
Other securities	—	48.1	—	—	—	—
Total fixed maturity securities	$—	$2,394.6	$ —	$—	$2,463.4	$—
Equity securities at fair value:						
Industrial and miscellaneous	$162.0	$—	$ —	$181.7	$—	$—
Non-redeemable preferred stock (FHLB)	—	—	—	—	—	4.7
Other	27.6	—	—	23.9	—	—
Total equity securities at fair value	189.6	—	—	205.6	—	4.7
Short-term investments	—	—	—	—	4.0	—
Total investments at fair value	$189.6	$2,394.6	$ —	$205.6	$2,467.4	$4.7

Certain cash equivalents, principally money market securities, are measured at fair value using the net asset value (NAV) per share. The following table presents cash equivalents at NAV and total cash and cash equivalents carried at fair value on the Company's Consolidated Balance Sheets.

	September 30, 2018	December 31, 2017
	(in millions)	
Cash and cash equivalents at fair value	$56.0	$ 34.3
Cash equivalents measured at NAV, which approximates fair value	147.0	39.0
Total cash and cash equivalents	$203.0	$ 73.3

The following table provides a reconciliation of the beginning and ending balances of investments that are recorded at fair value and are measured using Level 3 inputs for the nine months ended September 30, 2018 and 2017.

	Level 3 Securities	
	2018	2017
	(in millions)	
Beginning balance, January 1	$4.7	$11.9
Transfers out of Level 3 (1)	(4.7)	(7.0)
Purchases and sales, net	—	(0.2)
Ending balance, September 30	$—	$4.7

(1) The transfer during the nine months ended September 30, 2018 was the result of adoption of ASU 2016-01, which specified that FHLB stock shall be carried at cost and is no longer measured at fair value. Transfers during the nine months ended September 30, 2017 were from Level 3 to Level 2 as observable market data became available for these securities.

5. Investments

The Company's investments in fixed maturity securities, equity securities at fair value (prior to 2018), and short-term investments are classified as available-for-sale (AFS) that are reported at fair value with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of deferred taxes, in Accumulated other comprehensive (loss) income (AOCI) on the Company’s Consolidated Balance Sheets. Beginning in 2018, with the adoption of ASU 2016-01, the

Company's investments in equity securities at fair value are no longer classified as AFS and changes in fair value are included in Net realized and unrealized gains on investments on the Company's Consolidated Statements of Comprehensive Income. Effective January 1, 2018, the Company's investment in FHLB stock is presented within Equity securities at cost on the Company's Consolidated Balance Sheets. Other securities within fixed maturity securities consist of bank loans, which are classified as AFS and are reported at fair value.

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

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in millions)			
At September 30, 2018				
Fixed maturity securities				
U.S. Treasuries	$112.7	$ 0.8	$ (2.2)	$111.3
U.S. Agencies	11.3	0.2	(0.1)	11.4
States and municipalities	518.4	11.5	(2.5)	527.4
Corporate securities	1,129.1	5.9	(24.1)	1,110.9
Residential mortgage-backed securities	437.7	1.6	(15.4)	423.9
Commercial mortgage-backed securities	98.6	—	(3.5)	95.1
Asset-backed securities	67.1	0.1	(0.7)	66.5
Other securities	48.1	—	—	48.1
Total fixed maturity securities	2,423.0	20.1	(48.5)	2,394.6
Total AFS investments	$2,423.0	$ 20.1	$ (48.5)	$2,394.6
At December 31, 2017				
Fixed maturity securities				
U.S. Treasuries	$135.8	$2.0	$(0.8)	$137.0
U.S. Agencies	11.3	0.5	—	11.8
States and municipalities	617.0	25.5	—	642.5
Corporate securities	1,103.4	18.0	(3.4)	1,118.0
Residential mortgage-backed securities	388.3	3.6	(2.6)	389.3
Commercial mortgage-backed securities	106.5	0.4	(0.9)	106.0
Asset-backed securities	58.7	0.3	(0.2)	58.8
Total fixed maturity securities	2,421.0	50.3	(7.9)	2,463.4
Equity securities at fair value				
Industrial and miscellaneous	100.8	81.5	(0.6)	181.7
Non-redeemable preferred stock (FHLB)	4.7	—	—	4.7
Other	11.2	12.7	—	23.9
Total equity securities at fair value	116.7	94.2	(0.6)	210.3
Short-term investments	4.0	—	—	4.0
Total AFS investments	$2,541.7	$144.5	$(8.5)	$2,677.7

The cost and estimated fair value of the Company's equity securities recorded at fair value at September 30, 2018 were as follows:

	Cost	Estimated Fair Value
	(in millions)	
At September 30, 2018		
Equity securities at fair value		
Industrial and miscellaneous	$78.3	$ 162.0

Other	15.9	27.6
Total equity securities at fair value	$94.2	$ 189.6

The amortized cost and estimated fair value of the Company's fixed maturity securities at September 30, 2018, 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	Estimated Fair Value
	(in millions)	
Due in one year or less	$154.3	$154.6
Due after one year through five years	804.4	803.1
Due after five years through ten years	730.4	718.5
Due after ten years	130.5	132.9
Mortgage and asset-backed securities	603.4	585.5
Total	$2,423.0	$2,394.6

The following is a summary of AFS investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or greater as of September 30, 2018 and December 31, 2017.

	September 30, 2018			December 31, 2017		
	Estimated Fair Value	Gross Unrealized Losses	Number of Issues	Estimated Fair Value	Gross Unrealized Losses	Number of Issues
	(in millions, except number of issues data)					
Less than 12 months:						
Fixed maturity securities						
U.S. Treasuries	$52.3	$ (1.4)	20	$86.0	$ (0.5)	28
U.S. Agencies	3.7	(0.1)	2	—	—	—
States and municipalities	148.9	(2.5)	41	—	—	—
Corporate securities	828.6	(19.5)	267	307.6	(2.3)	113
Residential mortgage-backed securities	293.4	(9.4)	97	165.0	(0.8)	45
Commercial mortgage-backed securities	66.8	(2.1)	29	41.8	(0.2)	19
Asset-backed securities	52.8	(0.7)	35	29.3	(0.2)	25
Total less than 12 months	$1,446.5	$ (35.7)	491	$629.7	$ (4.0)	230
12 months or greater:						
Fixed maturity securities						
U.S. Treasuries	$42.8	$ (0.8)	16	$23.4	$ (0.3)	10
Corporate securities	82.3	(4.6)	32	53.2	(1.1)	17
Residential mortgage-backed securities	101.8	(6.0)	42	77.1	(1.8)	32
Commercial mortgage-backed securities	26.7	(1.4)	12	25.1	(0.7)	8
Total 12 months or greater	$253.6	$ (12.8)	102	$178.8	$ (3.9)	67

At December 31, 2017, the Company also had $0.6 million of gross unrealized losses on 24 equity securities that were in a continuous loss position for less than 12 months.

The Company recognized impairments on fixed maturity securities of $2.0 million (consisting of 57 securities) during the nine months ended September 30, 2018 as a result of the Company's intent to sell these securities. There were no other-than-temporary impairments on fixed maturity securities recognized during the nine months ended September 30, 2017. The Company determined that the remaining unrealized losses on fixed maturity securities for the nine months ended September 30, 2018 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 lack of 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 at an amount less than their amortized cost.
The adoption of ASU 2016-01 removed the impairment assessment for equity securities at fair value, and, beginning in 2018, changes in fair value are included in Net realized and unrealized gains on investments on the Company's Consolidated Statements of Comprehensive Income. Prior to the adoption of this standard, the Company recognized an impairment on equity securities of $0.2 million (consisting of one security) during the nine months ended September 30, 2017. The other-than-temporary impairment recognized during this period was the result of the severity and duration of the change in fair value of this security. Certain unrealized

losses on equity securities during the nine months ended September 30, 2017 were not considered to be other-than-temporary due to the financial condition and near-term prospects of the issuers, and the Company's intent to hold the securities until fair value recovers to above cost.

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 on fixed maturity securities are also recognized when securities are written down as a result of an other-than-temporary impairment.

Net realized gains on investments and the change in unrealized gains on the Company's investments recorded at fair value are determined on a specific-identification basis and were as follows:

	Gross Realized Gains	Gross Realized Losses	Change in Net Unrealized Gains (Losses)	Changes in Fair Value Reflected in Earnings	Changes in Fair Value Reflected in AOCI, before tax
		(in millions)			
Three Months Ended September 30, 2018					
Fixed maturity securities	$ —	$—	$ (11.6)	$ —	$ (11.6)
Equity securities	4.9	(0.5)	11.2	15.6	—
Total investments	$ 4.9	$(0.5)	$ (0.4)	$ 15.6	$ (11.6)
Nine Months Ended September 30, 2018					
Fixed maturity securities	$ 2.1	$(2.6)	$ (70.8)	$ (0.5)	$ (70.8)
Equity securities	13.0	(1.1)	1.8	13.7	—
Total investments	$ 15.1	$(3.7)	$ (69.0)	$ 13.2	$ (70.8)
Three Months Ended September 30, 2017					
Fixed maturity securities	$3.5	$(0.7)	$(1.9)	$2.8	$(1.9)
Equity securities	1.3	—	2.4	1.3	2.4
Total investments	$4.8	$(0.7)	$0.5	$4.1	$0.5
Nine Months Ended September 30, 2017					
Fixed maturity securities	$4.0	$(0.8)	$17.0	$3.2	$17.0
Equity securities	4.4	(0.2)	7.8	4.2	7.8
Total investments	$8.4	$(1.0)	$24.8	$7.4	$24.8

Net investment income was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in millions)			
Fixed maturity securities	$18.8	$17.4	$56.5	$52.4
Equity securities	1.5	1.7	4.8	5.2
Cash equivalents and restricted cash	0.9	0.2	1.4	0.4
Gross investment income	21.2	19.3	62.7	58.0
Investment expenses	(1.0)	(0.8)	(2.8)	(2.6)
Net investment income	$20.2	$18.5	$59.9	$55.4

The Company is required by various state laws and regulations to hold securities or letters of credit in depository accounts with certain states in which it does business. These laws and regulations govern not only the amount but also the types of securities that are eligible for deposit. As of September 30, 2018 and December 31, 2017, securities having a fair value of $864.3 million and $1,009.7 million, respectively, were on deposit. Additionally, standby letters of credit from the FHLB were in place in lieu of $140.0 million of securities on deposit as of September 30, 2018 (See Note 9).

Certain reinsurance contracts require the Company's 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 and restricted cash and cash equivalents held in trust for the benefit of ceding reinsurers at September 30, 2018 and December 31, 2017 was $23.0 million and $24.5 million, respectively.

6. Income Taxes

Income tax expense for interim periods is measured using an estimated effective tax rate for the annual period. The Company's effective tax rates were 18.4% and 16.8% for the three and nine months ended September 30, 2018, respectively, compared to 24.2% and 23.2% for the same periods of 2017. Tax-advantaged investment income, Deferred Gain amortization, LPT Reserve Adjustments, LPT Contingent Commission Adjustments, and certain other adjustments reduced the Company's effective income tax rate below the U.S. statutory rates of 21% and 35% for periods in 2018 and 2017, respectively.

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.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in millions)			
Unpaid losses and LAE at beginning of period	$2,227.9	$2,284.9	$2,266.1	$2,301.0
Less reinsurance recoverable, excluding bad debt allowance, on unpaid losses and LAE	512.5	559.8	537.0	580.0
Net unpaid losses and LAE at beginning of period	1,715.4	1,725.1	1,729.1	1,721.0
Losses and LAE, net of reinsurance, incurred during the period related to:				
Current period	121.1	119.7	342.5	341.0
Prior periods	(11.9)	(0.2)	(40.8)	(0.5)
Total net losses and LAE incurred during the period	109.2	119.5	301.7	340.5
Paid losses and LAE, net of reinsurance, related to:				
Current period	31.2	23.5	56.9	45.2
Prior periods	71.5	75.3	252.0	270.5
Total net paid losses and LAE during the period	102.7	98.8	308.9	315.7
Ending unpaid losses and LAE, net of reinsurance	1,721.9	1,745.8	1,721.9	1,745.8
Reinsurance recoverable, excluding bad debt allowance, on unpaid losses and LAE	511.8	553.1	511.8	553.1
Unpaid losses and LAE at end of period	$2,233.7	$2,298.9	$2,233.7	$2,298.9

Total net losses and LAE included in the above table exclude amortization of the deferred reinsurance gain—LPT Agreement, LPT Reserve Adjustments, and LPT Contingent Commission Adjustments, which totaled $2.6 million and $2.5 million for the three months ended September 30, 2018 and 2017, respectively, and $12.0 million and $8.5 million for the nine months ended September 30, 2018 and 2017, respectively (See Note 8).

The change in incurred losses and LAE attributable to prior periods included $12.0 million and $40.5 million of favorable development on the Company's voluntary risk business for the three and nine months ended September 30, 2018, respectively, and $0.1 million of unfavorable development and $0.3 million of favorable development on the Company's assigned risk business for the three and nine months ended September 30, 2018, respectively. The favorable prior accident year loss development on voluntary business during the three and nine months ended September 30, 2018 was the result of the Company's determination that adjustments were necessary to reflect observed favorable paid loss trends. Paid loss trends have been impacted by cost savings associated with accelerated claims settlement activity that began in 2014 and continued in 2018.

8. LPT Agreement

The Company is party to the LPT Agreement under which $1.5 billion in liabilities for losses and LAE related to claims incurred by the Fund prior to July 1, 1995 were reinsured for consideration of $775.0 million. The LPT Agreement provides coverage up to $2.0 billion. The Company records its estimate of contingent profit commission in the accompanying Consolidated Balance Sheets as Contingent commission receivable–LPT Agreement and a corresponding liability is recorded in the accompanying Consolidated Balance Sheets in Deferred reinsurance gain–LPT Agreement. The Deferred Gain is being amortized using the recovery method. Amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries over the life of the LPT Agreement, except for the contingent profit commission, which is amortized through June 30, 2024, the date through which the Company is entitled to receive a contingent profit commission under the LPT Agreement. The amortization is recorded in losses and LAE incurred in the accompanying consolidated statements of comprehensive income. Any adjustments to the Deferred Gain are recorded in losses and LAE incurred in the accompanying consolidated statements of comprehensive income.

The Company amortized $2.6 million and $2.5 million of the Deferred Gain for the three months ended September 30, 2018 and 2017, respectively, and $9.3 million and $8.5 million for the nine months ended September 30, 2018 and 2017, respectively. Additionally, the Deferred Gain was further reduced by $2.2 million for the nine months ended September 30, 2018 due to a favorable LPT Reserve Adjustment and by $0.5 million of amortization for the nine months ended September 30, 2018 due to a favorable LPT Contingent Commission Adjustment (see Note 2). The remaining Deferred Gain was $152.1 million and $163.6 million as of September 30, 2018 and December 31, 2017, respectively. The estimated remaining liabilities subject to the LPT Agreement were $414.0 million and $438.9 million as of September 30, 2018 and December 31, 2017, respectively. Losses and LAE paid with respect to the LPT Agreement totaled $767.8 million and $749.3 million from inception through September 30, 2018 and December 31, 2017, respectively.

9. Notes Payable and Other Financing Arrangements

Notes payable is comprised of the following:

	September 30, 2018	December 31, 2017
	(in millions)	
Dekania Surplus Note, due April 29, 2034	$ 10.0	$ 10.0
Alesco Surplus Note, due December 15, 2034	10.0	10.0
Total	$ 20.0	$ 20.0

EPIC has a $10.0 million surplus note to Dekania CDO II, Ltd. issued as part of a pooled transaction. The note matures in 2034 and became callable by the Company in 2009. The terms of the note provide for quarterly interest payments at a rate 425 basis points in excess of the 90-day LIBOR. Both the payment of interest and repayment of the principal under this note and the surplus note described in the following paragraph are subject to the prior approval of the Florida Department of Financial Services.

EPIC has a $10.0 million surplus note to Alesco Preferred Funding V, LTD issued as part of a pooled transaction. The note matures in 2034 and became callable by the Company in 2009. The terms of the note provide for quarterly interest payments at a rate 405 basis points in excess of the 90-day LIBOR.

Other financing arrangements is comprised of the following:

Each of the Company's insurance subsidiaries is a member of the FHLB. Membership allows the insurance subsidiaries access to collateralized advances, which may be used to support and enhance liquidity management. The amount of advances that may be taken is dependent on statutory admitted assets on a per company basis. Currently, none of the Company's insurance subsidiaries has advances outstanding under the FHLB facility.

FHLB membership also allows the Company's insurance subsidiaries access to standby letters of credit. On March 9, 2018, ECIC, EPIC, and EAC entered into standby Letter of Credit Reimbursement Agreements (Letter of Credit Agreements) with the FHLB. The Letter of Credit Agreements are between the FHLB and each of EAC, in the amount of $40.0 million, ECIC, in the amount of $50.0 million, and EPIC, in the amount of $50.0 million. The Letter of Credit Agreements became effective March 9, 2018 and expire March 31, 2019; however, the Letter of Credit Agreements will remain evergreen with automatic one-year extensions unless the FHLB notifies the beneficiary at least 60 days prior to the then applicable expiration date of its election not to renew. The Letter of Credit Agreements may only be used to satisfy, in whole or in part, insurance deposit requirements with the State of California and are fully secured with eligible collateral at all times. The Letter of Credit Agreements are subject to annual maintenance charges and a fee of 15 basis points on issued amounts. As of September 30, 2018, letters of credit totaling $140.0 million were issued in lieu of securities on deposit with the State of California under these Letter of Credit Agreements.

As of September 30, 2018, investment securities having a fair value of $247.9 million were pledged to the FHLB by the Company's insurance subsidiaries in support of the collateralized advance facility and the Letter of Credit Agreements.

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10. Accumulated Other Comprehensive Income

Accumulated other comprehensive income is comprised of unrealized (losses) gains on investments classified as AFS, net of deferred tax expense. Beginning in 2018, with the adoption of ASU No. 2016-01, the Company's investments in equity securities at fair value are no longer considered to be AFS and are reported at fair value with unrealized gains and losses included in Net realized and unrealized (losses) gains on investments on the Company's Consolidated Statements of Comprehensive Income. Prior to 2018, investments in equity securities at fair value were classified as AFS and changes in fair value were excluded from earnings and reported in accumulated other comprehensive income. The following table summarizes the components of accumulated other comprehensive (loss) income:

	September 30, 2018	December 31, 2017
	(in millions)	
Net unrealized (losses) gains on investments, before taxes	$(28.4)	$ 136.0
Deferred tax benefit (expense) on net unrealized (losses) gains	5.9	(28.6)
Total accumulated other comprehensive (loss) income	$(22.5)	$ 107.4

11. Stock-Based Compensation

The Company awarded restricted stock units (RSUs) and performance share units (PSUs) to certain employees and non-employee Directors of the Company as follows:

	Number Awarded	Weighted Average Fair Value on Date of Grant	Aggregate Fair Value on Date of Grant
			(in millions)
March 2018			
RSUs(1)	71,400	$ 40.30	$ 2.9
RSUs(2)	736	40.50	—
PSUs(3)	96,940	40.30	3.9
May 2018			
RSUs(4)	13,347	$ 39.65	$ 0.5

(1) The RSUs awarded in March 2018 were awarded to certain employees of the Company and vest 25% on March 15, 2019, and each of the subsequent three anniversaries of that date. The RSUs are subject to accelerated vesting in certain circumstances, including but not limited to: death, disability, retirement, or in connection with a change of control of the Company.

(2) The RSUs awarded in March 2018 were awarded to non-employee Directors of the Company and vested in full on May 25, 2018.

(3) The PSUs awarded in March 2018 were awarded to certain employees of the Company and have a performance period of two years followed by an additional one year vesting period. The PSU awards are subject to certain performance goals with payouts that range from 0% to 200% of the target awards. The value shown in the table represents the aggregate number of PSUs awarded at the target level.

(4) The RSUs awarded in May 2018 were awarded to non-employee Directors of the Company and vest in full on May 24, 2019.

Employees who were awarded RSUs and PSUs are entitled to receive dividend equivalents for eligible awards, payable in cash, when the underlying award vests and becomes payable. If the underlying award does not vest or is forfeited, any dividend equivalents with respect to the underlying award will also fail to become payable and will be forfeited.

Stock options exercised totaled 51,091 for the nine months ended September 30, 2018, 169,024 for the nine months ended September 30, 2017, and 307,076 for the year ended December 31, 2017.
As of September 30, 2018, the Company had 196,256 options, 313,181 RSUs, and 266,164 PSUs (based on target number awarded) outstanding.

12. Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilutive impact of all common stock equivalents on earnings per share. Diluted earnings per share includes shares that are assumed to be issued under the “treasury stock method,” which reflects the potential dilution that would occur if outstanding RSUs and PSUs had vested and options were to be exercised.

Commencing in 2017, certain stock-based compensation awards are eligible to receive dividend equivalents on awards that fully vest or become payable. The dividend equivalents are reflected in the Company's net income; therefore, these awards are not considered participating securities for the purposes of determining earnings per share.

The following table presents the net income and the weighted average number of shares outstanding used in the earnings per common share calculations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in millions, except share data)			
Net income—basic and diluted	$47.6	$ 21.9	$115.7	$ 69.9
Weighted average number of shares outstanding—basic	32,906,246	32,563,800	32,864,612	32,454,443
Effect of dilutive securities:				
PSUs	253,612	243,470	253,269	262,992
Stock options	104,450	180,421	101,907	212,044
RSUs	51,852	66,294	59,002	77,738
Dilutive potential shares	409,914	490,185	414,178	552,774
Weighted average number of shares outstanding—diluted	33,316,160	33,053,985	33,278,790	33,007,217

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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 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.

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, strategic initiatives, expected losses, accident year loss estimates, loss experience, loss reserves, acquisitions, competition, the impact of changes in interest rates, rate increases with respect to our business, and the insurance industry in general. Statements including words such as "expect," "intend," "plan," "believe," "estimate," "may," "anticipate," 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 43 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 and unrealized 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 given our expertise in underwriting this market segment. 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 strategy is to pursue profitable growth opportunities across market cycles and maximize total investment returns within the constraints of prudent portfolio management. We pursue profitable growth opportunities by focusing on disciplined underwriting and claims management, utilizing medical provider networks designed to produce superior medical and indemnity outcomes, establishing and maintaining strong, long-term relationships with independent insurance agencies, development and implementation of new technologies, and developing important alternative distribution channels. We continue to execute a number of ongoing business initiatives, including: focusing on internal and customer-facing business process excellence; accelerating the settlement of open claims; diversifying our risk exposure across geographic markets; utilizing a multi-company pricing platform; utilizing territory-specific pricing; and leveraging data-driven strategies to target, price, and underwrite profitable classes of business across all of our markets.

The insurance industry is highly competitive, and there is significant competition in the national workers' compensation industry that is based on price and quality of services. We compete with other specialty workers' compensation carriers, state agencies, multi-line insurance companies, professional employer organizations, self-insurance funds, and state insurance pools.

Pricing on our renewals showed overall price decreases of 14.1% and 11.0% versus the rate level in effect on such business a year earlier for each of the three and nine months ended September 30, 2018. We believe that we can continue to write attractive business due to favorable loss costs and frequency trends and the success of our accelerated claims initiatives, despite the competitive market conditions we currently face. Given the strength of our balance sheet and the execution of our underwriting, claims, and investment strategies, we believe that we are well positioned for the current market cycle.

On August 11, 2017, we entered into a Purchase Agreement, as amended, with PRUS with respect to the Acquisition of all of the outstanding shares of capital stock of PRNY. The purchase price is equal to the sum of: (i) the amount of statutory capital and surplus of PRNY at closing (which is currently estimated to be approximately $40.0 million); and (ii) $5.8 million. We expect to fund the Acquisition with cash on hand.

Pursuant to the Purchase Agreement, all liabilities and obligations of PRNY existing as of the closing date, whether known or unknown, will be indemnified by PRUS. In addition, PartnerRe Ltd., the parent company of PRUS, has provided us with a Guaranty that unconditionally, absolutely and irrevocably guarantees the full and prompt payment and performance by PRUS of all of its obligations, liabilities and indemnities under the Purchase Agreement and the transactions contemplated thereby.

We will not be acquiring any employees or ongoing business operations pursuant to the Acquisition. The Acquisition is subject to certain closing conditions, including, among other things, approval from the Department of Financial Services of the State of New York.

Results of Operations

A primary measure of our performance is our ability to increase Adjusted stockholders' equity over the long-term. We believe that this measure is important to our investors, analysts, and other interested parties who benefit from having an objective and consistent basis for comparison with other companies within our industry. The following table shows a reconciliation of our Stockholders' equity on a GAAP basis to our Adjusted stockholders' equity.

	September 30, 2018	December 31, 2017
	(in millions)	
GAAP stockholders' equity	$991.2	$ 947.7
Deferred reinsurance gain–LPT Agreement	152.1	163.6
Less: Accumulated other comprehensive (loss) income, net(1)	(22.5)	107.4
Adjusted stockholders' equity(2)	$1,165.8	$ 1,003.9

(1) The adoption of ASU No. 2016-01 resulted in a $74.0 million reclassification adjustment from Accumulated other comprehensive income, net to Retained earnings as of January 1, 2018.

(2) Adjusted stockholders' equity is a non-GAAP measure consisting of total GAAP stockholders' equity plus the Deferred Gain, less Accumulated other comprehensive (loss) income, net.

Our net income was $47.6 million and $115.7 million for the three and nine months ended September 30, 2018, respectively, compared to $21.9 million and $69.9 million for the corresponding periods of 2017. Our underwriting income was $22.7 million and $66.6 million for the three and nine months ended September 30, 2018, respectively, compared to $13.7 million and $34.2 million for the same periods of 2017. Underwriting income or loss is determined by deducting losses and LAE, commission expense, and underwriting and other operating expenses from net premiums earned.

Our results of operations during the three months ended September 30, 2018 were impacted by: (i) favorable prior accident year loss development of $11.9 million, which decreased our losses and LAE by the same amount; and (ii) the inclusion of $11.2 million in net unrealized gains on equity securities during the period (unrealized gains and losses on equity securities were not included in net income during the comparable 2017 period). Collectively, these items increased our pre-tax net income by $23.1 million during the third quarter of 2018. Additionally, our income tax expense was favorably impacted by the Tax Cuts and Jobs Act, which reduced the statutory tax rate from 35% to 21% beginning in 2018.

Our results of operations during the nine months ended September 30, 2018 were impacted by: (i) favorable prior accident year loss development of $40.8 million, which decreased our losses and LAE by the same amount; (ii) favorable development in the estimated reserves ceded under the LPT Agreement that resulted in a $2.2 million LPT Reserve Adjustment during the second quarter of 2018; (iii) an increase in the contingent commission receivable under the LPT Agreement that resulted in a $0.5 million LPT Contingent Commission Adjustment during the second quarter of 2018; and (iv) the inclusion of $1.8 million in net unrealized gains on equity securities during the period (unrealized gains and losses on equity securities were not included in net income during the comparable 2017 period). Collectively, these items increased our pre-tax net income by $45.3 million during nine months ended September 30, 2018. Additionally, our income tax expense was favorably impacted by the Tax Cuts and Jobs Act, which reduced the statutory tax rate from 35% to 21% beginning in 2018.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(in millions)			
Gross premiums written	$189.2	$179.2	$587.2	$561.3
Net premiums written	$187.3	$177.6	$582.5	$556.8
Net premiums earned	$192.9	$187.9	$547.5	$535.0
Net investment income	20.2	18.5	59.9	55.4
Net realized and unrealized gains on investments	15.6	4.1	13.2	7.4
Gain on redemption of notes payable	—	—	—	2.1
Other income	0.2	0.4	0.4	0.5
Total revenues	228.9	210.9	621.0	600.4
Losses and LAE	106.6	116.9	289.7	332.0
Commission expense	24.8	23.7	73.1	66.7
Underwriting and other operating expenses	38.8	33.6	118.1	102.1
Interest and financing expenses	0.4	0.3	1.1	1.1
Other expense	—	7.5	—	7.5
Total expenses	170.6	182.0	482.0	509.4
Income tax expense	10.7	7.0	23.3	21.1
Net income	$47.6	$21.9	$115.7	$69.9
Less amortization of the Deferred Gain related to losses	$2.1	$2.1	$7.8	$7.0
Less amortization of the Deferred Gain related to contingent commission	0.5	0.4	1.5	1.5
Less impact of LPT Reserve Adjustments(1)	—	—	2.2	—
Less impact of LPT Contingent Commission Adjustments(2)	—	—	0.5	—
Net income before impact of the LPT Agreement(3)	$45.0	$19.4	$103.7	$61.4

(1) LPT Reserve Adjustments result in a cumulative adjustment to the Deferred Gain, which is recognized in losses and LAE incurred on our Consolidated Statements of Comprehensive Income, such that the Deferred Gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement. (See Note 2 in the Notes to our Consolidated Financial Statements.)

(2) LPT Contingent Commission Adjustments result in an adjustment to the Deferred Gain, which is recognized in losses and LAE incurred on our Consolidated Statements of Comprehensive Income, such that the Deferred Gain reflects the balance that would have existed had the revised contingent profit commission been recognized at the inception of the LPT Agreement. (See Note 2 in the Notes to our Consolidated Financial Statements.)

(3) We define net income before impact of the LPT Agreement as net income before the impact of: (a) amortization of the Deferred Gain; (b) adjustments to the LPT Agreement ceded reserves; and (c) adjustments to the Contingent commission receivable–LPT Agreement. The Deferred Gain reflects the unamortized gain from the LPT Agreement. Under GAAP, this gain is deferred and is being amortized using the recovery method in which amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries over the life of the LPT Agreement, except for the contingent profit commission, which is amortized through June 30, 2024. The amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement and the expected losses and LAE subject to the contingent profit commission under the LPT Agreement. Our reevaluation results in corresponding adjustments, if needed, to reserves, ceded reserves, contingent commission receivable, and the Deferred Gain, with the net effect being an increase or decrease to our net income. Net income before impact of the LPT Agreement is not a measurement of financial performance under GAAP, but rather reflects a 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 or net income, or any other measure of performance derived in accordance with GAAP.

We present net income before impact of the LPT Agreement because we believe that it is an important supplemental measure of our ongoing operating performance to be used by analysts, investors, and other interested parties in evaluating us. The LPT Agreement was a non-recurring transaction under which the Deferred Gain does not affect our ongoing operations, and, 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 LPT Agreement has limited significance on our current and ongoing operations.

Gross Premiums Written

Gross premiums written were $189.2 million and $587.2 million for the three and nine months ended September 30, 2018, respectively, compared to $179.2 million and $561.3 million for the corresponding periods of 2017. The year-over-year increases for the three and nine months ended September 30, 2018 were primarily due to increases in new business premiums written, partially offset by declines in renewal business premiums. The increase in new business premiums was primarily driven by higher policy counts and payroll exposure, partially offset by decreases in average rates.

Net Premiums Written

Net premiums written were $187.3 million and $582.5 million for the three and nine months ended September 30, 2018, respectively, compared to $177.6 million and $556.8 million for the corresponding periods of 2017. Reinsurance premiums ceded were $1.9 million and $4.7 million for the three and nine months ended September 30, 2018, respectively, compared to $1.6 million and $4.5 million for the corresponding periods of 2017.

Net Premiums Earned

Net premiums earned were $192.9 million and $547.5 million for the three and nine months ended September 30, 2018, respectively, compared to $187.9 million and $535.0 million for the corresponding periods of 2017. Net premiums earned are primarily a function of the amount and timing of net premiums previously written.

The following table shows the percentage change in our in-force premiums, policy count, average policy size, and payroll exposure upon which our premiums are based for California, where 54% of our premiums were generated as of September 30, 2018 and for all other states, excluding California:

	As of September 30, 2018					
	Year-to-Date Increase			Year-Over-Year Increase		
	Overall	California	All Other States	Overall	California	All Other States
In-force premiums	5.6 %	2.5 %	9.6 %	5.7 %	2.3 %	10.0 %
In-force policy count	5.5	1.9	8.8	5.2	0.7	9.3
Average in-force policy size	0.1	0.6	0.7	0.5	1.6	0.6
In-force payroll exposure	16.6	17.4	16.0	17.3	19.7	15.8

The following table shows our in-force premiums and number of policies in-force for each state with at least five percent of our in-force premiums and all other states combined for the periods presented:

State	September 30, 2018		December 31, 2017		September 30, 2017		December 31, 2016	
	In-force Premiums	Policies In-force	In-force Premiums	Policies In-force	In-force Premiums	Policies In-force	In-force Premiums	Policies In-force
	(dollars in millions)							
California	$358.1	41,335	$349.4	40,573	$349.9	41,051	$348.3	42,120
Florida	42.0	5,745	41.8	5,625	40.0	5,611	35.2	5,263
Other (41 states and D.C.)	262.0	43,110	235.7	39,296	236.4	39,078	235.1	37,439
Total	$662.1	90,190	$626.9	85,494	$626.3	85,740	$618.6	84,822

Our alternative distribution channels that utilize partnerships and alliances generated $157.6 million and $131.1 million, or 23.8% and 20.9%, of our in-force premiums as of September 30, 2018 and 2017, 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 actively seek new partnerships and alliances.

Net Investment Income and Net Realized and Unrealized Gains on Investments

We invest in fixed maturity securities, equity securities, short-term investments, 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 increased 9.2% and 8.1% for the three and nine months ended September 30, 2018, respectively, compared to the same periods of 2017. The average pre-tax book yield on invested assets increased to 3.30% as of September 30, 2018, up from 3.12% as of September 30, 2017. Average invested assets remained relatively consistent year-over-year.

Realized and certain unrealized 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. Beginning in 2018, equity securities at fair value are no longer classified as AFS and changes in fair value are included in Net realized and unrealized gains on investments on our Consolidated Statements of Comprehensive Income.

Net realized and unrealized gains on investments were $15.6 million and $13.2 million for the three and nine months ended September 30, 2018, respectively, compared to $4.1 million and $7.4 million for the corresponding periods of 2017. The net realized and unrealized gains on investments for the three months ended September 30, 2018 included $11.2 million of unrealized gains on equity securities and $4.4 million of net realized gains on investments. The net realized and unrealized gains on investments for the nine months ended September 30, 2018 included $1.8 million of unrealized gains on equity securities and $11.4 million of net realized gains on investments. The unrealized gains on equity securities for the three and nine months ended September 30, 2018 were primarily the result of volatility in equity markets during those periods. Realized gains in both periods were primarily related to the sale of fixed maturity and equity securities, resulting from a rebalancing of our investment portfolio. Net realized and unrealized gains on investments included $2.0 million and $0.2 million of other-than-temporary impairments for the nine months ended September 30, 2018 and 2017, respectively.

Additional information regarding our Investments is set forth under "—Liquidity and Capital Resources—Investments."

Losses and LAE, Commission Expenses, and Underwriting and Other Operating Expenses

The combined ratio, a key measurement of underwriting profitability, is the sum of the loss and LAE ratio, the commission expense ratio, and the underwriting and other operating expenses ratio. A combined ratio below 100% indicates that an insurance company is generating an underwriting profit, and conversely, a combined ratio above 100% indicates that an insurance company is generating an underwriting loss.

The following table presents our calendar year combined ratios.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Loss and LAE ratio	55.3%	62.2%	52.9%	62.1%
Underwriting and other operating expenses ratio	20.0	17.9	21.5	19.1
Commission expense ratio	12.9	12.6	13.4	12.4
Combined ratio	88.2%	92.7%	87.8%	93.6%

We include all of the operating expenses of our holding company in the calculation of our combined ratio, which added approximately 2.1 and 2.2 percentage points to that ratio for the three and nine months ended September 30, 2018, respectively, compared to 1.4 and 1.9 percentage points for the corresponding periods of 2017.

Loss and LAE Ratio

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.

Our indemnity claims frequency (the number of claims expressed as a percentage of payroll) continued to decrease year-over-year; however, through September 30, 2018, we saw a slight upward movement in medical and indemnity costs per claim that is reflected in our current accident year loss estimate. We believe our current accident year loss estimate is adequate; however, ultimate losses will not be known with any certainty for many years.

Our loss and LAE ratio decreased 6.9 and 9.2 percentage points, or 11.1% and 14.8%, for the three and nine months ended September 30, 2018, compared to the same periods of 2017. The decreases in our loss and LAE ratios were primarily attributable to favorable prior accident year loss development of $11.9 million and $40.8 million during the three and nine months ended September 30, 2018, respectively. Favorable development during the three months ended

September 30, 2018 included $12.0 million favorable development on our voluntary business and $0.1 million unfavorable development on our assigned risk business, while favorable development for the nine months ended September 30, 2018 included $40.5 million of favorable development on our voluntary business and $0.3 million of favorable development on our assigned risk business. Favorable development during the three and nine months ended September 30, 2017 was related to our assigned risk business. Favorable prior accident year loss development in both periods of 2018 was primarily the result of observed favorable loss cost trends, primarily for the 2015 through

2017 accident years, which have been impacted by our internal initiatives to reduce loss costs, including the accelerated claims settlement activity that began in 2014 and have continued into 2018.
Our current accident year loss and LAE ratio was 62.8% and 62.6% for the three and nine months ended September 30, 2018, respectively compared to 63.7% for each of the corresponding periods of 2017. Our current accident year loss and LAE ratios continue to reflect the impact of key business initiatives, including: an emphasis on the accelerated settlement of open claims; diversifying our risk exposure across geographic markets; and leveraging data-driven strategies to target, underwrite, and price profitable classes of business across all of our markets. Our assigned risk business added 0.3 percentage points and 0.1 percentage point to our current accident year loss and LAE ratio for the three and nine months ended September 30, 2018, respectively.
Excluding the impact from the LPT, losses and LAE would have been \$109.2 million and \$119.4 million, or 56.6% and 63.5% of net premiums earned, for the three months ended September 30, 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017 losses and LAE, excluding the impact of the LPT, would have been \$301.7 million and \$340.5 million, or 55.1% and 63.6% of net premium earned, respectively.
The table below reflects prior accident year loss and LAE reserve adjustments and the impact of the LPT on net income before income taxes.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(in millions)			
Prior accident year favorable loss development, net	$11.9	$0.2	$ 40.8	$ 0.5
Amortization of the Deferred Gain related to losses	$2.1	$2.1	$ 7.8	$ 7.0
Amortization of the Deferred Gain related to contingent commission	0.5	0.4	1.5	1.5
Impact of LPT Reserve Adjustments	—	—	2.2	—
Impact of LPT Contingent Commission Adjustments	—	—	0.5	—
Total impact of the LPT on losses and LAE	2.6	2.5	12.0	8.5
Total losses and LAE reserve adjustments	$14.5	$2.7	$ 52.8	$ 9.0

Underwriting and Other Operating Expenses Ratio
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 policyholder dividends, 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. Other operating expenses are more fixed in nature and become a smaller percentage of net premiums earned as premiums increase.
Our underwriting and other operating expenses ratio increased 2.1 and 2.4 percentage points, or 11.7% and 12.6%, for the three and nine months ended September 30, 2018, compared to the same periods of 2017. During the three months ended September 30, 2018, our compensation-related expenses increased \$3.4 million and our professional fees increased \$1.8 million compared to the same period of 2017. During the nine months ended September 30, 2018, our compensation-related expenses increased \$6.8 million, our professional fees increased \$4.4 million, our bad debt expense increased \$3.3 million, and our premium taxes and assessments increased \$0.7 million compared to the same period of 2017. These increases were largely the result of our aggressive development and implementation of new digital technologies and capabilities.
Commission Expense Ratio
Commission expenses include direct commissions to our agents and brokers, including our partnerships and alliances, for the premiums that they produce for us, as well as incentive payments, other marketing costs, and fees.
Our commission expense ratio increased 0.3 and 1.0 percentage points, or 2.4% and 8.1%, for the three and nine months ended September 30, 2018, compared to the same periods of 2017. The increases in the commission expense

ratio were primarily the result of an increase in projected 2018 agency incentive commissions and a 13.9% year-over-year increase in the percentage of business produced by our partnerships and alliances, as of September 30, 2018, which is subject to a higher commission rate.

Income Tax Expense

Income tax expense was $10.7 million and $23.3 million for the three and nine months ended September 30, 2018, respectively, compared to $7.0 million and $21.1 million for the corresponding periods of 2017. The effective tax rates were 18.4% and 16.8% for the three and nine months ended September 30, 2018, respectively, compared to 24.2% and 23.2% for the same periods of

2017. Tax-advantaged investment income, Deferred Gain amortization, LPT Reserve Adjustments, LPT Contingent Commission Adjustments, and certain other adjustments reduced our effective income tax rate below the U.S. statutory rates of 21% and 35% for periods in 2018 and 2017, respectively.

Liquidity and Capital Resources

Holding Company Liquidity

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

Our insurance subsidiaries' ability to pay dividends to their parent is based on reported capital, surplus, and dividends paid within the prior 12 months. The maximum dividends that may be paid in 2018 by EPIC without prior regulatory approval is $15.9 million. During the first quarter of 2018, EICN made a $17.7 million cash dividend payment to its parent company. As a result of that payment, EICN's dividend capacity is limited to $2.2 million without prior regulatory approval for the remainder of 2018. During the second quarter of 2018, EAC made a $18.9 million cash dividend payment to its parent company. As a result of that payment, EAC's dividend capacity is limited to $0.1 million without prior regulatory approval for the remainder of 2018. During the third quarter of 2018, ECIC made a $48.4 million cash dividend payment to its parent company. As a result of that payment, ECIC cannot pay any dividends without prior regulatory approval for the remainder of 2018.

Total cash and investments at the holding company was $140.2 million at September 30, 2018, consisting of $129.7 million of cash and cash equivalents and $10.5 million of unaffiliated fixed maturity securities. We do not currently have a revolving credit facility because we believe that the holding company's cash needs for the foreseeable future will be met with its cash and investments on hand, as well as dividends available from our insurance subsidiaries.

Operating Subsidiaries' Liquidity

The primary sources of cash for our operating subsidiaries, which include our insurance and other operating subsidiaries, are premium collections, investment income, sales and maturities of investments, and reinsurance recoveries. The primary uses of cash by our operating subsidiaries are payments of losses and LAE, commission expenses, underwriting and other operating expenses, ceded reinsurance, investment purchases and dividends paid to their parent.

Total cash and investments held by our operating subsidiaries was $2,655.4 million at September 30, 2018, consisting of $75.3 million of cash and cash equivalents, $2,384.1 million of fixed maturity securities, and $196.0 million of equity securities. Sources of immediate and unencumbered liquidity at our operating subsidiaries as of September 30, 2018 consisted of $71.3 million of cash and cash equivalents, $189.6 million of publicly traded equity securities whose proceeds are available within three business days, and $1,157.7 million of highly liquid fixed maturity securities whose proceeds are available within three business days. We believe that our subsidiaries' liquidity needs over the next 24 months will be met with cash from operations, investment income, and maturing investments.

Each of our insurance subsidiaries is a member of the FHLB. Membership allows our insurance subsidiaries access to collateralized advances, which may be used to support and enhance liquidity management. The amount of advances that may be taken is dependent on statutory admitted assets on a per company basis. Currently, none of our insurance subsidiaries has advances outstanding under the FHLB facility.

FHLB membership also allows our insurance subsidiaries access to Letter of Credit Agreements and on March 9, 2018, ECIC, EPIC, and EAC entered into Letter of Credit Agreements with the FHLB. The Letter of Credit Agreements are between the FHLB and each of EAC, in the amount of $40.0 million, ECIC, in the amount of $50.0 million, and EPIC, in the amount of $50.0 million. The Letter of Credit Agreements became effective March 9, 2018 and expire March 31, 2019. The Letter of Credit Agreements may only be used to satisfy, in whole or in part, insurance deposit requirements with the State of California and are fully secured with eligible collateral at all times (See Note 9).

We purchase reinsurance to protect us against the costs of severe claims and catastrophic events. On July 1, 2018, we entered into a new reinsurance program that is effective through June 30, 2019. The reinsurance program consists of one treaty covering excess of loss and catastrophic loss events in four layers of coverage. Our reinsurance coverage is $190.0 million in excess of our $10.0 million retention on a per occurrence basis, subject to certain exclusions. We believe that our reinsurance program meets our needs and that we are sufficiently capitalized.

Various state laws and regulations require us to hold investment securities or letters of credit on deposit with certain states in which we do business. These laws and regulations govern both the amount and types of investment securities that are eligible for deposit. Securities having a fair value of $864.3 million and $1,009.7 million were on deposit at September 30, 2018 and December 31, 2017, respectively. Additionally, standby letters of credit from the FHLB have been issued in lieu of $140.0 million of securities on deposit at September 30, 2018.

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 our ceding reinsurers was $23.0 million and $24.5 million at September 30, 2018 and December 31, 2017, respectively.

Sources of Liquidity

We monitor the cash flows of each of our subsidiaries individually, as well as collectively as a consolidated group. 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,	
	2018	2017
	(in millions)	
Cash, cash equivalents, and restricted cash provided by (used in):		
Operating activities	$133.1	$103.8
Investing activities	19.9	(80.5)
Financing activities	(22.3)	(23.6)
Increase (decrease) in cash, cash equivalents, and restricted cash	$130.7	$(0.3)

For additional information regarding our cash flows, see Item 1, Consolidated Statements of Cash Flows.

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2018 included net premiums received of $561.2 million, and investment income received of $66.9 million. These operating cash inflows were partially offset by net claims payments of $309.6 million, underwriting and other operating expenses paid of $112.8 million, and commissions paid of $69.4 million.

Net cash provided by operating activities for the nine months ended September 30, 2017 included net premiums received of $528.4 million, and investment income received of $67.9 million. These operating cash inflows were partially offset by net claims payments of $314.8 million, underwriting and other operating expenses paid of $96.5 million, and commissions paid of $61.9 million.

Investing Activities

Net cash provided by investing activities for the nine months ended September 30, 2018 was primarily related to sales, maturities, and redemptions of investments whose proceeds were used to accumulate cash on hand, fund claims payments, underwriting and other operating expenses, and stockholder dividend payments, partially offset by the investment of premiums received and the reinvestment of funds from sales, maturities, redemptions, and interest income.

Net cash used in investing activities for the nine months ended September 30, 2017 was primarily related to the investment of premiums received and the reinvestment of funds from sales, maturities, redemptions, and interest income. These investing cash outflows were partially offset by investment sales whose proceeds were used to fund claims payments, underwriting and other operating expenses, and stockholder dividend payments.

Financing Activities

Net cash used in financing activities for the nine months ended September 30, 2018 was primarily related to stockholder dividend payments.

Net cash used in financing activities for the nine months ended September 30, 2017 was primarily related to stockholder dividend payments and the redemption of notes payable.

Dividends

Stockholder dividends paid were $19.9 million and $14.7 million for the nine months ended September 30, 2018 and 2017, respectively. On October 24, 2018, the Board of Directors declared a $0.20 dividend per share and eligible RSU and PSU, payable November 21, 2018, to stockholders of record on November 7, 2018.

Share Repurchases

On February 21, 2018, the Board of Directors authorized a share repurchase program for repurchases of up to $50.0 million of our common stock (the 2018 Program). The 2018 Program provides that shares may be purchased at prevailing market prices from February 26, 2018 through February 26, 2020 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 that may be 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 2018 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. Through September 30, 2018, we repurchased a total of 9,997 shares of common stock under the 2018 Program at an average price of $39.77 per share, including commissions, for a total cost of $0.4 million.

Capital Resources

As of September 30, 2018, the capital resources available to us consisted of: (i) $20.0 million in surplus notes maturing in 2034; (ii) $991.2 million of stockholders' equity; and (iii) the $152.1 million Deferred Gain.

Contractual Obligations and Commitments

The following table identifies our long-term debt and contractual obligations as of September 30, 2018.

	Payment Due By Period							
	Total	Less Than 1-Year	1-3 Years	4-5 Years	More Than 5 Years			
	(in millions)							
Operating leases	$23.8	$5.3	$7.9	$3.9	$6.7			
Non-cancellable obligations	18.2	3.3	8.0	6.2	0.7			
Notes payable[(1)]	30.6	1.3	2.6	2.6	24.1			
Capital leases	1.0	0.3	0.5	0.2	—			
Unpaid losses and LAE reserves [(2)(3)]	2,233.7	382.9	491.2	288.2	1,071.4			
Total contractual obligations	$2,307.3	$393.1	$510.2	$$ 66	$ 49	$88	$86	

(1) Unallocated legacy and corporate income (expense), net represents items that are not directly related to the company's business segments. These items primarily include asbestos-related charges and settlements, pension and retiree medical costs associated with sold businesses, and other legacy costs for environmental and product liability.

(2) Amounts for the three and nine months ended June 30, 2017 have been recast to reflect reportable segment changes.

	June 30, 2018	September 30, 2017 [(3)]
Segment Assets:		
Commercial Truck & Trailer	$1,884	$ 1,708
Aftermarket & Industrial	498	466
Total segment assets	2,382	2,174
Corporate [(1)]	544	869
Less: Accounts receivable sold under off-balance sheet factoring programs[(2)]	(310)	(261)
Total assets	$2,616	$ 2,782

(1) Corporate assets consist primarily of cash, deferred income taxes and prepaid pension costs.

(2) At June 30, 2018 and September 30, 2017, segment assets include $310 million and $261 million, respectively, of accounts receivable sold under off-balance sheet accounts receivable factoring programs (see Note 9). These sold receivables are included in segment assets as the CODM reviews segment assets inclusive of these balances.

(3) Amounts as of September 30, 2017 have been recast to reflect reportable segment changes, including the reallocation of goodwill.

23. Supplemental Guarantor Condensed Consolidating Financial Statements

Rule 3-10 of Regulation S-X requires that separate financial information for issuers and guarantors of registered securities be filed in certain circumstances. Certain of the company's 100-percent-owned subsidiaries, as defined in the credit agreement (the "Guarantors"), irrevocably and unconditionally guarantee amounts outstanding under the senior secured revolving credit facility on a joint and several basis. Similar subsidiary guarantees were provided for the benefit of the holders of the notes outstanding under the company's indentures (see Note 17).

In lieu of providing separate audited financial statements for the Parent and Guarantors, the company has included the accompanying condensed consolidating financial statements as permitted by Regulation S-X Rules 3-10. These condensed consolidating financial statements are presented on the equity method. Under this method, the investments in subsidiaries are recorded at cost and adjusted for the Parent's share of the subsidiary's cumulative results of operations, capital contributions and distribution and other equity changes. The Guarantors are combined in the condensed consolidating financial statements.

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
(In millions)
(Unaudited)

	Three Months Ended June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Sales					
External	$—	$ 629	$ 500	$—	$ 1,129
Subsidiaries	—	40	61	(101)	—
Total sales	—	669	561	(101)	1,129
Cost of sales	(15)	(559)	(479)	101	(952)
GROSS MARGIN	(15)	110	82	—	177
Selling, general and administrative	(31)	(27)	(18)	—	(76)
Restructuring costs	(2)	(1)	—	—	(3)
Other operating income, net	—	—	—	—	—
OPERATING INCOME (LOSS)	(48)	82	64	—	98
Other income (expense), net	24	(15)	(7)	—	2
Equity in earnings of affiliates	—	6	3	—	9
Interest income (expense), net	(26)	6	6	—	(14)
INCOME (LOSS) BEFORE INCOME TAXES	(50)	79	66	—	95
Benefit (provision) for income taxes	7	(13)	(20)	—	(26)
Equity income from continuing operations of subsidiaries	109	39	—	(148)	—
INCOME FROM CONTINUING OPERATIONS	66	105	46	(148)	69
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(2)	(2)	(2)	4	(2)
NET INCOME	64	103	44	(144)	67
Less: Net income attributable to noncontrolling interests	—	—	(3)	—	(3)
NET INCOME ATTRIBUTABLE TO MERITOR, INC.	$64	$ 103	$ 41	$(144)	$ 64

MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(In millions)
(Unaudited)

	Three Months Ended June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Net income	$64	$ 103	$ 44	$(144)	$ 67
Other comprehensive loss, net of tax	(48)	(57)	(8)	63	(50)
Total comprehensive income	16	46	36	(81)	17
Less: Comprehensive income attributable to noncontrolling interests	—	—	(1)	—	(1)
Comprehensive income attributable to Meritor, Inc.	$16	$ 46	$ 35	$(81)	$ 16

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
(In millions)
(Unaudited)

	Three Months Ended June 30, 2017 [1]				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Sales					
External	$—	$ 528	$ 392	$—	$ 920
Subsidiaries	—	33	77	(110)	—
Total sales	—	561	469	(110)	920
Cost of sales	(13)	(480)	(395)	110	(778)
GROSS MARGIN	(13)	81	74	—	142
Selling, general and administrative	(34)	(12)	(27)	—	(73)
Restructuring costs	—	1	(1)	—	—
Other operating income (expense), net	(1)	—	1	—	—
OPERATING INCOME (LOSS)	(48)	70	47	—	69
Other income (expense), net	12	(7)	(4)	—	1
Equity in earnings of affiliates	—	12	2	—	14
Interest income (expense), net	(32)	7	4	—	(21)
INCOME (LOSS) BEFORE INCOME TAXES	(68)	82	49	—	63
Benefit (provision) for income taxes	19	(22)	(8)	—	(11)
Equity income from continuing operations of subsidiaries	98	35	—	(133)	—
INCOME FROM CONTINUING OPERATIONS	49	95	41	(133)	52
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(1)	—	—	—	(1)
NET INCOME	48	95	41	(133)	51
Less: Net income attributable to noncontrolling interests	—	—	(3)	—	(3)
NET INCOME ATTRIBUTABLE TO MERITOR, INC.	$48	$ 95	$ 38	$(133)	$ 48

(1) Amounts have been recast to reflect the release of certain guarantors in accordance with the company's senior secured revolving credit facility.

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(In millions)
(Unaudited)

	Three Months Ended June 30, 2017 [1]				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Net income	$48	$ 95	$ 41	$(133)	$ 51
Other comprehensive income, net of tax	27	18	18	(37)	26
Total comprehensive income	75	113	59	(170)	77
Less: Comprehensive loss (income) attributable to noncontrolling interests	—	—	(3)	—	(3)
Comprehensive income attributable to Meritor, Inc.	$75	$ 113	$ 56	$(170)	$ 74

(1) Amounts have been recast to reflect the release of certain guarantors in accordance with the company's senior secured revolving credit facility.

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Sales					
External	$—	$ 1,663	$ 1,435	$—	$ 3,098
Subsidiaries	—	107	159	(266)	—
Total sales	—	1,770	1,594	(266)	3,098
Cost of sales	(44)	(1,477)	(1,348)	266	(2,603)
GROSS MARGIN	(44)	293	246	—	495
Selling, general and administrative	(90)	(74)	(53)	—	(217)
Restructuring costs	(2)	(2)	(2)	—	(6)
Other operating income (expense)	(10)	(1)	(1)	—	(12)
OPERATING INCOME (LOSS)	(146)	216	190	—	260
Other income (loss), net	57	(10)	(46)	—	1
Equity in earnings of affiliates	—	14	6	—	20
Interest income (expense), net	(91)	21	16	—	(54)
INCOME (LOSS) BEFORE INCOME TAXES	(180)	241	166	—	227
Benefit (Provision) for income taxes	(8)	(75)	(48)	—	(131)
Equity income from continuing operations of subsidiaries	276	100	—	(376)	—
INCOME FROM CONTINUING OPERATIONS	88	266	118	(376)	96
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(3)	(2)	(2)	4	(3)
NET INCOME	85	264	116	(372)	93
Less: Net income attributable to noncontrolling interests	—	—	(8)	—	(8)
NET INCOME ATTRIBUTABLE TO MERITOR, INC.	$85	$ 264	$ 108	$(372)	$ 85

MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Net income	$85	$ 264	$ 116	$(372)	$ 93
Other comprehensive income, net of tax	(33)	(45)	6	38	(34)
Total comprehensive income	52	219	122	(334)	59
Less: Comprehensive income attributable to noncontrolling interests	—	—	(7)	—	(7)
Comprehensive income attributable to Meritor, Inc.	$52	$ 219	$ 115	$(334)	$ 52

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2017 [1]				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Sales					
External	$—	$ 1,244	$ 1,181	$—	$ 2,425
Subsidiaries	—	89	103	(192)	—
Total sales	—	1,333	1,284	(192)	2,425
Cost of sales	(42)	(1,122)	(1,101)	192	(2,073)
GROSS MARGIN	(42)	211	183	—	352
Selling, general and administrative	(77)	(64)	(51)	—	(192)
Restructuring costs	2	(1)	(5)	—	(4)
Other operating expense, net	(3)	—	(2)	—	(5)
OPERATING INCOME (LOSS)	(120)	146	125	—	151
Other income (loss), net	36	(12)	(23)	—	1
Equity in earnings of affiliates	—	27	5	—	32
Interest income (expense), net	(99)	26	10	—	(63)
INCOME (LOSS) BEFORE INCOME TAXES	(183)	187	117	—	121
Benefit (Provision) for income taxes	54	(57)	(27)	—	(30)
Equity income from continuing operations of subsidiaries	215	76	—	(291)	—
INCOME FROM CONTINUING OPERATIONS	86	206	90	(291)	91
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(1)	—	—	—	(1)
NET INCOME	85	206	90	(291)	90
Less: Net income attributable to noncontrolling interests	—	—	(5)	—	(5)
NET INCOME ATTRIBUTABLE TO MERITOR, INC.	$85	$ 206	$ 85	$(291)	$ 85

(1) Amounts have been recast to reflect the release of certain guarantors in accordance with the company's senior secured revolving credit facility.

MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2017 [1]				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
Net income	$85	$ 206	$ 90	$(291)	$ 90
Other comprehensive income	41	14	12	(27)	40
Total comprehensive income	126	220	102	(318)	130
Less: Comprehensive loss (income) attributable to noncontrolling interests	—	—	(4)	—	(4)
Comprehensive income attributable to Meritor, Inc.	$126	$ 220	$ 98	$(318)	$ 126

(1) Amounts have been recast to reflect the release of certain guarantors in accordance with the company’s senior secured revolving credit facility.

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MERITOR, INC.
CONDENSED CONSOLIDATING BALANCE SHEET
(In millions)
(Unaudited)

	June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
CURRENT ASSETS:					
Cash and cash equivalents	$15	$ 7	$ 78	$—	$ 100
Receivables trade and other, net	3	55	551	—	609
Inventories	—	226	240	—	466
Other current assets	1	6	29	—	36
TOTAL CURRENT ASSETS	19	294	898	—	1,211
NET PROPERTY [(1)]	20	225	202	—	447
GOODWILL	—	249	170	—	419
OTHER ASSETS	186	136	217	—	539
INVESTMENTS IN SUBSIDIARIES	3,496	858	—	(4,354)	—
TOTAL ASSETS	$3,721	$ 1,762	$ 1,487	$(4,354)	$ 2,616
CURRENT LIABILITIES:					
Short-term debt	$47	$ 1	$ —	$—	$ 48
Accounts and notes payable	56	289	386	—	731
Other current liabilities	97	54	127	—	278
TOTAL CURRENT LIABILITIES	200	344	513	—	1,057
LONG-TERM DEBT	724	—	4	—	728
RETIREMENT BENEFITS	261	—	21	—	282
INTERCOMPANY PAYABLE (RECEIVABLE)	2,217	(2,555)	338	—	—
OTHER LIABILITIES	45	90	109	—	244
MEZZANINE EQUITY	2	—	—	—	2
EQUITY ATTRIBUTABLE TO MERITOR, INC.	272	3,883	471	(4,354)	272
NONCONTROLLING INTERESTS	—	—	31	—	31
TOTAL LIABILITIES, MEZZANINE EQUITY AND EQUITY	$3,721	$ 1,762	$ 1,487	$(4,354)	$ 2,616

[(1)] As of June 30, 2018, Assets and liabilities held for sale consisted of $1 million Net property. These assets and liabilities held for sale are included in the Guarantor column.

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MERITOR, INC.
CONDENSED CONSOLIDATING BALANCE SHEET
(In millions)
(Unaudited)

	September 30, 2017				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
CURRENT ASSETS:					
Cash and cash equivalents [1]	$10	$ 3	$ 75	$—	$ 88
Receivables trade and other, net [1]	—	296	493	—	789
Inventories [1]	—	184	194	—	378
Other current assets	5	6	32	—	43
TOTAL CURRENT ASSETS	15	489	794	—	1,298
NET PROPERTY [1]	21	227	226	—	474
GOODWILL [1]	—	237	177	—	414
OTHER ASSETS [1]	271	106	219	—	596
INVESTMENTS IN SUBSIDIARIES	3,222	787	—	(4,009)	—
TOTAL ASSETS	$3,529	$ 1,846	$ 1,416	$(4,009)	$ 2,782
CURRENT LIABILITIES:					
Short-term debt	$195	$ 2	$ 91	$—	$ 288
Accounts and notes payable [1]	55	246	321	—	622
Other current liabilities	69	69	134	—	272
TOTAL CURRENT LIABILITIES	319	317	546	—	1,182
LONG-TERM DEBT	743	—	7	—	750
RETIREMENT BENEFITS	291	—	23	—	314
INTERCOMPANY PAYABLE (RECEIVABLE)	1,866	(2,160)	294	—	—
OTHER LIABILITIES	40	93	106	—	239
MEZZANINE EQUITY	2	—	—	—	2
EQUITY ATTRIBUTABLE TO MERITOR, INC.	268	3,596	413	(4,009)	268
NONCONTROLLING INTERESTS [1]	—	—	27	—	27
TOTAL LIABILITIES, MEZZANINE EQUITY AND EQUITY	$3,529	$ 1,846	$ 1,416	$(4,009)	$ 2,782

[1] As of September 30, 2017, Assets and Liabilities held for sale were: (i) $1 million Cash and cash equivalents; (ii) $13 million Receivables, trade and other, net; (iii) $2 million Inventories; (iv) $3 million Net property, including land, buildings and equipment; (v) $1 million Goodwill; (vi) $1 million Other assets; (vii) $12 million Accounts and notes payable; and (viii) $2 million Noncontrolling interests. These Assets and liabilities held for sale are included in the Non-Guarantors column, other than $1 million of Net property that is included in the Guarantor column.

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2018				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	$(26)	$ 31	$ 186	$ —	$ 191
INVESTING ACTIVITIES					
Capital expenditures	(3)	(25)	(24)	—	(52)
Proceeds from sale of a business	4	—	—	—	4
Proceeds from prior year sale of equity method investment	250	—	—	—	250
Cash paid for investment in Transportation Power, Inc.	(6)	—	—	—	(6)
Cash paid for acquisition of AA Gear & Manufacturing, Inc.	(36)	—	—	—	(36)
Proceeds from sale of assets	—	—	2	—	2
CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	209	(25)	(22)	—	162
FINANCING ACTIVITIES					
Borrowings and securitization	—	—	(89)	—	(89)
Redemption of notes	(181)	—	—	—	(181)
Repurchase of common stock	(63)	—	—	—	(63)
Intercompany advances	67	—	(67)	—	—
Other financing activities	(1)	(2)	—	—	(3)
CASH USED FOR FINANCING ACTIVITIES	(178)	(2)	(156)	—	(336)
EFFECT OF CHANGES IN FOREIGN CURRENCY EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	—	—	(5)	—	(5)
CHANGE IN CASH AND CASH EQUIVALENTS	5	4	3	—	12
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	10	3	75	—	88
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$15	$ 7	$ 78	$ —	$ 100

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MERITOR, INC.
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS
(In millions)
(Unaudited)

	Nine Months Ended June 30, 2017 [1]				
	Parent	Guarantors	Non-Guarantors	Elims	Consolidated
CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES	$(24)	$ 28	$ 132	$ —	$ 136
INVESTING ACTIVITIES					
Capital expenditures	(8)	(27)	(17)	—	(52)
Net investing cash flows provided by discontinued operations	—	2	—	—	2
CASH USED FOR INVESTING ACTIVITIES	(8)	(25)	(17)	—	(50)
FINANCING ACTIVITIES					
Debt issuance costs	(4)	—	—	—	(4)
Intercompany advances	96	—	(96)	—	—
Other financing activities	—	(3)	(9)	—	(12)
CASH PROVIDED BY (USED FOR) FINANCING ACTIVITIES	92	(3)	(105)	—	(16)
EFFECT OF CHANGES IN FOREIGN CURRENCY EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	—	—	1	—	1
CHANGE IN CASH AND CASH EQUIVALENTS	60	—	11	—	71
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	90	4	66	—	160
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$150	$ 4	$ 77	$ —	$ 231

(1) Amounts have been recast to reflect the release of certain guarantors in accordance with the company's senior secured revolving credit facility.

Basis of Presentation

Certain information and footnote disclosures normally included in financial statements prepared in conformity with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. As of June 30, 2018 and September 30, 2017, Parent-only obligations included $273 million and $303 million of pension and retiree medical benefits, respectively (see Note 19). All debt is debt of the Parent other than $5 million and $100 million at June 30, 2018 and September 30, 2017, respectively (see Note 17), and is primarily related to U.S. accounts receivable securitization and capital lease obligations. There were $29 million and $1 million of cash dividends paid to the Parent by subsidiaries and investments accounted for by the equity method for the six months ended June 30, 2018 and June 30, 2017, respectively.

MERITOR, INC.

Item 2. Management’s Discussion and Analysis of Financial Conditions and Results of Operations
OVERVIEW
Meritor, Inc. (the “company,” “our,” “we” or “Meritor”), headquartered in Troy, Michigan, is a premier global supplier of a broad range of integrated systems, modules and components to original equipment manufacturers (“OEMs”) and the aftermarket for the commercial vehicle, transportation and industrial sectors. The company serves commercial truck, trailer, military, bus and coach, construction, and other industrial OEMs and certain aftermarkets. Meritor common stock is traded on the New York Stock Exchange under the ticker symbol MTOR.
3rd Quarter Fiscal Year 2018 Results
Our sales for the third quarter of fiscal year 2018 were $1,129 million, an increase compared to $920 million in the same period in the prior fiscal year. The increase in sales was driven primarily by higher production in all of our major markets. Sales for the quarter were also favorably impacted by revenue outperformance, primarily through increased market share and new business wins.
Net income attributable to Meritor for the third quarter of fiscal year 2018 was $64 million compared to $48 million in the same period in the prior fiscal year. Higher net income year over year was driven primarily by conversion on increased revenue.
Adjusted EBITDA (see Non-GAAP Financial Measures below) for the third quarter of fiscal year 2018 was $135 million compared to $103 million in the same period in the prior fiscal year. Our adjusted EBITDA margin (see Non-GAAP Financial Measures below) in the third quarter of fiscal year 2018 was 12.0 percent compared to 11.2 percent in the same period a year ago. Higher adjusted EBITDA and adjusted EBITDA margin year over year were driven primarily by conversion on higher revenue and $11 million of lower pension and retiree medical benefits. These increases were partially offset by $8 million of Meritor WABCO Vehicle Control Systems ("Meritor WABCO") affiliate earnings in the prior year that did not repeat.
Net income from continuing operations attributable to the company for the third quarter of fiscal year 2018 was $66 million compared to $49 million in the same period in the prior fiscal year. Adjusted income from continuing operations attributable to the company (see Non-GAAP Financial Measures below) for the third quarter of fiscal year 2018 was $80 million compared to $60 million in the same period in the prior fiscal year.
Cash provided by operating activities was $119 million in the third quarter of fiscal year 2018 compared to $106 million in the third quarter of fiscal year 2017. Higher earnings helped drive cash flow performance in the third quarter of fiscal year 2018.
Equity Repurchase Authorization
On July 21, 2016, our Board of Directors authorized the repurchase of up to $100 million of our common stock from time to time through open market purchases, privately negotiated transactions or otherwise, until September 30, 2019, subject to compliance with legal and regulatory requirements and our debt covenants. During the third quarter of fiscal year 2018, we repurchased 1.4 million shares of common stock for $30 million (including commission costs) pursuant to this authorization. The amount remaining available for repurchases under this authorization was $37 million as of June 30, 2018.
Acquisition of AA Gear & Manufacturing, Inc.
On April 30, 2018, we acquired substantially all of the assets of AA Gear & Manufacturing, Inc. and its subsidiaries (“AAG”) for a cash purchase price of approximately $36 million. The AAG acquisition was accounted for as a business combination. AAG provides low-to-medium volume batch manufacturing for complex gear and shaft applications, as well as quick-turnaround prototyping solutions and emergency plant support. AAG had developed relationships with some of the world’s leading manufacturers across a wide range of attractive end markets including agriculture, construction, heavy truck, diversified industrial and automotive. AAG sales for the three and nine months ended June 30, 2018 were $4 million and $13 million, respectively.

MERITOR, INC.

Trends and Uncertainties

Industry Production Volumes

The following table reflects estimated on-highway commercial truck production volumes for selected original equipment ("OE") markets for the three and nine months ended June 30, 2018 and 2017 based on available sources and management's estimates.

	Three Months Ended June 30,		Percent		Nine Months Ended June 30,		Percent	
	2018	2017	Change		2018	2017	Change	
Estimated Commercial Truck production (in thousands):								
North America, Heavy-Duty Trucks	79	66	20	%	219	164	34	%
North America, Medium-Duty Trucks	72	67	7	%	193	185	4	%
North America, Trailers	81	74	9	%	227	206	10	%
Western Europe, Heavy- and Medium-Duty Trucks	122	120	2	%	364	358	2	%
South America, Heavy- and Medium-Duty Trucks	25	20	25	%	74	50	48	%
India, Heavy- and Medium-Duty Trucks	110	48	129	%	337	227	48	%

North America:

During the fourth quarter of fiscal year 2018, we expect Class 8 truck production volumes in North America to continue to increase from the production levels experienced in the first nine months of fiscal year 2018.

Western Europe:

During the fourth quarter of fiscal year 2018, we expect production volumes in Western Europe to decrease slightly from the levels experienced in the first nine months of fiscal year 2018, due to the normal impact of the European summer holidays.

South America:

During the fourth quarter of fiscal year 2018, we expect production volumes in South America to increase from the levels experienced in the first nine months of fiscal year 2018, partially due to recovery from the truck drivers strike in the third quarter.

China:

Fourth quarter fiscal year 2018 production volumes are expected to increase compared to the same quarter last year, however volumes will be below levels experienced in the first nine months of fiscal year 2018 due to the normal impact of seasonality.

India:

Fourth quarter fiscal year 2018 production volumes are expected to be consistent with the same quarter last year, however volumes will be below levels experienced in the first nine months of fiscal year 2018 due to the normal impact of seasonality.

Industry-Wide Issues

Our business continues to address a number of challenging industry-wide issues including the following:

- Uncertainty around the global market outlook;
- Volatility in price and availability of steel, components and other commodities;
- Potential for disruptions in the financial markets and their impact on the availability and cost of credit;

- Volatile energy and transportation costs;
- Impact of currency exchange rate volatility; and
- Consolidation and globalization of OEMs and their suppliers.

Other

MERITOR, INC.

Other significant factors that could affect our results and liquidity include:

- Significant contract awards or losses of existing contracts or failure to negotiate acceptable terms in contract renewals;
- Ability to successfully launch a significant number of new products, including potential product quality issues, and obtain new business;
- Ability to manage possible adverse effects on our European operations, or financing arrangements related thereto, following the United Kingdom's decision to exit the European Union, or in the event one or more other countries exit the European monetary union;
- Ability to further implement planned productivity, cost reduction, and other margin improvement initiatives;
- Ability to successfully execute and implement strategic initiatives;
- Ability to work with our customers to manage rapidly changing production volumes;
- Ability to recover, and timing of recovery of, steel price and other cost increases from our customers;
- Any unplanned extended shutdowns or production interruptions by us, our customers or our suppliers;
- A significant deterioration or slowdown in economic activity in the key markets in which we operate;
- Competitively driven price reductions to our customers;
- Potential price increases from our suppliers;
- Additional restructuring actions and the timing and recognition of restructuring charges, including any actions associated with the prolonged softness in markets in which we operate;
- Higher-than-planned warranty expenses, including the outcome of known or potential recall campaigns;
- Uncertainties of asbestos claim and other legal proceedings, including the outcome of litigation with insurance companies regarding scope of asbestos coverage, and the long-term solvency of our insurance carriers;
- Significant pension costs; and
- Restrictive government actions (such as restrictions on transfer of funds and trade protection measures, including import and export duties, quotas and customs duties and tariffs).

NON-GAAP FINANCIAL MEASURES

In addition to the results reported in accordance with accounting principles generally accepted in the United States (“GAAP”), we have provided information regarding non-GAAP financial measures. These non-GAAP financial measures include adjusted income (loss) from continuing operations attributable to the company, adjusted diluted earnings (loss) per share from continuing operations, adjusted EBITDA, adjusted EBITDA margin, segment adjusted EBITDA, segment adjusted EBITDA margin, free cash flow and net debt.

Adjusted income (loss) from continuing operations attributable to the company and adjusted diluted earnings (loss) per share from continuing operations are defined as reported income (loss) from continuing operations and reported diluted earnings (loss) per share from continuing operations before restructuring expenses, asset impairment charges, non-cash tax expense related to the use of deferred tax assets in jurisdictions with net operating loss carry forwards, and other special items as determined by management. Adjusted EBITDA is defined as income (loss) from continuing operations before interest, income taxes, depreciation and amortization, non-controlling interests in consolidated joint ventures, loss on sale of receivables, restructuring expenses, asset impairment charges and other special items as determined by management. Adjusted EBITDA margin is defined as adjusted EBITDA divided by consolidated sales from continuing operations. Segment adjusted EBITDA is defined as income (loss) from continuing operations before interest expense, income taxes, depreciation and amortization, noncontrolling interests in consolidated joint ventures, loss on sale of receivables, restructuring expense, asset impairment charges and other special items as determined by management. Segment adjusted EBITDA excludes unallocated legacy and corporate expense (income), net. Segment adjusted EBITDA margin is defined as segment adjusted EBITDA divided by consolidated sales from continuing operations, either in the aggregate or by segment as applicable. Free cash flow is defined as cash flows provided by (used for) operating activities less capital expenditures. Net debt is defined as total debt less cash and cash equivalents.

MERITOR, INC.

Management believes these non-GAAP financial measures are useful to both management and investors in their analysis of the company's financial position and results of operations. In particular, adjusted EBITDA, adjusted EBITDA margin, segment adjusted EBITDA, segment adjusted EBITDA margin, adjusted income (loss) from continuing operations attributable to the company and adjusted diluted earnings (loss) per share from continuing operations are meaningful measures of performance to investors as they are commonly utilized to analyze financial performance in our industry, perform analytical comparisons, benchmark performance between periods and measure our performance against externally communicated targets.

Free cash flow is used by investors and management to analyze our ability to service and repay debt and return value directly to shareholders. Net debt over adjusted EBITDA is a specific financial measure in our current M2019 plan used to measure the company's leverage in order to assist management in its assessment of appropriate allocation of capital.

Management uses the aforementioned non-GAAP financial measures for planning and forecasting purposes, and segment adjusted EBITDA is also used as the primary basis for the Chief Operating Decision Maker ("CODM") to evaluate the performance of each of our reportable segments.

Our Board of Directors uses adjusted EBITDA margin, free cash flow, adjusted diluted earnings (loss) per share from continuing operations and net debt over adjusted EBITDA as key metrics to determine management's performance under our performance-based compensation plans.

Adjusted income (loss) from continuing operations attributable to the company, adjusted diluted earnings (loss) per share from continuing operations, adjusted EBITDA, adjusted EBITDA margin, segment adjusted EBITDA and segment adjusted EBITDA margin should not be considered a substitute for the reported results prepared in accordance with GAAP and should not be considered as an alternative to net income as an indicator of our financial performance. Free cash flow should not be considered a substitute for cash provided by (used for) operating activities, or other cash flow statement data prepared in accordance with GAAP, or as a measure of financial position or liquidity. In addition, this non-GAAP cash flow measure does not reflect cash used to repay debt or cash received from the divestitures of businesses or sales of other assets and thus does not reflect funds available for investment or other discretionary uses. Net debt should not be considered a substitute for total debt as reported on the balance sheet. These non-GAAP financial measures, as determined and presented by the company, may not be comparable to related or similarly titled measures reported by other companies. Set forth below are reconciliations of these non-GAAP financial measures to the most directly comparable financial measures calculated in accordance with GAAP.

Adjusted income from continuing operations attributable to the company and adjusted diluted earnings per share from continuing operations are reconciled to Income from continuing operations attributable to the company and Diluted earnings per share from continuing operations below (in millions, except per share amounts).

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2018	2017	2018	2017
Income from continuing operations attributable to the company	$66	$49	$88	$86
Loss on debt extinguishment	—	—	8	—
Restructuring costs	3	—	6	4
Asset impairment charges, net of noncontrolling interests	—	—	2	2
Non-cash tax expense (1)	12	11	26	22
U.S. tax reform impacts (2)	1	—	77	—
Income tax benefits	(2)	—	(4)	—
Adjusted income from continuing operations attributable to the company	$80	$60	$203	$114
Diluted earnings per share from continuing operations	$0.73	$0.52	$0.96	$0.94
Impact of adjustments on diluted earnings per share	0.16	0.12	1.27	0.31

Adjusted diluted earnings per share from continuing operations	$0.89	$0.64	$2.23	$1.25

MERITOR, INC.

(1) Represents tax expense related to the use of deferred tax assets in jurisdictions with net operating loss carry forwards.
(2) The nine months ended June 30, 2018 include $43 million of non-cash tax expense related to the revaluation of our deferred tax assets and liabilities as a result of the U.S. tax reform and $34 million of non-cash tax expense related to the one-time deemed repatriation of accumulated foreign earnings, which has no cash tax impact due to the use of foreign tax credits.

Free cash flow is reconciled to cash provided by operating activities below (in millions).

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2018	2017	2018	2017
Cash provided by operating activities	$119	$106	$191	$136
Capital expenditures	(17)	(12)	(52)	(52)
Free cash flow	$102	$94	$139	$84

MERITOR, INC.

Adjusted EBITDA and segment adjusted EBITDA are reconciled to net income attributable to Meritor, Inc. below (dollars in millions).

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2018	2017	2018	2017
Net income attributable to Meritor, Inc.	$64	$48	$85	$85
Loss from discontinued operations, net of tax, attributable to Meritor, Inc.	2	1	3	1
Income from continuing operations, net of tax, attributable to Meritor, Inc.	$66	$49	$88	$86
Interest expense, net	14	21	54	63
Provision for income taxes	26	11	131	30
Depreciation and amortization	22	18	64	55
Noncontrolling interests	3	3	8	5
Loss on sale of receivables	1	2	3	4
Asset impairment charges	—	(1)	2	2
Restructuring costs	3	—	6	4
Adjusted EBITDA	$135	$103	$356	$249
Adjusted EBITDA margin [1]	12.0 %	11.2 %	11.5 %	10.3 %
Unallocated legacy and corporate expense (income), net [2]	3	(2)	15	—
Segment adjusted EBITDA	$138	$101	$371	$249
Commercial Truck & Trailer [3]				
Segment adjusted EBITDA	$103	$71	$268	$163
Segment adjusted EBITDA margin [4]	11.4 %	9.8 %	10.8 %	8.7 %
Aftermarket & Industrial [3]				
Segment adjusted EBITDA	$35	$30	$103	$86
Segment adjusted EBITDA margin [4]	12.8 %	12.7 %	13.6 %	13.1 %

[1] Adjusted EBITDA margin equals adjusted EBITDA divided by consolidated sales from continuing operations.
[2] Unallocated legacy and corporate expense (income), net represents items that are not directly related to the company's business segments. These items primarily include asbestos-related charges and settlements, pension and retiree medical costs associated with sold businesses, and other legacy costs for environmental and product liability.
[3] Amounts for the three and nine months ended June 30, 2017 have been recast to reflect reportable segment changes.
[4] Segment adjusted EBITDA margin equals segment adjusted EBITDA divided by consolidated sales from continuing operations, either in the aggregate or by segment as applicable.

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Net debt is reconciled to total debt and adjusted EBITDA is reconciled to net income attributable to Meritor, Inc. below (dollars in millions).

	June 30, 2018	September 30, 2017
Short-term debt [1]	$ 48	$ 288
Long-term debt	728	750
Total debt	776	1,038
Less: Cash and cash equivalents	(100)	(88)
Net debt	$ 676	$ 950

[1] In the first quarter of fiscal year 2018, we redeemed the remaining $175 million aggregate principal amount outstanding of the 6.75 percent notes due 2021. In the second quarter of fiscal year 2018, the 4.0 percent convertible notes due 2027 were classified as short-term as the securities are redeemable at the option of the holder on February 15, 2019.

	Twelve Months Ended [1] June 30, 2018	Twelve Months Ended September 30, 2017
Net income attributable to Meritor, Inc.	$ 324	$ 324
Loss from discontinued operations, net of tax, attributable to Meritor, Inc.	3	1
Income from continuing operations, net of tax, attributable to Meritor, Inc.	$ 327	$ 325
Interest expense, net	110	119
Gain on sale of equity investment	(243)	(243)
Provision for income taxes	153	52
Depreciation and amortization	84	75
Noncontrolling interests	7	4
Loss on sale of receivables	4	5
Asset impairment charges	4	4
Restructuring costs	8	6
Adjusted EBITDA	$ 454	$ 347
Net debt over adjusted EBITDA	1.5	2.7

[1] Trailing-twelve-month period ended June 30, 2018 is used to measure the company's leverage in order to assist management in its assessment of appropriate allocation of capital as part of our current M2019 plan and is also used to assess management's performance under one of our performance-based compensation plans.

MERITOR, INC.

Results of Operations

Three Months Ended June 30, 2018 Compared to Three Months Ended June 30, 2017

Sales

The following table reflects total company and business segment sales for the three months ended June 30, 2018 and 2017 (dollars in millions). The reconciliation is intended to reflect the trend in business segment sales and to illustrate the impact that changes in foreign currency exchange rates, volumes and other factors had on sales. Business segment sales include intersegment sales.

	Three Months Ended June 30,				Dollar Change Due To	
	2018	2017 [1]	Dollar Change	% Change	Currency	Volume/ Other
Sales:						
Commercial Truck & Trailer						
North America	$474	$369	$ 105	28 %	$—	$ 105
Europe	196	175	21	12 %	10	11
South America	55	46	9	20 %	(6)	15
China	53	38	15	39 %	3	12
India	58	44	14	32 %	(2)	16
Other	25	17	8	47 %	1	7
Total External Sales	$861	$689	$ 172	25 %	$6	$ 166
Intersegment Sales	43	39	4	10 %	2	2
Total Sales	$904	$728	$ 176	24 %	$8	$ 168
Aftermarket & Industrial						
North America	$237	$200	$ 37	19 %	$2	$ 35
Europe	31	31	—	— %	2	(2)
Total External Sales	$268	$231	$ 37	16 %	$4	$ 33
Intersegment Sales	5	6	(1)	(17)%	3	(4)
Total Sales	$273	$237	$ 36	15 %	$7	$ 29
Total External Sales	$1,129	$920	$ 209	23 %	$10	$ 199

(1) Amounts for the three months ended June 30, 2017 have been recast to reflect reportable segment changes.

Commercial Truck & Trailer sales were $904 million in the third quarter of fiscal year 2018, up 24 percent compared to the third quarter of fiscal year 2017. The increase in sales was driven primarily by higher production in all of our major markets and revenue outperformance.

Aftermarket & Industrial sales were $273 million in the third quarter of fiscal year 2018, up 15 percent compared to the third quarter of fiscal year 2017. The increase in sales was driven by increased Aftermarket volumes across North America and higher sales in our Industrial business, which included sales from the Fabco Holdings, Inc. ("Fabco") business that was acquired in the fourth quarter of fiscal year 2017.

Cost of Sales and Gross Profit

Cost of sales primarily represents materials, labor and overhead production costs associated with the company’s products and production facilities. Cost of sales for the three months ended June 30, 2018 was $952 million compared to $778 million in the same period in the prior fiscal year, representing an increase of 22 percent, primarily driven by increased volumes. Total cost of sales was 84.3 and 84.6 percent of sales for the three-month periods ended June 30, 2018 and 2017, respectively.

The following table summarizes significant factors contributing to the changes in costs of sales during the third quarter of fiscal year 2018 compared to the same quarter in the prior year (in millions):

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	Cost of Sales
Three Months Ended June 30, 2017	$ 778
Volume, mix and other, net	171
Foreign exchange	3
Three Months Ended June 30, 2018	$ 952

Changes in the components of cost of sales year over year are summarized as follows (in millions):

	Change in Cost of Sales
Higher material costs	$ 153
Higher labor and overhead costs	27
Other, net	(6)
Total change in costs of sales	$ 174

Material costs represent the majority of our cost of sales and include raw materials, composed primarily of steel and purchased components. Material costs for the three months ended June 30, 2018 increased $153 million compared to the same period in the prior fiscal year primarily due to higher volumes.

Labor and overhead costs increased $27 million compared to the same period in the prior fiscal year primarily due to higher volumes.

Other, net decreased $6 million compared to the same period in the prior fiscal year primarily due to lower retiree medical expense.

Gross margin was $177 million and $142 million for the three-month periods ended June 30, 2018 and 2017, respectively. Gross margin, as a percentage of sales, was 15.7 and 15.4 percent for the three-month periods ended June 30, 2018 and 2017, respectively. Gross margin as a percentage of sales increased due primarily to conversion on higher sales and lower pension and retiree medical expense.

Other Income Statement Items

Selling, general and administrative expenses ("SG&A") for the three months ended June 30, 2018 and 2017 are summarized as follows (dollars in millions):

	Three Months Ended					
	June 30, 2018		June 30, 2017		Increase (Decrease)	
SG&A	Amount	% of sales	Amount	% of sales	Amount	% of sales
Loss on sale of receivables	$(1)	(0.1)%	$(2)	(0.2)%	$(1)	(0.1) pts
Short and long-term variable compensation	(16)	(1.4)%	(18)	(2.0)%	(2)	(0.6) pts
Asbestos-related expense, net of asbestos-related insurance recoveries	(3)	(0.3)%	(2)	(0.2)%	1	0.1 pts
All other SG&A	(56)	(4.9)%	(51)	(5.5)%	5	(0.6) pts
Total SG&A	$(76)	(6.7)%	$(73)	(7.9)%	$3	(1.2) pts

We recognized $3 million and $4 million related to previous cash settlements with insurance companies for recoveries of defense and indemnity costs associated with asbestos liabilities in the third quarter of fiscal years 2018 and 2017, respectively, which are included in Asbestos-related expense, net of asbestos-related insurance recoveries (see Note 20 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report).

All other SG&A, which represents normal selling, general and administrative expense, increased year over year, primarily due to investments to support M2019 plan growth initiatives.

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Restructuring costs were $3 million in the third quarter of fiscal year 2018, up $3 million from an insignificant amount in the third quarter of fiscal year 2017. During the three months ended June 30, 2018, these costs primarily related to employee severance costs.
Operating income increased by $29 million from $69 million in the third quarter of fiscal year 2017 to $98 million in the same period in fiscal year 2018. Key items affecting operating income are discussed above.
Equity in earnings of affiliates decreased by $5 million from $14 million in the third quarter of fiscal year 2017 to $9 million in the same period in fiscal year 2018. In the fourth quarter of fiscal year 2017, we sold our interest in Meritor WABCO to a subsidiary of our joint venture partner, WABCO Holdings Inc. The decrease in equity in earnings of affiliates was primarily driven by Meritor WABCO earnings that were included in fiscal year 2017 results but not in fiscal year 2018. This decrease was partially offset by improved earnings in our remaining joint ventures.
Interest expense, net decreased by $7 million from $21 million in the third quarter of fiscal year 2017 to $14 million in the same period in fiscal year 2018. The decrease in Interest expense was primarily attributable to the decrease in fixed-rate debt as a result of capital market transactions completed in the fourth quarter of fiscal year 2017 and the first quarter of fiscal year 2018, which lowered our total average debt balance and associated weighted average interest rate, as well as the benefits from the cross-currency swaps entered into during the third quarter of fiscal year 2018.
Provision for income taxes was $26 million in the third quarter of fiscal year 2018 compared to $11 million in the same period in the prior fiscal year. The increase in tax expense primarily relates to stronger earnings in certain jurisdictions that do not have a tax valuation allowance. In the third quarter of fiscal year 2018, a Research and Development ("R&D") tax credit project was completed which resulted in a $4 million income tax benefit.
Income from continuing operations (before noncontrolling interests) was $69 million in the third quarter of fiscal year 2018 compared to $52 million in the third quarter of fiscal year 2017. The reasons for the increase are discussed above.
Loss from discontinued operations, net of tax was a $2 million in the third quarter of fiscal year 2018 compared to $1 million in the third quarter of fiscal year 2017.
Net income attributable to Meritor, Inc. was $64 million in the third quarter of fiscal year 2018 compared to $48 million in the third quarter of fiscal year 2017. The various factors affecting net income are discussed above.

Segment Adjusted EBITDA and Segment Adjusted EBITDA Margins
Segment adjusted EBITDA is defined as income (loss) from continuing operations before interest expense, income taxes, depreciation and amortization, noncontrolling interests in consolidated joint ventures, loss on sale of receivables, restructuring expense, asset impairment charges and other special items as determined by management. Segment adjusted EBITDA excludes unallocated legacy and corporate expense (income), net. We use segment adjusted EBITDA as the primary basis for the CODM to evaluate the performance of each of our reportable segments. Segment adjusted EBITDA margin is defined as segment adjusted EBITDA divided by consolidated sales from continuing operations, either in the aggregate or by segment, as applicable. Segment adjusted EBITDA and segment adjusted EBITDA margin are non-GAAP measures (see Non-GAAP Financial Measures above).

The following table reflects segment adjusted EBITDA and segment adjusted EBITDA margins for the three months ended June 30, 2018 and 2017 (dollars in millions).

	Segment adjusted EBITDA			Segment adjusted EBITDA margins		
	Three Months Ended June 30,			Three Months Ended June 30,		
	2018	2017 (1)	Change	2018	2017 (1)	Change
Commercial Truck & Trailer	$103	$71	$ 32	11.4%	9.8 %	1.6 pts

Aftermarket & Industrial	35	30	5	12.8%	12.7%	0.1 pts
Segment adjusted EBITDA	$138	$101	$ 37	12.2%	11.0%	1.2 pts

(1) Amounts for the three months ended June 30, 2017 have been recast to reflect reportable segment changes.

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Significant items impacting year-over-year segment adjusted EBITDA include the following (in millions):

	Commercial Truck & Trailer	Aftermarket & Industrial	TOTAL
Segment adjusted EBITDA– Quarter ended June 30, 2017[1]	$ 71	$ 30	$ 101
Lower earnings from unconsolidated affiliates	(5)	—	(5)
Lower short-and long-term variable compensation	2	1	3
Lower pension and retiree medical expense, net	4	7	11
Impact of foreign currency exchange rates	4	1	5
Volume, mix, pricing and other	27	(4)	23
Segment adjusted EBITDA – Quarter ended June 30, 2018	$ 103	$ 35	$ 138

(1) Amounts for the three months ended June 30, 2017 have been recast to reflect reportable segment changes.

Commercial Truck & Trailer segment adjusted EBITDA was $103 million in the third quarter of fiscal year 2018, up $32 million from the same period in the prior fiscal year. Segment adjusted EBITDA margin increased to 11.4 percent compared to 9.8 percent in the same period in the prior fiscal year. The increases in both segment adjusted EBITDA and segment adjusted EBITDA margin were driven primarily by conversion on higher revenue and the favorable impact of changes to retiree medical benefits, partially offset by lower affiliate earnings arising from the sale of our interest in the Meritor WABCO joint venture in the previous year.

Aftermarket & Industrial segment adjusted EBITDA was $35 million in the third quarter of fiscal year 2018, up $5 million from the same period in the prior fiscal year. Segment adjusted EBITDA margin increased to 12.8 percent compared to 12.7 percent in the third quarter of fiscal year 2017. The increases in both segment Adjusted EBITDA and segment Adjusted EBITDA margin were driven primarily by the favorable impact of changes to retiree medical benefits and conversion on higher sales, partially offset by higher material and freight costs.

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Nine Months Ended June 30, 2018 Compared to Nine Months Ended June 30, 2017

Sales

The following table reflects total company and business segment sales for the nine months ended June 30, 2018 and 2017 (dollars in millions). The reconciliation is intended to reflect the trend in business segment sales and to illustrate the impact that changes in foreign currency exchange rates, volumes and other factors had on sales. Business segment sales include intersegment sales.

	Nine Months Ended June 30,				Dollar Change Due To	
	2018	2017 (1)	Dollar Change	% Change	Currency	Volume/ Other
Sales:						
Commercial Truck & Trailer						
North America	$1,223	$913	$ 310	34 %	$—	$ 310
Europe	567	464	103	22 %	51	52
South America	162	113	49	43 %	(7)	56
China	149	90	59	66 %	10	49
India	172	139	33	24 %	2	31
Other	81	60	21	35 %	2	19
Total External Sales	$2,354	$1,779	$ 575	32 %	$58	$ 517
Intersegment Sales	117	104	13	13 %	10	3
Total Sales	$2,471	$1,883	$ 588	31 %	$68	$ 520
Aftermarket & Industrial						
North America	$652	$568	$ 84	15 %	$3	$ 81
Europe	92	78	14	18 %	9	5
Total External Sales	$744	$646	$ 98	15 %	$12	$ 86
Intersegment Sales	14	13	1	8 %	9	(8)
Total Sales	$758	$659	$ 99	15 %	$21	$ 78
Total External Sales	$3,098	$2,425	$ 673	28 %	$70	$ 603

(1) Amounts for the nine months ended June 30, 2017 have been recast to reflect reportable segment changes.

Commercial Truck & Trailer sales were $2,471 million in the first nine months of fiscal year 2018, up 31 percent compared to the first nine months of fiscal year 2017. The increase in sales was driven primarily by higher production in all of our major markets. Higher sales were also driven by revenue outperformance, as well as favorable foreign currency.

Aftermarket & Industrial sales were $758 million in the first nine months of fiscal year 2018, up 15 percent compared to the first nine months of fiscal year 2017. The increase in sales was driven by increased volumes across the segment. Higher sales were also driven by higher sales in our Industrial business, which included sales from the Fabco business that was acquired in the fourth quarter of fiscal year 2017.

Cost of Sales and Gross Profit

Cost of sales primarily represents materials, labor and overhead production costs associated with the company’s products and production facilities. Cost of sales for the nine months ended June 30, 2018 was $2,603 million compared to $2,073 million in the same period in the prior fiscal year, representing an increase of 26 percent, primarily driven by increased volumes. Total cost of sales was 84.0 and 85.5 percent of sales for the nine-month periods ended June 30, 2018 and 2017, respectively.

The following table summarizes significant factors contributing to the changes in costs of sales during the first nine months of fiscal year 2018 compared to the same period in the prior year (in millions):

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	Cost of Sales
Nine Months Ended June 30, 2017	$2,073
Volume, mix and other, net	484
Foreign exchange	46
Nine Months Ended June 30, 2018	$2,603

Changes in the components of cost of sales year over year are summarized as follows (in millions):

	Change in Cost of Sales
Higher material costs	$ 449
Higher labor and overhead costs	105
Other, net	(24)
Total change in costs of sales	$ 530

Material costs represent the majority of our cost of sales and include raw materials, composed primarily of steel and purchased components. Material costs for the nine months ended June 30, 2018 increased $449 million compared to the same period in the prior fiscal year primarily due to higher volumes.

Labor and overhead costs increased $105 million compared to the same period in the prior fiscal year primarily due to higher volumes.

Other, net decreased $24 million compared to the same period in the prior fiscal year primarily due to lower retiree medical expense.

Gross margin was $495 million and $352 million for the nine-month periods ended June 30, 2018 and 2017, respectively. Gross margin, as a percentage of sales, was 16.0 and 14.5 percent for the nine-month periods ended June 30, 2018 and 2017, respectively. Gross margin as a percentage of sales increased due primarily to conversion on higher sales and lower pension and retiree medical expense.

Other Income Statement Items

SG&A for the nine months ended June 30, 2018 and 2017 are summarized as follows (dollars in millions):

	Nine Months Ended					
	June 30, 2018		June 30, 2017		Increase (Decrease)	
SG&A	Amount	% of sales	Amount	% of sales	Amount	% of sales
Loss on sale of receivables	$(3)	(0.1)%	$(4)	(0.2)%	$(1)	(0.1) pts
Short and long-term variable compensation	(43)	(1.4)%	(35)	(1.4)%	8	0.0 pts
Asbestos-related expense, net of asbestos-related insurance recoveries	(7)	(0.2)%	(3)	(0.1)%	4	0.1 pts
2017 Legal settlement charge	—	— %	(10)	(0.4)%	(10)	(0.4) pts
All other SG&A	(164)	(5.3)%	(140)	(5.8)%	24	(0.5) pts
Total SG&A	$(217)	(7.0)%	$(192)	(7.9)%	$25	(0.9) pts

We recognized $7 million and $15 million related to previous cash settlements with insurance companies for recoveries of defense and indemnity costs associated with asbestos liabilities in the first nine months of fiscal years 2018 and 2017, respectively, which are included in Asbestos-related expense, net of asbestos-related insurance recoveries (see Note 20 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report). In the second quarter of fiscal year 2017, we recognized a $10 million charge for a legal settlement related to a dispute with a joint venture.

All other SG&A, which represents normal selling, general and administrative expense, increased year over year, primarily due to investments to support M2019 plan growth initiatives.

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Restructuring costs increased by $2 million from $4 million in the first nine months of fiscal year 2017 to $6 million in the same period in fiscal year 2018. During the nine months ended June 30, 2018 and June 30, 2017, these costs primarily related to employee severance costs.

Other operating expense, net increased by $7 million from $5 million in the first nine months of fiscal year 2017 to $12 million in the first nine months of 2018. During the nine months ended June 30, 2018, these costs primarily related to environmental remediation. During the nine months ended June 30, 2017, we recognized an asset impairment of $3 million related to a business classified as held for sale, and we incurred $2 million of environmental remediation costs.

Operating income increased by $109 million from $151 million in the first nine months of fiscal year 2017 to $260 million in the same period in fiscal year 2018. Key items affecting operating income are discussed above.

Equity in earnings of affiliates decreased by $12 million from $32 million in the first nine months of fiscal year 2017 to $20 million in the same period in fiscal year 2018. The decrease in equity in earnings of affiliates was primarily driven by Meritor WABCO earnings that were included in fiscal year 2017 results but not in fiscal year 2018. This decrease was partially offset by improved earnings in our remaining joint ventures.

Interest expense, net decreased by $9 million from $63 million in the first nine months of fiscal year 2017 to $54 million in the same period in fiscal year 2018. In the first nine months of fiscal year 2018, we recognized an approximately $8 million loss on debt extinguishment, which is included in Interest expense, net, related to the redemption of our 6.75 percent notes due 2021 (the "6.75 Percent Notes"). The decrease in Interest expense was primarily attributable to the decrease in fixed-rate debt as a result of capital market transactions completed in the fourth quarter of fiscal year 2017 and the first quarter of fiscal year 2018, which lowered our total average debt balance and associated weighted average interest rate, as well as the benefits of cross-currency swaps entered into during the third quarter of fiscal year 2018.

Provision for income taxes was $131 million in the first nine months of fiscal year 2018 compared to $30 million in the same period in the prior fiscal year. The nine months ended June 30, 2018 include $43 million of non-cash tax expense related to the revaluation of our deferred tax assets and liabilities as a result of the U.S. tax reform and $34 million of non-cash tax expense related to the one-time deemed repatriation of accumulated foreign earnings, which has no cash impact due to the use of foreign tax credits. In the third quarter of fiscal year 2018, an R&D tax credit project was completed which resulted in a $4 million income tax benefit. Also, a tax planning strategy was implemented that resulted in a $4 million tax benefit from the reversal of a tax valuation allowance in Sweden.

Income from continuing operations (before noncontrolling interests) was $96 million in the first nine months of fiscal year 2018 compared to $91 million in the same period in fiscal year 2017. The reasons for the increase are discussed above.

Loss from discontinued operations, net of tax was $3 million in the first nine months of fiscal year 2018 compared to $1 million in the same period in fiscal year 2017.

Net income attributable to Meritor, Inc. was $85 million in the first nine months of fiscal years 2018 and 2017. The various factors affecting net income are discussed above.

Segment Adjusted EBITDA and Segment Adjusted EBITDA Margins

The following table reflects segment adjusted EBITDA and segment adjusted EBITDA margins for the nine months ended June 30, 2018 and 2017 (dollars in millions).

	Segment adjusted EBITDA			Segment adjusted EBITDA margins		
	Nine Months Ended June 30,			Nine Months Ended June 30,		
	2018	2017 (1)	Change	2018	2017 (1)	Change

Commercial Truck & Trailer	$268	$163	$ 105	10.8%	8.7 %	2.1 pts
Aftermarket & Industrial	103	86	17	13.6%	13.1%	0.5 pts
Segment adjusted EBITDA	$371	$249	$ 122	12.0%	10.3%	1.7 pts

(1) Amounts for the nine months ended June 30, 2017 have been recast to reflect reportable segment changes.

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Significant items impacting year-over-year segment adjusted EBITDA include the following (in millions):

	Commercial Truck & Trailer	Aftermarket & Industrial	TOTAL
Segment adjusted EBITDA– Nine months ended June 30, 2017[1]	$ 163	$ 86	$ 249
Lower earnings from unconsolidated affiliates	(12)	—	(12)
Higher short-and long-term variable compensation	(7)	(2)	(9)
Lower pension and retiree medical expense, net	12	21	33
Impact of foreign currency exchange rates	10	1	11
2017 Legal settlement charge	10	—	10
Volume, mix, pricing and other	92	(3)	89
Segment adjusted EBITDA – Nine months ended June 30, 2018	$ 268	$ 103	$ 371

[1] Amounts for the nine months ended June 30, 2017 have been recast to reflect reportable segment changes.

Commercial Truck & Trailer segment adjusted EBITDA was $268 million in the first nine months of fiscal year 2018, up $105 million from the same period in the prior fiscal year. Segment adjusted EBITDA margin increased to 10.8 percent compared to 8.7 percent in the same period in the prior fiscal year. The increases in both segment adjusted EBITDA and segment adjusted EBITDA margin were driven primarily by conversion on higher revenue, the favorable impact of changes to retiree medical benefits and a one-time legal charge related to a dispute with a joint venture in the prior year that did not repeat, partially offset by lower affiliate earnings arising from the sale of our interest in the Meritor WABCO joint venture in the previous year and higher variable compensation.

Aftermarket & Industrial segment adjusted EBITDA was $103 million in the first nine months of fiscal year 2018, up $17 million from the same period in the prior fiscal year. Segment adjusted EBITDA margin increased to 13.6 percent compared to 13.1 percent in the first nine months of fiscal year 2017. The increases in both segment adjusted EBITDA and segment adjusted EBITDA margin were driven by the favorable impact of changes to retiree medical benefits and conversion on higher sales, partially offset by higher material and freight costs.

Financial Condition

Cash Flows (in millions)

	Nine Months Ended June 30,	
	2018	2017
OPERATING CASH FLOWS		
Income from continuing operations	$96	$91
Depreciation and amortization	64	55
Deferred income tax expense	92	19
Loss on debt extinguishment	8	—
Restructuring costs	6	4
Asset impairment charges	2	2
Equity in earnings of affiliates	(20)	(32)
Pension and retiree medical expense (income)	(23)	11
Dividends received from equity method investments	9	25
Pension and retiree medical contributions	(17)	(28)
Restructuring payments	(7)	(11)
Increase in working capital	(136)	(75)
Changes in off-balance sheet accounts receivable factoring	65	62
Other, net	51	14
Cash flows provided by continuing operations	190	137
Cash flows provided by (used for) discontinued operations	1	(1)

CASH PROVIDED BY OPERATING ACTIVITIES	$191	$136

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Cash provided by operating activities in the first nine months of fiscal year 2018 was $191 million compared to $136 million in the same period of fiscal year 2017. The increase in cash provided by operating activities was primarily driven by conversion on higher sales year over year.

	Nine Months Ended June 30, 2018	2017
INVESTING CASH FLOWS		
Capital expenditures	$(52)	$(52)
Proceeds from prior year sale of equity method investment	250	—
Cash paid for acquisition of AA Gear & Manufacturing, Inc.	(36)	—
Cash paid for investment in Transportation Power, Inc.	(6)	—
Proceeds from sale of a business	4	—
Proceeds from sale of assets	2	—
Net investing cash flows provided by discontinued operations	—	2
CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	$162	$(50)

Cash provided by investing activities was $162 million in the first nine months of fiscal year 2018 compared to cash used for investing activities of $50 million in the same period in fiscal year 2017. The increase in cash provided by investing activities was driven by $250 million of proceeds received in the first quarter of fiscal year 2018, from the sale of our interest in Meritor WABCO in the fourth quarter of fiscal year 2017. The increase in cash provided by investing activities was partially offset by cash used for the acquisition of AAG.

	Nine Months Ended June 30, 2018	2017
FINANCING CASH FLOWS		
Borrowings and securitization	$(89)	$—
Redemption of notes	(181)	—
Debt issuance costs	—	(4)
Other financing activities	(3)	(12)
Net change in debt	(273)	(16)
Repurchase of common stock	(63)	—
CASH USED FOR FINANCING ACTIVITIES	$(336)	$(16)

Cash used for financing activities was $336 million in the first nine months of fiscal year 2018 compared to $16 million in the same period of fiscal year 2017. The increase in cash used for financing activities is primarily related to the redemption of the 6.75 Percent Notes in the first quarter of fiscal year 2018. We utilized $185 million to redeem $175 million principal amount of our 6.75 Percent Notes (see Note 17 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report). The increase in cash used for financing activities was also driven by a reduction in outstanding borrowings against our securitization facility in the current year and the repurchase of 2.8 million shares of common stock for $63 million (including commission costs) pursuant to the July 2016 equity repurchase authorization (see Note 21 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report).

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Liquidity

Our outstanding debt, net of discounts and unamortized debt issuance costs, where applicable, is summarized in the table below (in millions).

	June 30, 2018	September 30, 2017
Fixed-rate debt securities	$444	$ 616
Fixed-rate convertible notes	364	363
Unamortized discount on convertible notes	(39)	(42)
Other borrowings	7	101
Total debt	$776	$ 1,038

Overview – Our principal operating and capital requirements are for working capital needs, capital expenditure requirements, debt service requirements, funding of pension and retiree medical costs and restructuring and product development programs. We expect fiscal year 2018 capital expenditures for our business segments to be approximately $95 million.

We generally fund our operating and capital needs with cash on hand, cash flows from operations, our various accounts receivable securitization and factoring arrangements and availability under our revolving credit facility. Cash in excess of local operating needs is generally used to reduce amounts outstanding, if any, under our revolving credit facility or U.S. accounts receivable securitization program. Our ability to access additional capital in the long term will depend on availability of capital markets and pricing on commercially reasonable terms, as well as our credit profile at the time we are seeking funds. We continuously evaluate our capital structure to ensure the most appropriate and optimal structure and may, from time to time, retire, repurchase, exchange or redeem outstanding indebtedness or common equity, issue new equity or debt securities or enter into new lending arrangements if conditions warrant.

In December 2017, we filed a shelf registration statement with the Securities and Exchange Commission ("SEC"), registering an indeterminate amount of debt and/or equity securities that we may offer in one or more offerings on terms to be determined at the time of sale.

We believe our current financing arrangements provide us with the financial flexibility required to maintain our operations and fund future growth, including actions required to improve our market share and further diversify our global operations, through the term of our revolving credit facility, which matures in March 2022.

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Sources of liquidity as of June 30, 2018, in addition to cash on hand, are as follows (in millions):

	Total Facility Size	Utilized as of 6/30/18	Readily Available as of 6/30/18	Current Expiration
On-balance sheet arrangements:				
Revolving credit facility (1)	$ 525	$ —	$ 525	March 2022 (1)
Committed U.S. accounts receivable securitization (2)	100	—	89	December 2020
Total on-balance sheet arrangements	$ 625	$ —	$ 614	
Off-balance sheet arrangements: (2)				
Committed Swedish factoring facility (3)	$ 179	$ 190	$ —	March 2020
Committed U.S. factoring facility	93	52	—	February 2019
Uncommitted U.K. factoring facility	29	12	—	February 2022
Uncommitted Italy factoring facility	35	35	—	June 2022
Other uncommitted factoring facilities	29	21	—	None
Letter of credit facility	25	3	22	March 2019
Total off-balance sheet arrangements	390	313	22	
Total available sources	$ 1,015	$ 313	$ 636	

(1)The availability under the revolving credit facility is subject to a collateral test and a priority debt-to-EBITDA ratio covenant.

(2)Availability subject to adequate eligible accounts receivable available for sale.

(3)Actual amounts may exceed the bank's commitment at the bank's discretion.

Cash and Liquidity Needs – Our cash and liquidity needs have been affected by the level, variability and timing of our customers' worldwide vehicle production and other factors outside of our control. At June 30, 2018, we had $100 million in cash and cash equivalents.

At June 30, 2018, we had approximately $17 million of our cash and cash equivalents held in jurisdictions outside of the U.S. that, if repatriated, could result in local withholding taxes. It is our intent to reinvest those cash balances in our foreign operations, and we will continue to meet our liquidity needs in the U.S. through ongoing cash flows from operations in the U.S., external borrowings or both.

Our availability under the revolving credit facility is subject to a collateral test and a priority debt-to-EBITDA ratio covenant, as defined in the credit agreement, which may limit our borrowings under such agreement as of each quarter end. As long as we are in compliance with those covenants as of the quarter end, we have full availability (up to the amount of collateral under the collateral test) under the revolving credit facility every other day during the quarter.

Our future liquidity is subject to a number of factors, including access to adequate funding under our revolving credit facility, access to other borrowing arrangements such as factoring or securitization facilities, vehicle production schedules and customer demand. Even taking into account these and other factors, management expects to have sufficient liquidity to fund our operating requirements through the term of our revolving credit facility. At June 30, 2018, we were in compliance with all covenants under our credit agreement.

Equity Repurchase Authorization – On July 21, 2016, our Board of Directors authorized the repurchase of up to $100 million of our common stock from time to time through open market purchases, privately negotiated transactions or otherwise, until September 30, 2019, subject to compliance with legal and regulatory requirements and our debt covenants. During the second quarter of fiscal year 2018, we repurchased 1.4 million shares of common stock for $33 million (including commission costs) pursuant to this authorization. During the third quarter of fiscal year 2018, we repurchased 1.4 million shares of common stock for $30 million (including commission costs) pursuant to this authorization. The amount remaining available for repurchases under this authorization was $37 million as of June 30, 2018.

Debt Repurchase Authorization – On July 21, 2016, our Board of Directors authorized the repurchase of up to $150 million aggregate principal amount of any of our debt securities (including convertible debt securities) from time to time through open market purchases, privately negotiated transactions or otherwise, until September 30, 2019, subject to compliance with legal and regulatory requirements and our debt covenants. The amount remaining available for repurchases under this authorization was $50 million as of June 30, 2018.

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Redemption of 6.75 Percent Notes - On September 28, 2017, we redeemed $100 million of the outstanding $275 million aggregate principal amount of our 6.75 Percent Notes at a price of $1,033.75 per $1,000 of principal amount, plus accrued and unpaid interest. As a result, a loss on debt extinguishment of $5 million was recorded in the consolidated statement of operations within Interest expense, net during fiscal year 2017. The redemption was made pursuant to the July 2016 debt repurchase authorization (see Note 21 of the Notes to Consolidated Financial Statements).

On November 2, 2017, we redeemed the remaining $175 million aggregate principal amount outstanding of the 6.75 Percent Notes at a price of $1,033.75 per $1,000 of principal amount, plus accrued and unpaid interest. As a result, a loss on debt extinguishment of $8 million was recorded in the consolidated statement of operations within Interest expense, net. The redemption was made pursuant to a special authorization from the Board of Directors in connection with the sale of our interest in Meritor WABCO.

Revolving Credit Facility – On March 31, 2017, we amended and restated our revolving credit facility. Pursuant to the revolving credit agreement, as amended, we have a $525 million revolving credit facility that matures in March 2022. Additionally, $4 million was capitalized as deferred issuance costs and will be amortized over the term of the agreement. The availability under this facility is dependent upon various factors, including performance against certain financial covenants as highlighted below.

The availability under the revolving credit facility is subject to certain financial covenants based on (i) the ratio of our priority debt (consisting principally of amounts outstanding under the revolving credit facility, U.S. accounts receivable securitization and factoring programs, and third-party non-working capital foreign debt) to EBITDA and (ii) the amount of annual capital expenditures. We are required to maintain a total priority debt-to-EBITDA ratio, as defined in the agreement, of 2.25 to 1.00 or less as of the last day of each fiscal quarter throughout the term of the agreement. At June 30, 2018, we were in compliance with all covenants under the revolving credit facility with a ratio of approximately 0.14x for the priority debt-to-EBITDA ratio covenant.

The availability under the revolving credit facility is also subject to a collateral test, pursuant to which borrowings on the revolving credit facility cannot exceed 1.0x the collateral test value. The collateral test is performed on a quarterly basis. At June 30, 2018, the revolving credit facility was collateralized by approximately $864 million of our assets, primarily consisting of eligible domestic U.S. accounts receivable, inventory, plant, property and equipment, intellectual property and our investment in all or a portion of certain of our wholly-owned subsidiaries.

Borrowings under the revolving credit facility are subject to interest based on quoted LIBOR rates plus a margin and a commitment fee on undrawn amounts, both of which are based upon our current corporate credit rating. At June 30, 2018, the margin over LIBOR rate was 275 basis points and the commitment fee was 37.5 basis points. Overnight revolving credit loans are at the prime rate plus a margin of 175 basis points.

Certain of our subsidiaries, as defined in the revolving credit agreement, irrevocably and unconditionally guarantee amounts outstanding under the revolving credit facility. Similar subsidiary guarantees are provided for the benefit of the holders of the publicly-held notes outstanding under our indentures (see Note 23 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report).

No borrowings were outstanding under the revolving credit facility at June 30, 2018 and September 30, 2017. The amended and extended revolving credit facility includes $100 million of availability for the issuance of letters of credit. At June 30, 2018 and September 30, 2017, there were no letters of credit outstanding under the revolving credit facility.

U.S. Securitization Program – We have a $100 million U.S. accounts receivables securitization facility. On December 5, 2017, we entered into an amendment that extended the facility expiration date to December 2020. The maximum permitted priority debt-to-EBITDA ratio as of the last day of each fiscal quarter under the facility is 2.25 to 1.00. This program is provided by PNC Bank, National Association, as Administrator and Purchaser, and the other Purchasers and Purchaser Agents from time to time (participating lenders), which are party to the agreement. Under this program, we have the ability to sell an undivided percentage ownership interest in substantially all of our trade receivables (excluding the receivables due from AB Volvo and subsidiaries eligible for sale under the U.S. accounts receivable factoring facility) of certain U.S. subsidiaries to ArvinMeritor Receivables Corporation ("ARC"), a wholly-owned, special purpose subsidiary. ARC funds these purchases with borrowings from participating lenders under a loan agreement. This program also includes a letter of credit facility pursuant to which ARC may request the issuance of letters of credit issued for our U.S. subsidiaries (originators) or their designees, which when issued will constitute a utilization of the facility for the amount of letters of credit issued. Amounts outstanding under this agreement are collateralized by eligible receivables purchased by ARC and are reported as short-term debt in the condensed consolidated balance sheet. At June 30, 2018, no amounts were outstanding under this program. At September 30, 2017, $89 million was outstanding under this program. At June 30, 2018, $11 million was outstanding for letters of credit under this program. At September 30, 2017, no amounts were outstanding for letters of credit. This securitization program contains a cross default to our revolving credit facility. At June 30, 2018, we were in compliance with all covenants under our credit agreement (see Note 17 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report). At certain times during any given month, we may sell eligible accounts receivable under this program to fund intra-month working capital needs. In such months, we would then typically utilize the cash received from our customers throughout the month to repay the borrowings under the program. Accordingly, during any given month, we may borrow under this program in amounts exceeding the amounts shown as outstanding at fiscal quarter ends.

Capital Leases – In March 2012, we entered into a master lease agreement with Wells Fargo Equipment Finance, under which we can enter into lease arrangements for equipment. Each lease term is 60 months and the lease interest rate is equal to the 5-year Swap Rate published by the Federal Reserve Board plus 564 basis points. We had $1 million and $3 million outstanding under this capital lease arrangement as of June 30, 2018 and September 30, 2017, respectively. In addition, we had another $6 million and $10 million outstanding through other capital lease arrangements at June 30, 2018 and September 30, 2017, respectively.

Export financing arrangements – Our export financing arrangements were entered into through our Brazilian subsidiary pursuant to an incentive program of the Brazilian government to fund working capital for Brazilian companies in exportation programs. The arrangements bore interest at 5.5 percent and had maturity dates in 2017. These financing arrangements were paid off at maturity, as of March 31, 2017.

Other – One of our consolidated joint ventures in China participates in a bills of exchange program to settle its obligations with its trade suppliers. These programs are common in China and generally require the participation of local banks. Under these programs, our joint venture issues notes payable through the participating banks to its trade suppliers. If the issued notes payable remain unpaid on their respective due dates, this could constitute an event of default under our revolving credit facility if the defaulted amount exceeds $35 million per bank. As of June 30, 2018 and September 30, 2017, we had $14 million and $24 million, respectively, outstanding under this program at more than one bank.

Credit Ratings – At August 1, 2018, our Standard & Poor’s corporate credit rating and senior unsecured credit rating were BB and BB-, respectively, and our Moody’s Investors Service corporate credit rating and senior unsecured credit rating were B1 and B2, respectively. Any lowering of our credit ratings could increase our cost of future borrowings and could reduce our access to capital markets and result in lower trading prices for our securities.

Off-Balance Sheet Arrangements

Accounts Receivable Factoring Arrangements – We participate in accounts receivable factoring programs with a total amount utilized at June 30, 2018 of $310 million, of which $242 million was attributable to committed factoring facilities involving the sale of AB Volvo accounts receivables. The remaining amount of $68 million was related to factoring by certain of our European subsidiaries under uncommitted factoring facilities with financial institutions. The receivables under all of these programs are sold at face value and are excluded from the consolidated balance sheet. Total facility size, utilized amounts, readily available amounts and expiration dates for each of these programs are shown in the table above under Liquidity.

The Swedish facility is backed by a 364-day liquidity commitment from Nordea Bank, which was renewed through February 12, 2019. Commitments under all of our factoring facilities are subject to standard terms and conditions for these types of arrangements (including, in the case of the U.K. and Italy commitments, a sole discretion clause whereby the bank retains the right to not purchase receivables, which has not been invoked since the inception of the respective programs).

Letter of Credit Facilities – On February 21, 2014, we amended and restated our letter of credit facility with Citicorp USA, Inc., as administrative agent and issuing bank, and the other lenders party thereto. Under the terms of this amended credit agreement, which expires in March 2019, we have the right to obtain the issuance, renewal, extension and increase of letters of credit up to an aggregate availability of $25 million. This facility contains covenants and events of default generally similar to those existing in our public debt indentures. We had $3 million and $18 million of letters of credit outstanding under this facility at June 30, 2018 and September 30, 2017, respectively. In addition, we had another $5 million of letters of credit outstanding through other letter of credit facilities at June 30, 2018 and September 30, 2017, respectively.

Contingencies

Contingencies related to environmental, asbestos and other matters are discussed in Note 20 of the Notes to Condensed Consolidated Financial Statements in Part I of this Quarterly Report.

Critical Accounting Policies

Our significant accounting policies are consistent with those described in Note 2 to our consolidated financial statements in Item 8 of our 2017 Form 10-K. Our critical accounting estimates are consistent with those described in Item 7 of our 2017 Form 10-K.

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New Accounting Pronouncements

New Accounting Pronouncements are discussed in Note 3 of the Notes to Condensed Consolidated Financial Statements in Item 1. Financial Statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain global market risks, including foreign currency exchange risk and interest rate risk associated with our debt.

As a result of our substantial international operations, we are exposed to foreign currency risks that arise from our normal business operations, including in connection with our transactions that are denominated in foreign currencies. In addition, we translate sales and financial results denominated in foreign currencies into U.S. dollars for purposes of our consolidated financial statements. As a result, appreciation of the U.S. dollar against these foreign currencies generally will have a negative impact on our reported revenues and operating income while depreciation of the U.S. dollar against these foreign currencies will generally have a positive effect on reported revenues and operating income.

We use foreign currency forward contracts to minimize the earnings exposures arising from foreign currency exchange risk on foreign currency purchases and sales. Gains and losses on the underlying foreign currency exposures are partially offset with gains and losses on the foreign currency forward contracts. Under this cash flow hedging program, we designate the foreign currency contracts (the “contracts”) as cash flow hedges of underlying foreign currency forecasted purchases and sales. The effective portion of changes in the fair value of the contracts is recorded in Accumulated other comprehensive loss (“AOCL”) in the statement of shareholders' equity and is recognized in operating income when the underlying forecasted transaction impacts earnings. The contracts generally mature within 18 months or less.

We use foreign currency option contracts to mitigate foreign currency exposure on expected future Indian Rupee-denominated purchases. In the second quarter of fiscal year 2015, we monetized our outstanding foreign currency option contracts and entered into a new series of foreign currency option contracts with effective dates from the start of the third quarter of fiscal year 2015 through the end of fiscal year 2017. In the fourth quarter of fiscal year 2016, we entered into a new series of foreign currency option contracts with effective dates from the start of the first quarter of fiscal year 2017 through the end of fiscal year 2018. In the third quarter of fiscal year 2017, we monetized our outstanding foreign currency option contracts and in the third and fourth quarters of fiscal year 2017, entered into a new series of foreign currency option contracts with maturity dates in fiscal year 2018 and fiscal year 2019. In the third quarter of fiscal year 2018, we entered into a new series of foreign currency option contracts with maturity dates in fiscal year 2020. Changes in fair value associated with these contracts are recorded in cost of sales in the consolidated statements of operations.

We use foreign currency option contracts to mitigate foreign currency exposure on expected future South Korean won-denominated purchases. In the first quarter of fiscal year 2018, we entered into a new series of foreign currency option contracts with effective dates from the start of the third quarter of fiscal year 2018 through the end of fiscal year 2018. As of June 30, 2018, there were no South Korean won foreign exchange option contracts outstanding. Changes in fair value associated with these contracts are recorded in cost of sales in the consolidated statements of operations.

We use foreign currency option contracts to mitigate foreign currency exposure on expected future Brazilian real-denominated purchases. In the third quarter of fiscal year 2018, we entered into a new series of foreign currency option contracts with effective dates from the start of the third quarter of fiscal year 2018 through the end of fiscal year 2019. Changes in fair value associated with these contracts are recorded in cost of sales in the consolidated statements of operations.

In the fourth quarter of fiscal year 2015 and first quarter of fiscal year 2016, due to the risk of volatility of the euro as compared to the U.S. dollar, we entered into a series of foreign currency option contracts that did not qualify for hedge accounting but were expected to mitigate foreign currency translation exposure of euro earnings to U.S. dollars. In the third and fourth quarters of fiscal year 2017, we entered into a new series of foreign currency option contracts with maturity dates in fiscal year 2017 and fiscal year 2018. Changes in fair value associated with these contracts were recorded in other income, net, in the consolidated statements of operations.

In the fourth quarter of fiscal year 2015 and the first quarter of fiscal year 2016, due to the risk of volatility of the Swedish krona as compared to the U.S. dollar, we entered into a series of foreign currency option contracts that did not qualify for hedge accounting but were expected to mitigate foreign currency translation exposure of Swedish krona earnings to U.S. dollars. In the fourth quarter of fiscal year 2017, we entered into a new series of foreign currency option contracts with maturity dates in fiscal year 2018. Changes in fair value associated with these contracts were recorded in other income, net, in the consolidated statement of operations.

We use cross-currency swap contracts to hedge a portion of our net investment in a foreign subsidiary against volatility in foreign exchange rates. These derivative instruments are designated and qualify as hedges of net investments in foreign operations. Settlements and changes in fair values of the instruments are recognized in foreign currency translation adjustments, a component of other comprehensive income (loss) on the consolidated statement of comprehensive income (loss), to offset the changes in the

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values of the net investments being hedged. Any portion of net investment hedges that is determined to be ineffective is recorded in other expenses, net on the consolidated statements of operations.
In the third quarter of fiscal year 2018, we entered into multiple cross-currency swaps. These swaps hedged a portion of the net investment in a certain European subsidiary against volatility in the EUR/USD foreign exchange rate. They mature in May 2021.
Interest rate risk relates to the gain/increase or loss/decrease we could incur on our debt balances and interest expense associated with changes in interest rates. To manage this risk, we may enter into interest rate swaps from time to time to economically convert portions of our fixed-rate debt into floating rate exposure, ensuring that the sensitivity of the economic value of debt falls within our corporate risk tolerances. It is our policy not to enter into derivative instruments for speculative purposes, and therefore, we hold no derivative instruments for trading purposes.
Included below is a sensitivity analysis to measure the potential gain (loss) in the fair value of financial instruments with exposure to market risk (in millions). The model assumes a 10% hypothetical change (increase or decrease) in exchange rates and instantaneous, parallel shifts of 50 basis points in interest rates.

Market Risk

	Assuming a 10% Increase in Rates	Assuming a 10% Decrease in Rates	Increase (Decrease) in
Foreign Currency Sensitivity:			
Forward contracts in USD [1]	$ 1.6	$ (1.6)	Fair Value
Forward contracts in Euro [1]	(3.8)	3.8	Fair Value
Foreign currency denominated debt [2]	0.5	(0.5)	Fair Value
Foreign currency option contracts in USD	1.9	3.1	Fair Value
Foreign currency option contracts in Euro	(0.2)	1.7	Fair Value
Cross-currency swaps	(24.0)	24.0	Fair Value

	Assuming a 50 BPS Increase in Rates	Assuming a 50 BPS Decrease in Rates	Increase (Decrease) in
Interest Rate Sensitivity:			
Debt – fixed rate [3]	$ (34.9)	$ 37.3	Fair Value
Debt – variable rate	—	—	Cash flow

(1)Includes only the risk related to the derivative instruments and does not include the risk related to the underlying exposure. The analysis assumes overall derivative instruments and debt levels remain unchanged for each hypothetical scenario.

(2)At June 30, 2018, the fair value of outstanding foreign currency denominated debt was $5 million. A 10% decrease in quoted currency exchange rates would result in a decrease of $1 million in foreign currency denominated debt. At June 30, 2018, a 10% increase in quoted currency exchange rates would result in an increase of $1 million in foreign currency denominated debt.

(3) At June 30, 2018, the fair value of outstanding debt was $855 million. A 50 basis points decrease in quoted interest rates would result in an increase of $37.3 million in the fair value of fixed rate debt. A 50 basis points increase in quoted interest rates would result in a decrease of $34.9 million in the fair value of fixed rate debt.

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Item 4. Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934 (the “Exchange Act”), management, with the participation of the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2018. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that, as of June 30, 2018, our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and to ensure that information required to be disclosed by us in the reports we file or submit is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There have been no changes in the company’s internal control over financial reporting that occurred during the quarter ended June 30, 2018 that materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.

In connection with the rule, the company continues to review and document its disclosure controls and procedures, including the company’s internal control over financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and ensuring that the company’s systems evolve with the business.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Except as set forth in Note 20 of the Notes to the Condensed Consolidated Financial Statements in Part I of this Quarterly Report on Form 10-Q, there have been no material developments in legal proceedings involving the company or its subsidiaries since those reported in the company's Annual Report on Form 10-K for the fiscal year ended September 30, 2017, as amended.

Item 1A. Risk Factors

There have been no material changes in risk factors involving the company or its subsidiaries from those previously disclosed in the company's Annual Report on Form 10-K for the fiscal year ended September 30, 2017, as amended.

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

Issuer repurchases

The table below sets forth information with respect to purchases made by or on behalf of us of shares of our common stock during the three months ended June 30, 2018:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)
April 1- 30, 2018	—	$ —	—	$ 66,908,568
May 1- 31, 2018	880,819	$ 21.47	880,819	$ 48,000,529
June 1- 30, 2018	517,572	$ 21.43	517,572	$ 36,908,585
Total	1,398,391		1,398,391	

(1) On July 21, 2016, the Board of Directors authorized the repurchase of up to $100 million of the company's common stock and up to $150 million aggregate principal amount of any of the company's debt securities (including convertible debt securities), in each case from time to time through open market purchases, privately negotiated transactions or otherwise, until September 30, 2019, subject to compliance with legal and regulatory requirements and the company's debt covenants.

The independent trustee of our 401(k) plans purchases shares in the open market to fund investments by employees in our common stock, one of the investment options available under such plans, and any matching contributions in company stock we provide under certain of such plans. In addition, our stock incentive plans permit payment of an option exercise price by means of cashless exercise through a broker and permit the satisfaction of the minimum statutory tax obligations upon exercise of options and the vesting of restricted stock units through stock withholding. There were no shares withheld in the third quarter of fiscal 2018 to satisfy tax obligations for exercise of options. In addition, our stock incentive plans also permit the satisfaction of tax obligations upon the vesting of restricted stock through stock withholding. There were no shares withheld in the third quarter of fiscal 2018 to satisfy tax obligations upon the vesting of restricted shares. The company does not believe such purchases or transactions described above are issuer repurchases for the purposes of this Item 2 of Part II of this Quarterly Report on Form 10-Q.

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Item 5. Other Information

Cautionary Statement

This Quarterly Report on Form 10-Q contains statements relating to future results of the company (including certain projections and business trends) that are “forward-looking statements” as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are typically identified by words or phrases such as “believe,” “expect,” “anticipate,” “estimate,” “should,” “are likely to be,” “will” and similar expressions. Actual results may differ materially from those projected as a result of certain risks and uncertainties, including but not limited to reliance on major OEM customers and possible negative outcomes from contract negotiations with our major customers, including failure to negotiate acceptable terms in contract renewal negotiations and our ability to obtain new customers; the outcome of actual and potential product liability, warranty and recall claims; our ability to successfully manage rapidly changing volumes in the commercial truck markets and work with our customers to manage demand expectations in view of rapid changes in production levels; global economic and market cycles and conditions; availability and sharply rising costs of raw materials, including steel, and our ability to manage or recover such costs; our ability to manage possible adverse effects on our European operations, or financing arrangements related thereto following the United Kingdom's decision to exit the European Union or, in the event one or more other countries exit the European monetary union; risks inherent in operating abroad (including foreign currency exchange rates, restrictive government actions regarding trade, implications of foreign regulations relating to pensions and potential disruption of production and supply due to terrorist attacks or acts of aggression); risks related to our joint ventures; rising costs of pension benefits; the ability to achieve the expected benefits of strategic initiatives and restructuring actions; our ability to successfully integrate the products and technologies of Fabco Holdings, Inc. and AA Gear Mfg., Inc. and future results of such acquisitions, including their generation of revenue and their being accretive; the demand for commercial and specialty vehicles for which we supply products; whether our liquidity will be affected by declining vehicle productions in the future; OEM program delays; demand for and market acceptance of new and existing products; successful development and launch of new products; labor relations of our company, our suppliers and customers, including potential disruptions in supply of parts to our facilities or demand for our products due to work stoppages; the financial condition of our suppliers and customers, including potential bankruptcies; possible adverse effects of any future suspension of normal trade credit terms by our suppliers; potential impairment of long-lived assets, including goodwill; potential adjustment of the value of deferred tax assets; competitive product and pricing pressures; the amount of our debt; our ability to continue to comply with covenants in our financing agreements; our ability to access capital markets; credit ratings of our debt; the outcome of existing and any future legal proceedings, including any litigation with respect to environmental, asbestos-related, or other matters; the actual impacts of our modifications to benefits provided to certain former union employee retirees on the company’s balance sheet, earnings and amount of cash payments; possible changes in accounting rules; ineffective internal controls; and other substantial costs, risks and uncertainties, including but not limited to those detailed herein and from time to time in other filings of the company with the SEC. These forward-looking statements are made only as of the date hereof, and the company undertakes no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise, except as otherwise required by law.

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Item 6. Exhibits

3-a	Amended and Restated Articles of Incorporation of Meritor, filed as Exhibit 3-a to Meritor's Annual Report on Form 10-K for the fiscal year ended September 27, 2015, is incorporated herein by reference.
3-b	Amended and Restated By-laws of Meritor, filed as Exhibit 3-b to Meritor's Annual Report on Form 10-K for the fiscal year ended October 2, 2016, is incorporated herein by reference.
12**	Computation of ratio of earnings to fixed charges
23**	Consent of Bates White LLC
31-a**	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) under the Exchange Act
31-b**	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) under the Exchange Act
32-a**	Certification of the Chief Executive Officer pursuant to Rule 13a-14(b) under the Exchange Act and 18 U.S.C. Section 1350
32-b**	Certification of the Chief Financial Officer pursuant to Rule 13a-14(b) under the Exchange Act and 18 U.S.C. Section 1350
101.INS	XBRL INSTANCE DOCUMENT
101.SCH	XBRL TAXONOMY EXTENSION SCHEMA
101.PRE	XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE
101.LAB	XBRL TAXONOMY EXTENSION LABEL LINKBASE
101.CAL	XBRL TAXONOMY EXTENSION CALCULATION LINKBASE
101.DEF	XBRL TAXONOMY EXTENSION DEFINITION LINKBASE

** Filed herewith.

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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.

MERITOR, INC.

Date:	August 2, 2018	By:	/s/	April Miller Boise
				April Miller Boise Senior Vice President, Chief Legal Officer and Corporate Secretary (For the registrant)
Date:	August 2, 2018	By:	/s/	Paul D. Bialy
				Paul D. Bialy Vice President, Controller and Principal Accounting Officer
Date:	August 2, 2018	By:	/s/	Kevin A. Nowlan
				Kevin A. Nowlan Senior Vice President and President, Trailer and Components, and Chief Financial Officer

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