SAFETY INSURANCE GROUP INC
Form 10-Q
May 10, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from ________ to ______

Commission File Number: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**13-4181699**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 Custom House Street, Boston, Massachusetts 02110
(Address of principal executive offices including zip code)

(617) 951-0600
(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 x No o

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer o Accelerated filer x Non-accelerated filer 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 x

As of May 7, 2007, there were 16,226,163 shares of common stock with a par value of $0.01 per share outstanding.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	March 31, 2007 (Unaudited)	December 31, 2006
Assets		
Investment securities available for sale:		
Fixed maturities, at fair value (amortized cost: $911,526 and $936,534)	**$ 913,100**	$ 936,280
Equity securities, at fair value (cost: $6,393 and $4,038)	**6,628**	4,325
Total investment securities	**919,728**	940,605
Cash and cash equivalents	**66,140**	26,283
Accounts receivable, net of allowance for doubtful accounts	**171,994**	158,190
Accrued investment income	**9,919**	9,776
Taxes recoverable		1,781
Receivable from reinsurers related to paid loss and loss adjustment expenses	**13,363**	13,282
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	**79,806**	78,464
Ceded unearned premiums	**33,760**	33,042
Deferred policy acquisition costs	**50,579**	47,404
Deferred income taxes	**16,176**	16,868
Equity and deposits in pools	**28,721**	26,166
Other assets	**5,866**	3,887
Total assets	**$ 1,396,052**	$ 1,355,748
Liabilities		
Loss and loss adjustment expense reserves	**$ 453,536**	$ 449,444
Unearned premium reserves	**354,446**	333,404
Accounts payable and accrued liabilities	**25,688**	48,666
Taxes payable	**7,017**	
Outstanding claims drafts	**17,507**	16,279
Payable to reinsurers	**14,016**	11,568
Payable for securities purchased	**4,431**	
Capital lease obligations		39
Total liabilities	**876,641**	859,400
Commitments and contingencies (Note 7)		
Shareholders equity		
Common stock: $0.01 par value; 30,000,000 shares authorized; 16,223,363 and 16,096,004 shares issued and outstanding, respectively	**162**	161
Additional paid-in capital	**131,086**	129,785
Accumulated other comprehensive income, net of taxes	**1,176**	21
Retained earnings	**386,987**	366,381
Total shareholders equity	**519,411**	496,348
Total liabilities and shareholders equity	**$ 1,396,052**	$ 1,355,748

The accompanying notes are an integral part of these financial statements.

Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share and share data)

	Three Months Ended March 31, 2007	2006
Net earned premiums	**$ 153,590**	$ 157,778
Net investment income	**11,039**	9,378
Net realized gains (losses) on investments	**71**	(74)
Finance and other service income	**3,993**	3,859
Total revenue	**168,693**	170,941
Losses and loss adjustment expenses	**92,558**	85,751
Underwriting, operating and related expenses	**40,698**	40,395
Interest expenses	**22**	24
Total expenses	**133,278**	126,170
Income before income taxes	**35,415**	44,771
Income tax expense	**10,766**	13,969
Net income	**$ 24,649**	$ 30,802
Earnings per weighted average common share:		
Basic	**$ 1.54**	$ 1.96
Diluted	**$ 1.53**	$ 1.94
Cash dividends paid per common share	**$ 0.25**	$ 0.18
Weighted average number of common shares outstanding:		
Basic	**15,992,229**	15,710,587
Diluted	**16,064,746**	15,894,797

The accompanying notes are an integral part of these financial statements.

Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders Equity
(Unaudited)
(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income/(Loss), Net of Taxes	Retained Earnings	Total Shareholders Equity
Balance at December 31, 2005	$ 158	$ 120,451	$ (833)	$ 268,173	$ 387,949
Net income, January 1 to March 31, 2006				30,802	30,802
Other comprehensive loss, net of deferred federal income taxes			(6,426)		(6,426)
Exercise of options and unearned compensation on restricted stock net of deferred federal income taxes	1	1,627			1,628
Dividends paid				(2,843)	(2,843)
Balance at March 31, 2006	$ 159	$ 122,078	$ (7,259)	$ 296,132	$ 411,110

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income/(Loss), Net of Taxes	Retained Earnings	Total Shareholders Equity
Balance at December 31, 2006	**$ 161**	**$ 129,785**	**$ 21**	**$ 366,381**	**$ 496,348**
Net income, January 1 to March 31, 2007				**24,649**	**24,649**
Other comprehensive income, net of deferred federal income taxes			**1,155**		**1,155**
Exercise of options and unearned compensation on restricted stock, net of deferred federal income taxes	**1**	**1,301**			**1,302**
Dividends paid				**(4,043)**	**(4,043)**
Balance at March 31, 2007	**$ 162**	**$ 131,086**	**$ 1,176**	**$ 386,987**	**$ 519,411**

The accompanying notes are an integral part of these financial statements.

Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income
(Unaudited)
(Dollars in thousands)

	Three Months Ended March 31, 2007	2006
Net income	**$ 24,649**	$ 30,802
Other comprehensive gain (loss), net of taxes:		
Change in unrealized holding losses (gains), net of tax expense (benefit) of $646 and $(3,485)	**1,201**	(6,474)
Reclassification adjustment for (gains) losses included in net income, net of tax (expense) benefit of $(25) and $26	**(46)**	48
Unrealized gains (losses) on securities available for sale	**1,155**	(6,426)
Comprehensive income	**$ 25,804**	$ 24,376

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

	Three Months Ended March 31, 2007	2006
Cash flows from operating activities:		
Net income	**$ 24,649**	$ 30,802
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	**2,201**	2,097
Provision (benefit) for deferred income taxes	**71**	(537)
Net realized (gains) losses on investments	**(71)**	74
Changes in assets and liabilities:		
Accounts receivable	**(13,804)**	(1,738)
Accrued investment income	**(143)**	(1,074)
Receivable from reinsurers	**(1,423)**	5,302
Ceded unearned premiums	**(718)**	(1,180)
Deferred policy acquisition costs	**(3,175)**	(3,287)
Other assets	**(1,331)**	(1,238)
Loss and loss adjustment expense reserves	**4,092**	(14,965)
Unearned premium reserves	**21,042**	16,722
Accounts payable and accrued liabilities	**(22,978)**	(20,775)
Payable to reinsurers	**2,448**	1,118
Other liabilities	**8,131**	8,416
Net cash provided by operating activities	**18,991**	19,737
Cash flows from investing activities:		
Fixed maturities purchased	**(115,481)**	(106,696)
Equity securities purchased	**(3,241)**	(2,155)
Proceeds from sales of fixed maturities	**138,817**	13,787
Proceeds from maturities of fixed maturities	**5,000**	9,000
Proceed from sales of equity securities	**979**	229
Fixed assets purchased	**(1,346)**	(148)
Net cash provided by (used for) investing activities	**24,728**	(85,983)
Cash flows from financing activities:		
Proceeds and excess tax benefits from exercise of stock options	**181**	438
Dividends paid to shareholders	**(4,043)**	(2,843)
Net cash used for financing activities	**(3,862)**	(2,405)
Net increase (decrease) in cash and cash equivalents	**39,857**	(68,651)
Cash and cash equivalents at beginning of year	**26,283**	163,027
Cash and cash equivalents at end of period	**$ 66,140**	$ 94,376

The accompanying notes are an integral part of these financial statements.

Safety Insurance Group, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The consolidated financial statements include Safety Insurance Group, Inc. and its subsidiaries (the Company). The subsidiaries consist of Safety Insurance Company, Safety Indemnity Insurance Company, Safety Property and Casualty Insurance Company, Whiteshirts Asset Management Corporation (WAMC), and Whiteshirts Management Corporation, which is WAMC s holding company. All intercompany transactions have been eliminated. Prior period amounts have been reclassified to conform to the current period presentation.

The financial information as of March 31, 2007 and for the three months ended March 31, 2007 and 2006 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition and results of operations for the periods. These unaudited consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company s annual report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on March 1, 2007.

The Company is a leading provider of personal lines property and casualty insurance focused exclusively on the Massachusetts market. The Company s principal product line is private passenger automobile insurance, which accounted for 76.0% of its direct written premiums in 2006. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company, and Safety Property and Casualty Insurance Company.

2. Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 (FAS 155). This statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This statement also adds clarity regarding interest-only strips and principal-only strips that are not subject to the requirements of Statement No. 133, and requires companies to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments containing an embedded derivative that requires bifurcation. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The Company adopted FAS 155 on January 1, 2007. The adoption of FAS 155 did not have a material impact on the Company s consolidated results of operations or financial position.

For information regarding the Company s adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 (FIN 48), see Note 9.

3. Earnings Per Weighted Average Common Share

Basic earnings per weighted average common share (EPS) are calculated by dividing net income by the weighted average number of basic common shares outstanding during the period. Diluted EPS are calculated by dividing net income by the weighted average number of basic common shares outstanding and the net effect of potentially dilutive common shares. At March 31, 2007 and 2006, the Company s potentially dilutive instruments consisted of common shares under options of 366,368 and 590,883, respectively, and common shares under restriction of 176,781 and 118,790, respectively.

	Three Months Ended March 31, 2007	2006
Earnings per weighted average common share:		
Basic	**$ 1.54**	$ 1.96
Diluted	**$ 1.53**	$ 1.94
Weighted average number of common shares outstanding:		
Basic	**15,992,229**	15,710,587
Effect of dilutive securities:		
Stock options	**68,226**	166,684
Restricted stock	**4,291**	17,526
Diluted	**16,064,746**	15,894,797

Diluted EPS excludes stock options with exercise prices and exercise tax benefits greater than the average market price of the Company s common stock during the period because their inclusion would be anti-dilutive. There were 186,225 anti-dilutive stock options for the three months ended March 31, 2007 and no anti-dilutive stock options for the three months ended March 31, 2006.

Diluted EPS also excludes common shares under restriction with a fair value on the grant effective date greater than the average market price of the Company s common stock during the period because their inclusion would be anti-dilutive. There were 65,760 anti-dilutive shares under restriction for the three months ended March 31, 2007 and no anti-dilutive shares under restriction for the three months ended March 31, 2006.

4. Stock-Based Compensation

Management Omnibus Incentive Plan

Long-term incentive compensation is provided under the Company s 2002 Management Omnibus Incentive Plan (the Incentive Plan) which provides for a variety of stock-based compensation awards, including nonqualified stock options (NQSOs), incentive stock options, stock appreciation rights and restricted stock (RS) awards.

On March 10, 2006, the Board of Directors approved amendments to the Incentive Plan, subject to shareholder approval, to (i) increase the number of shares of common stock available for issuance by 1,250,000 shares, (ii) remove obsolete provisions, and (iii) make other non-material changes. A total of 1,250,000 shares of common stock had previously been authorized for issuance under the 2002 Management Omnibus Incentive Plan. The Incentive Plan, as amended, was approved by the shareholders at the 2006 Annual Meeting of Shareholders which was held on May 19, 2006.

The maximum number of shares of common stock with respect to which awards may be granted under the Incentive Plan is 2,500,000. Shares of stock covered by an award under the Incentive Plan that are forfeited will again be available for issuance in connection with future grants of awards under the plan. At March 31, 2007, there were 1,170,260 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

A summary of stock-based awards granted under the Incentive Plan during the three months ended March 31, 2007 is as follows:

Type of Equity Awarded	Effective Date	Number of Awards Granted	Fair Value per Share (1)		Vesting Terms
RS	**February 26, 2007**	**65,760**	**$ 45.62**	**(1)**	**3 years, 30%-30%-40%**
RS	**February 26, 2007**	**4,000**	**$ 45.62**	**(1)**	**No vesting period (2)**
RS	**March 22, 2007**	**49,971**	**$ 38.78**	**(1)**	**5 years, 20% annually**

(1) The fair value per share of the restricted stock grant is equal to the closing price of the Company s common stock on the grant effective date.

(2) The shares cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of the Board of Directors.

Accounting and Reporting for Stock-Based Awards

Effective January 1, 2006, the Company adopted FAS 123R (revised 2004), Share-Based Payment, which requires the Company to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of FAS 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period of the equity grant).

As permitted by FAS 123R, the Company elected the modified prospective transition method. Under the modified prospective transition method, (i) compensation expense for share-based awards granted prior to January 1, 2006 is recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FAS 123 as adjusted to incorporate forfeiture assumptions under FAS 123R, and (ii) compensation expense for all share-based awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of FAS 123R.

As a result of adopting FAS 123R on January 1, 2006, the Company s net income was lowered by $138, net of income tax benefit of $74, for both the three months ended March 31, 2007 and 2006. The impact on both basic and diluted EPS for the three months ended March 31, 2007 and 2006 was a reduction of $0.01 per share.

Stock Options

The fair value of stock options used to compute net income and earnings per share disclosures for the three month period ended March 31, 2007 and 2006 is the estimated fair value at grant date using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended March 31,	
	2007	2006
Expected dividend yield	**1.36% - 2.52%**	1.36% - 2.52%
Expected volatility	**0.20 - 0.36**	0.20 - 0.32
Risk-free interest rate	**3.23% - 4.76%**	3.23% - 4.76%
Expected holding period	**6.5 - 7 years**	6.5 - 7 years

Expected dividend yield is the Company s dividend yield on the measurement date and is based on the assumption that the current yield will continue in the future. Expected volatility is based on historical volatility of the Company s common stock as well as the volatility of a peer group of property and casualty insurers measured for a period equal to the expected holding period of the option. The risk-free interest rate is based upon the yield on the measurement date of a zero-coupon U.S. Treasury bond with a maturity period equal to the expected holding period of the option. The expected holding period is based upon the simplified method provided in SEC Staff Accounting Bulletin No. 107 Share-Based Payment , which utilizes the mid-points between the vesting dates and the expiration date of the option award to calculate the overall expected term.

The following table summarizes stock option activity under the Incentive Plan during the three months ended March 31, 2007.

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	373,996	$ 27.53		
Exercised	(7,628)	13.91		
Outstanding at end of quarter	366,368	27.82	7.5 years	$ 4,850
Exercisable at end of quarter	91,492	$ 27.10	7.4 years	$ 1,260

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based upon the Company s closing stock price of $40.12 on March 30, 2007, which would have been received by the option holders had all option holders exercised their options as of that date. The range of exercise prices on stock options outstanding under the Incentive Plan was $12.00 to $42.85 at March 31, 2007 and 2006. There were no stock option awards granted during the three months ended March 31, 2007. The weighted average grant-date fair value of options granted during the three months ended March 31, 2006 was estimated at $15.32. The total intrinsic value of options exercised during the three months ended March 31, 2007 and 2006 was $200 and $951, respectively.

A summary of the status of non-vested options as of March 31, 2007 is presented below:

	Number of Shares	Weighted Average Grant Date Exercise Price
Non-vested at beginning of year	347,721	$ 28.27
Vested	(72,845)	29.06
Non-vested at end of quarter	274,876	$ 28.06

As of March 31, 2007, there was $2,035 of unrecognized compensation expense related to non-vested option awards that is expected to be recognized over a weighted average period of 2.3 years.

Cash received from options exercised was $106 and $438 for the three months ended March 31, 2007 and 2006, respectively.

Restricted Stock

Restricted stock awarded to employees in the form of unvested shares is recorded at the market value of the Company s common stock on the grant date and amortized ratably as expense over the requisite service period.

The following table summarizes restricted stock activity under the Incentive Plan during the three months ended March 31, 2007.

	Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of the year	126,790	$ 35.67
Granted	119,731	42.77
Vested and unrestricted	(57,740)	34.57
Outstanding at end of quarter	188,781	$ 41.82

As of March 31, 2007, there was $7,230 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 2.0 years. The total fair value of the shares that became vested and unrestricted during the three months ended March 31, 2007 was $1,996. For the three months ended March 31, 2007 and 2006, the Company recorded compensation expense related to restricted stock of $468 and $286, net of income tax benefits of $252 and $154, respectively.

5. Investments

The gross unrealized appreciation (depreciation) of investments in fixed maturities securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, was as follows:

	March 31, 2007			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. Government agencies(1)	$ 216,015	$ 1,345	$ (2,448)	$ 214,912
Obligations of states and political subdivisions	490,559	5,547	(2,012)	494,094
Asset-backed securities (1)	119,941	396	(1,103)	119,234
Corporate and other securities	85,011	611	(762)	84,860
Subtotal, fixed maturity securities	911,526	7,899	(6,325)	913,100
Equity securities	6,393	235		6,628
Totals	$ 917,919	$ 8,134	$ (6,325)	$ 919,728

(1) Obligations of U.S. Government agencies include collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), and Small Business Administration (SBA). The total of these fixed maturity securities was $206,020 at amortized cost and $204,990 at estimated fair value as of March 31, 2007. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government Agencies.

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

	March 31, 2007	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 25,999	$ 25,793
Due after one year through five years	153,382	152,457
Due after five years through ten years	189,432	