

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

May 05, 2006

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549**

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarter ended March 31, 2006
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 1-14094

Meadowbrook Insurance Group, Inc.
(Exact name of Registrant as specified in its charter)

Michigan
(State of Incorporation)

38-2626206
(IRS Employer Identification No.)

26255 American Drive, Southfield, Michigan 48034
(Address, zip code of principal executive offices)

(248) 358-1100
(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 No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on May 2, 2006 was 28,818,316.

TABLE OF CONTENTS

	Page
<u>PART I FINANCIAL INFORMATION</u>	
<u>ITEM 1</u>	FINANCIAL STATEMENTS
	<u>Consolidated Statements of Income (unaudited)</u> 2
	<u>Consolidated Statements of Comprehensive Income (unaudited)</u> 3
	<u>Consolidated Balance Sheets (unaudited)</u> 4
	<u>Consolidated Statement of Cash Flows (unaudited)</u> 5
	<u>Notes to Consolidated Financial Statements (unaudited)</u> 6-17
<u>ITEM 2</u>	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS 18-29
<u>ITEM 3</u>	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK 29
<u>ITEM 4</u>	CONTROLS AND PROCEDURES 30
	
<u>PART II OTHER INFORMATION</u>	
<u>ITEM 1</u>	LEGAL PROCEEDINGS 31
<u>ITEM 1A</u>	RISK FACTORS 31
<u>ITEM 2</u>	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS 31
<u>ITEM 6</u>	EXHIBITS 32
<u>SIGNATURES</u>	33
	<u>Inter-Company Reinsurance Agreement</u>
	<u>Certification of Robert S. Cubbin, Chief Executive Officer, Pursuant to Securities Exchange Act Rule 13a-14(a)</u>
	<u>Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer, Pursuant to Securities Exchange Act Rule 13-14(a)</u>
	<u>Certification pursuant to Section 906, signed by Robert S. Cubbin, Chief Executive Officer</u>
	<u>Certification pursuant to Section 906, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer</u>

Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1 Financial Statements****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

	For the Three Months Ended March 31,	
	2006	2005
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$ 81,692	\$ 80,806
Ceded	(18,568)	(20,019)
Net earned premiums	63,124	60,787
Net commissions and fees	11,289	10,099
Net investment income	5,239	4,091
Net realized losses	(7)	(114)
Total revenues	79,645	74,863
Expenses		
Losses and loss adjustment expenses	49,884	56,342
Reinsurance recoveries	(12,841)	(19,208)
Net losses and loss adjustment expenses	37,043	37,134
Salaries and employee benefits	13,368	12,605
Policy acquisition and other underwriting expenses	11,424	10,822
Other administrative expenses	7,959	7,785
Interest expense	1,388	773
Total expenses	71,182	69,119
Income before taxes and equity earnings	8,463	5,744
Federal and state income tax expense	2,847	1,952
Equity earnings (losses), of affiliates	9	(49)
Net income	\$ 5,625	\$ 3,743

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

Earnings Per Share			
Basic	\$	0.20	\$ 0.13
Diluted	\$	0.19	\$ 0.13
Weighted average number of common shares			
Basic		28,757,603	29,072,619
Diluted		29,452,693	29,481,870

The accompanying notes are an integral part of the Consolidated Financial Statements.

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Three Months Ended March 31, 2006 2005 (Unaudited) (In thousands)	
Net income	\$ 5,625	\$ 3,743
Other comprehensive income, net of tax:		
Unrealized losses on securities	(2,777)	(4,463)
Less: reclassification adjustment for losses included in net income	19	77
Other comprehensive loss, net of tax	(2,758)	(4,386)
Comprehensive income (loss)	\$ 2,867	\$ (643)

The accompanying notes are an integral part of the Consolidated Financial Statements.

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED BALANCE SHEETS**

	March 31, 2006	December 31, 2005
	(Unaudited)	
	(In thousands, except share data)	
ASSETS		
Debt securities available for sale, at fair value (amortized cost of \$439,750 and \$403,947)	\$ 433,367	\$ 402,195
Cash and cash equivalents	34,378	58,038
Accrued investment income	5,262	4,953
Premiums and agent balances receivable, net	102,652	84,807
Reinsurance recoverable on:		
Paid losses	6,525	15,327
Unpaid losses	189,847	187,254
Prepaid reinsurance premiums	25,649	24,588
Deferred policy acquisition costs	27,249	26,371
Deferred federal income taxes	18,632	16,630
Goodwill	30,802	30,802
Other assets	51,155	50,379
Total assets	\$ 925,518	\$ 901,344
LIABILITIES AND SHAREHOLDERS EQUITY		
Losses and loss adjustment expenses	\$ 470,902	\$ 458,677
Unearned premiums	148,308	140,990
Debt	8,312	7,000
Debentures	55,930	55,930
Accounts payable and accrued expenses	30,351	26,667
Reinsurance funds held and balances payable	13,777	15,240
Payable to insurance companies	4,009	6,684
Other liabilities	12,982	12,791
Total liabilities	744,571	723,979
Common stock, \$0.01 stated value; authorized 50,000,000 shares; 28,814,544 and 28,672,009 shares issued and outstanding	288	287
Additional paid-in capital	125,532	124,819
Retained earnings	59,873	54,248
Note receivable from officer	(858)	(859)
Accumulated other comprehensive loss	(3,888)	(1,130)
Total shareholders equity	180,947	177,365

Total liabilities and shareholders' equity	\$ 925,518	\$ 901,344
--	------------	------------

The accompanying notes are an integral part of the Consolidated Financial Statements.

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Three Months Ended March 31, 2006 2005 (Unaudited) (In thousands)	
Cash Flows From Operating Activities		
Net income	\$ 5,625	\$ 3,743
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of other intangible assets	165	92
Amortization of deferred debenture issuance costs	59	38
Depreciation of furniture, equipment, and building	543	584
Net accretion of discount and premiums on bonds	626	581
Losses on sale of investments, net	30	136
Gain on sale of fixed assets	(22)	(22)
Stock-based employee compensation	98	14
Incremental tax benefits from stock options exercised	(268)	
Long term incentive plan expense	197	195
Deferred income tax benefit	(514)	(49)
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(17,845)	(18,150)
Reinsurance recoverable on paid and unpaid losses	6,210	(9,067)
Prepaid reinsurance premiums	(1,061)	(1,984)
Deferred policy acquisition costs	(878)	(1,596)
Other assets	60	2,894
Increase (decrease) in:		
Losses and loss adjustment expenses	12,225	20,709
Unearned premiums	7,319	10,187
Payable to insurance companies	(2,675)	(3,024)
Reinsurance funds held and balances payable	(1,463)	6,887
Other liabilities	4,641	2,001
Total adjustments	7,447	10,426
Net cash provided by operating activities	13,072	14,169
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(52,763)	(114,889)
Proceeds from sales and maturities of debt securities available for sale	16,304	95,274
Proceeds from sales of equity securities available for sale		8
Capital expenditures	(1,643)	(11,734)

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

Purchase of books of business	(82)	(78)
Other investing activities	92	185
Net cash used in investing activities	(38,092)	(31,234)
Cash Flows From Financing Activities		
Proceeds from lines of credit	3,936	
Payment of lines of credit	(2,624)	(2,344)
Book overdraft	(301)	(254)
Issuance of common stock	150	5
Retirement of common stock		(308)
Incremental tax benefits from stock options exercised	268	
Other financing activities	(69)	(49)
Net cash provided by (used in) by financing activities	1,360	(2,950)
Net decrease in cash and cash equivalents	(23,660)	(20,015)
Cash and cash equivalents, beginning of period	58,038	69,875
Cash and cash equivalents, end of period	\$ 34,378	\$ 49,860

The accompanying notes are an integral part of the Consolidated Financial Statements.

Table of Contents

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Note 1 Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the Company), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which are collectively referred to as the Insurance Company Subsidiaries), and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their subsidiaries.

Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), the Company does not consolidate its subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and the Company is not the primary beneficiary of the Trusts. The consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with FIN 46(R), the Company does not consolidate its subsidiary American Indemnity Insurance Company, Ltd. (American Indemnity). While the Company and its subsidiary Star are the common shareholders, they are not the primary beneficiaries of American Indemnity. The consolidated financial statements, however, include the equity earnings of American Indemnity.

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its annual report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2005.

Certain amounts in the 2005 financial statements and notes to the consolidated financial statements have been reclassified to conform to the 2006 presentation.

Revenue Recognition

Premiums written, which include direct, assumed, and ceded are recognized as earned on a pro rata basis over the life of the policy term. Unearned premiums represent the portion of premiums written that are applicable to the unexpired terms of policies in force. Provisions for unearned premiums on reinsurance assumed from others are made on the basis of ceding reports when received and actuarial estimates.

For the three months ending March 31, 2006, total assumed written premiums were \$22.2 million, of which \$18.3 million, relates to assumed business the Company manages directly, and therefore, no estimation is involved. The remaining \$3.9 million of assumed written premiums includes \$3.4 million related to residual markets.

Assumed premium estimates are specifically related to the mandatory assumed pool business from the National Council on Compensation Insurance (NCCI), or residual market business. The pool cedes workers compensation business to participating companies based upon the individual company s market share by state. The activity is reported from the NCCI to participating companies on a two quarter lag. To account for this lag, the Company estimates premium and loss activity based on historical and market based results. Historically, the Company has not experienced any material difficulties or disputes in collecting balances from NCCI; and therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.

In addition, certain premiums are subject to retrospective premium adjustments. Premium is recognized over the term of the insurance contract.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized during the period the services are provided. Depending on the terms of the contract, claims processing fees are recognized as revenue over the estimated life of the claims, or the estimated life of the contract. For those contracts

Table of Contents

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)**

that provide services beyond the expiration or termination of the contract, fees are deferred in an amount equal to management's estimate of the Company's obligation to continue to provide services.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Commission and other adjustments are recorded when they occur and the Company maintains an allowance for estimated policy cancellations and commission returns. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

The Company reviews, on an ongoing basis, the collectibility of its receivables and establishes an allowance for estimated uncollectible accounts.

Realized gains or losses on sale of investments are determined on the basis of specific costs of the investments. Dividend income is recognized when declared and interest income is recognized when earned. Discount or premium on debt securities purchased at other than par value is amortized using the effective yield method. Investments with other than temporary declines in fair value are written down to their estimated net fair value and the related realized losses are recognized in income.

Earnings Per Share

Basic earnings per share are based on the weighted average number of common shares outstanding during the period, while diluted earnings per share includes the weighted average number of common shares and potential dilution from shares issuable pursuant to stock options using the treasury stock method.

Outstanding options of 135,301 and 625,002 for the periods ended March 31, 2006 and 2005, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive.

Shares issuable pursuant to stock options included in diluted earnings per share were 271,750 and 329,731 for the three months ended March 31, 2006 and 2005, respectively. Restricted shares related to the Company's Long Term Incentive Plan (LTIP) included in diluted earnings per shar