

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

November 13, 2003

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington D.C. 20549**

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**Form 10-Q**

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

**For the quarter ended September 30, 2003**

**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.)*

**26600 Telegraph Road, Southfield, Michigan 48034**

*(Address, zip code of principal executive offices)*

**(248) 358-1100**

*(Registrant's telephone number, including area code)*

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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 an accelerated filer (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 November 6, 2003 was 29,022,435.

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**Third Amendment to Restated Credit Agreement**

**TPS Purchase Agreement**

**TPS Amended and Restated Declaration of Trust**

**TPS Guaranty Agreement**

**Certification of Robert S. Cubbin, CEO**

**Certification of Karen M. Spaun, SVP and CFO**

**906 Certification of Robrt S. Cubbin, CEO**

**906 Certification of Karen M. Spaun, SVP and CFO**

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

	For the Nine Months Ended September 30,	
	2003	2002
	(Unaudited) (In thousands, except share data)	
Revenues:		
Net premium earned	\$ 103,801	\$ 114,310
Net commissions and fees	35,430	27,586
Net investment income	10,127	10,380
Net realized gains on investments	878	325
Gain on sale of subsidiary		199
	<u>150,236</u>	<u>152,800</u>
Expenses:		
Net loss and loss adjustment expenses	67,652	79,735
Salaries and employee benefits	36,172	27,978
Policy acquisition and other underwriting expenses	15,745	26,879
Other administrative expenses	18,206	17,468
Interest on notes payable	656	2,706
Gain on debt reduction		(359)
	<u>138,431</u>	<u>154,407</u>
Income (loss) before income taxes	11,805	(1,607)
Federal income tax expense (benefit)	3,870	(748)
	<u>\$ 7,935</u>	<u>\$ (859)</u>
Earnings per share:		
Basic	\$ 0.27	\$ (0.05)
Diluted	\$ 0.27	\$ (0.05)
Weighted average number of common shares outstanding:		
Basic	29,245,087	17,477,035
Diluted	29,287,573	17,477,035

The accompanying notes are an integral part of the consolidated financial statements.

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## MEADOWBROOK INSURANCE GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	For the Quarter Ended September 30,	
	2003	2002
	(Unaudited) (In thousands, except share data)	
Revenues:		
Net premium earned	\$ 40,187	\$ 31,340
Net commissions and fees	10,803	8,654
Net investment income	3,197	3,751
Net realized gains on investments	299	626
	<u>54,486</u>	<u>44,371</u>
Expenses:		
Net loss and loss adjustment expenses	26,357	24,639
Salaries and employee benefits	12,372	9,130
Policy acquisition and other underwriting expenses	5,996	6,945
Other administrative expenses	5,816	5,977
Interest on notes payable	207	582
	<u>50,748</u>	<u>47,273</u>
Income (loss) before income taxes	3,738	(2,902)
Federal income tax expense (benefit)	1,238	(1,011)
	<u>\$ 2,500</u>	<u>\$ (1,891)</u>
Earnings per share:		
Basic	\$ 0.09	\$ (0.06)
Diluted	\$ 0.09	\$ (0.06)
Weighted average number of common shares outstanding:		
Basic	29,022,419	29,785,580
Diluted	29,169,826	29,785,580

The accompanying notes are an integral part of the consolidated financial statements.

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## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Nine Months Ended September 30,	
	2003	2002
	(Unaudited) (In thousands)	
Net income (loss)	\$7,935	\$ (859)
Other comprehensive income, net of tax:		
Unrealized gains on securities	297	5,678
Less: reclassification adjustment for gains included in net income	(236)	(264)
Other comprehensive income, net of tax	61	5,414
Comprehensive income	\$7,996	\$4,555

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## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Quarter Ended September 30,	
	2003	2002
	(Unaudited) (In thousands)	
Net income (loss)	\$ 2,500	\$ (1,891)
Other comprehensive income (loss), net of tax:		
Unrealized (losses) gains on securities	(2,006)	5,305
Less: reclassification adjustment for gains included in net income	(7)	(463)
Other comprehensive (loss) income, net of tax	(2,013)	4,842
Comprehensive income	\$ 487	\$ 2,951

The accompanying notes are an integral part of the consolidated financial statements.



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

	September 30, 2003	December 31, 2002
	(Unaudited)	
	(In thousands, except share data)	
<b>ASSETS</b>		
Invested assets:		
Debt securities available for sale, at fair value (amortized cost of \$255,374 and \$231,876)	\$ 268,454	\$ 244,861
Equity securities available for sale, at fair value (cost of \$1,980 and \$1,980)	1,804	1,804
<b>Total invested assets</b>	<b>270,258</b>	<b>246,665</b>
Cash and cash equivalents	44,662	39,385
Premiums and agent balances receivable	88,611	71,420
Reinsurance recoverable on:		
Paid losses	21,522	20,396
Unpaid losses	175,866	181,817
Prepaid reinsurance premiums	22,323	18,115
Deferred policy acquisition costs	18,973	12,140
Deferred federal income taxes	15,507	19,099
Goodwill	28,997	28,997
Other assets	39,026	36,805
<b>Total assets</b>	<b>\$ 725,745</b>	<b>\$ 674,839</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Liabilities:</b>		
Reserve for losses and loss adjustment expenses	\$ 362,351	\$ 374,933
Unearned premiums	111,631	68,678
Debt	19,303	32,497
Mandatorily redeemable trust preferred securities	10,000	
Reinsurance funds held and balances payable	20,940	16,199
Other liabilities	47,532	35,137
<b>Total liabilities</b>	<b>571,757</b>	<b>527,444</b>
Commitments and contingencies (Note 7)		
<b>Shareholders Equity:</b>		
Common stock, \$.01 par value; authorized 50,000,000 shares: 29,022,435 and 29,591,494 shares issued and outstanding	290	296
Additional paid-in capital	125,143	127,429
Retained earnings	20,905	12,073
Note receivable from officer	(884)	(876)
Accumulated other comprehensive income	8,534	8,473
<b>Total shareholders equity</b>	<b>153,988</b>	<b>147,395</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 725,745</b>	<b>\$ 674,839</b>

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The accompanying notes are an integral part of the consolidated financial statements.

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## MEADOWBROOK INSURANCE GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Nine Months Ended September 30,	
	2003	2002
	(Unaudited) (In thousands)	
Net cash provided by operating activities	\$ 31,572	\$ 879
Cash flows (used in) provided by investing activities:		
Purchase of debt securities available for sale	(70,715)	(123,036)
Proceeds from sale of debt securities available for sale	47,293	96,881
Proceeds from sale of equity securities available for sale		900
Other investing activities	998	3,342
Net cash used in investing activities	(22,424)	(21,913)
Cash flows (used in) provided by financing activities:		
Net payments on bank loan	(13,194)	(19,804)
Net proceeds from public offering		60,525
Net proceeds from issuance of mandatorily redeemable trust preferred securities	9,700	
Share repurchases	(1,562)	
Other financing activities	1,185	(19)
Net cash (used in) provided by financing activities	(3,871)	40,702
Increase in cash and cash equivalents	5,277	19,668
Cash and cash equivalents, beginning of period	39,385	33,302
Cash and cash equivalents, end of period	\$ 44,662	\$ 52,970

The accompanying notes are an integral part of the consolidated financial statements.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 Summary of Significant Accounting Policies**

***Basis of Presentation***

The condensed 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 American Indemnity Insurance Company, Ltd. and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc. and its subsidiaries, and Crest Financial Corporation and its subsidiaries.

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 for the year ended December 31, 2002.

The condensed consolidated financial statements reflect all normal recurring adjustments, which were, in the opinion of management, necessary to present a fair statement of the results for the interim period. The results of operations for the nine months ended September 30, 2003, are not necessarily indicative of the results expected for the full year.

***Revenue Recognition Policy***

Premiums written 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. Certain premiums are subject to retrospective premium adjustments. The estimated ultimate premium is recognized over the term of the insurance contract.

Commission income, which includes reinsurance brokerage, is recorded on the latter of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of sub-broker commission expense. Commission and other adjustments are recorded when they occur and the Company maintains an allowance for estimated policy cancellations and commission returns.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized in the period the services are provided. The claims processing fees are recognized as revenue over the estimated life of the claims. For those contracts that provide services beyond the contractually defined termination date of the related contracts, fees are deferred in an amount equal to management's estimate of the Company's obligation to continue to provide services.

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 and interest income are recognized when earned. Discount or premium on debt securities purchased at other than par value is amortized using the constant yield method. Investments with other than temporary declines in fair value are written down to their estimated fair value and the related realized losses are recognized in income.

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

***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 2,090,149 and 2,761,804 for the nine months ended September 30, 2003 and 2002, 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 42,486 for the nine months ended September 30, 2003. There were no shares issuable pursuant to stock options included in diluted earnings per share for the nine months ended September 30, 2002. In addition, outstanding warrants of 300,000 for the nine months ended September 30, 2003 and 2002, have been excluded from the diluted earnings per share as they were anti-dilutive.

Outstanding options of 1,129,649 and 2,761,804 for the quarters ended September 30, 2003 and 2002, 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 121,605 for the quarter ended September 30, 2003. There were no shares issuable pursuant to stock options included in diluted earnings per share for the quarter ended September 30, 2002. In addition, shares issuable pursuant to outstanding warrants included in diluted earnings per share were 25,802 for the quarter ended September 30, 2003. Outstanding warrants of 300,000 for the quarter ended September 30, 2002 have been excluded from the diluted earnings per share as they were anti-dilutive.

***New Accounting Pronouncements***

The Financial Accounting Standards Board ( FASB ) has issued Statement of Financial Accounting Standards ( SFAS ) No. 148 Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123 , for periods starting after December 15, 2003, or thereafter. SFAS No. 148 provides three optional transition methods for entities that voluntarily adopt the fair value recognition principles of SFAS No. 123, Accounting for Stock-Based Compensation , and modifies the disclosure requirements of that Statement. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. The modified prospective method recognizes stock-based compensation expense related to new and unvested awards in the year of change equal to that which would have been recognized had SFAS No. 123 been adopted as of its effective date, fiscal years beginning after December 15, 1994. The retrospective restatement method recognizes stock compensation costs for the year of change and restates financial statements for all prior periods presented as though the fair value recognition provisions of SFAS No. 123 had been adopted as of its effective date.

The Company, through its 1995 and 2002 Stock Option Plans (the Plans ), may grant options to key executives and other members of management of the Company and its subsidiaries in amounts not to exceed 2,000,000 shares of the Company s common stock allocated for each plan. The Plans are administered by the Compensation Committee (the Committee ) of the Board of Directors. Option shares may be exercised subject to the terms of the Plans and the terms prescribed by the Committee at the time of grant. Currently, the Plans options have either five or ten-year terms and are exercisable and vest in equal increments over the option term.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of January 1, 2003, the Company adopted the requirements of SFAS No. 148 utilizing the prospective method. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. If compensation cost for stock option grants had been determined based on a fair value method, net income and earnings per share on a pro forma basis for the periods ending September 30, 2003 and 2002 would be as follows (in thousands):

	<b>For the Nine-Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
Net income (loss), as reported	\$7,935	\$(859)
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	102	
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(699)	(777)