Hilltop Holdings Inc.
Form 10-K
March 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2011

OR

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

Commission File Number 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

MARYLAND	**84-1477939**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
200 Crescent Court, Suite 1330 **Dallas, Texas**	**75201**
(Address of principal executive offices)	(zip code)

(214) 855-2177

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if smaller reporting company)	Smaller reporting company o

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

The aggregate market value of the common stock of the registrant held by non-affiliates of the registrant, computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2011, was approximately $350 million. For purposes of this computation, all officers, directors and 10% stockholders were deemed to be affiliates. This determination should not be construed as an admission that such officers, directors and 10% stockholders are affiliates. The number of shares of the registrant s common stock outstanding at March 9, 2012 was 56,502,246.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant s definitive Proxy Statement pertaining to the 2012 Annual Meeting of Stockholders, filed or to be filed not later than 120 days after the end of the fiscal year pursuant to Regulation 14A, is incorporated herein by reference into Part III.

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MARKET AND INDUSTRY DATA AND FORECASTS

Market and industry data and other statistical information and forecasts used throughout this Annual Report on Form 10-K are based on independent industry publications, government publications and reports by market research firms or other published independent sources. We have not sought or obtained the approval or endorsement of the use of this third-party information. Some data also is based on our good faith estimates, which are derived from our review of internal surveys, as well as independent sources. Forecasts are particularly likely to be inaccurate, especially over long periods of time.

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Unless the context otherwise indicates, all references in this Annual Report on Form 10-K to the Company, Hilltop, HTH, we, us, our or ours or similar words are to Hilltop Holdings Inc.(formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K and the documents incorporated by reference into this report include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, or Exchange Act, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this Annual Report on Form 10-K that address results or developments that we expect or anticipate will or may occur in the future, where statements are preceded by, followed by or include the words believes, expects, may, will, would, could, should, seeks, approxima plans, projects, estimates or anticipates or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our liquidity and sources of funding, our capital expenditures, our products, market trends, operations and business, are forward-looking statements.

These forward-looking statements are based on our beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If an event occurs or further changes, our business, business plan, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Certain factors that could cause actual results to differ include, among others:

- changes in the acquisition market;
- our ability to find and complete strategic acquisitions with suitable merger or acquisition candidates or find other suitable ways in which to invest our capital;
- the adverse impact of external factors, such as changes in interest rates, inflation and consumer confidence;
- the condition of capital markets;
- actual outcome of the resolution of any conflict;
- our ability to use net operating loss carryforwards to reduce future tax payments;
- the impact of the tax code and rules on our financial statements;
- failure of NLASCO, Inc. s insurance subsidiaries to maintain their respective A.M. Best ratings;
- failure to maintain NLASCO, Inc. s current agents;
- lack of demand for insurance products;

- cost or availability of adequate reinsurance;
- changes in key management;
- severe catastrophic events in our geographic area;
- failure of NLASCO, Inc. s reinsurers to pay obligations under reinsurance contracts;
- failure of NLASCO, Inc. to maintain sufficient reserves for losses on insurance policies;
- failure to successfully implement NLASCO, Inc. s new information technology system; and
- failure of NLASCO, Inc. to maintain appropriate insurance licenses.

For a further discussion of these and other risks and uncertainties that could cause actual results to differ materially from those contained in our forward-looking statements, please refer to Risk Factors in this report. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized, or even substantially realized, and that they will have the expected consequences to, or effects on, us and our business or operations. Forward-looking statements made in this report speak as of the date of this report or as of the date specifically referenced in any such statement set forth in this report. Except as required by law, we undertake no obligation to update or revise any forward-looking statements in this report.

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PART I

ITEM 1. BUSINESS

General Information

We are a holding company that is endeavoring to make opportunistic acquisitions or effect a business combination. In connection with that strategy, we are identifying and evaluating potential targets across all industries on an ongoing basis. At December 31, 2011, we had approximately $533 million aggregate available cash and cash equivalents that may be used for this purpose. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or effect a combination or, if consummated, successfully integrate or operate the acquired business.

On July, 29, 2011, we extended SWS Group, Inc, or SWS, a $50 million term loan, which bears interest at 8% per annum, is prepayable by SWS subject to certain conditions after three years, and has a maturity of five years. SWS issued us a warrant to purchase 8,695,652 shares of SWS common stock, $0.10 par value per share, exercisable at a price of $5.75 per share subject to anti-dillution adjustments. If the warrant was fully exercised, we would own 17.4% of SWS. Additionally, we have purchased 1,475,387 shares of SWS common stock on the open market.

We also provide fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States through our wholly-owned property and casualty insurance holding company, NLASCO, Inc., or NLASCO. We acquired NLASCO in January 2007. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company, (NLIC), and American Summit Insurance Company, (ASIC).

NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites and uses a risk-adjusted return approach to capital allocation, which NLASCO believes allows it to generate underwriting profits.

NLIC and ASIC carry a financial strength rating of A (Excellent) by A.M. Best. An A rating is the third highest of 16 rating categories used by A.M. Best. Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. This rating is intended to provide an independent opinion of an insurer s ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best s expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and loss adjustment expenses, and is subject to revocation or revision at any time at the sole discretion of A.M. Best.

Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol HTH.

Our principal office is located at 200 Crescent Court, Suite 1330, Dallas, Texas 75201, and our telephone number at that location is (214) 855-2177. Our internet address is www.hilltop-holdings.com.

We currently are subject to the reporting requirements of the Exchange Act and, therefore, file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission, or the SEC. These filings, and amendments to these filings, may be accessed, free of charge, on the investor relations page of our website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. Additionally, any materials that we file with, or furnish to, the SEC may be read and copied at the SEC s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for more information regarding the operations of the SEC Public Reference Room. The SEC also maintains a website, www.sec.gov, which contains reports, proxy and information statements and other information regarding issuers, such as ourselves, that file electronically with the SEC. Our codes of conduct and ethics, including amendments to, and waivers of, those codes, our corporate governance guidelines, director independence criteria and board committee charters can be accessed, free of charge, on our website, as well. We will provide, at no cost, a copy of these documents upon request by telephone or in writing at the above phone number or address, attention: Investor Relations. The references to our website address do not constitute incorporation by reference of the information contained on our website into, and should not be considered a part of, this Annual Report on Form 10-K.

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In 2011, our Chief Executive Officer certified to the NYSE, pursuant to Section 303A.12 of the NYSE s listing standards, and that he is unaware of any violation by us of the NYSE s corporate governance listing standards.

Company Background

We were formed in 1998 under the name Affordable Residential Communities Inc. as a Maryland corporation that elected to be taxed as a real estate investment trust, or REIT. Until July 2007, we primarily engaged in the acquisition, renovation, repositioning and operation of all-age manufactured home communities, the retail sale and financing of manufactured homes, the rental of manufactured homes and other related businesses, including acting as agent in the sale of homeowners insurance and related products, to residents and prospective residents of those communities. Our primary operations previously were conducted through an operating partnership, in which we owned a general partnership interest.

On February 18, 2004, we completed our initial public offering, or IPO. Through the year ended December 31, 2005, we operated as a fully integrated, self-administered and self-managed equity REIT for U.S. federal income tax purposes. In 2006, we revoked our election as a REIT for U.S. federal income tax purposes.

In January 2007, we acquired NLASCO. NLASCO was incorporated in Delaware in 2000, but its origins trace back to 1948 through one of its subsidiaries, NLIC.

On July 31, 2007, we sold substantially all of the operating assets used in our manufactured home communities business and our retail sales and financing business to American Residential Communities LLC. We intend to make opportunistic acquisitions with certain of the remaining proceeds from this transaction and, if necessary or appropriate, from additional equity or debt financing sources. In conjunction with this transaction, we transferred to the buyer the rights to the Affordable Residential Communities name, changed our name to Hilltop Holdings Inc., and moved our headquarters to Dallas, Texas.

Following the completion of the sale of our manufactured home communities businesses, our current operations have consisted solely of those of NLASCO and its subsidiaries. Therefore, the remainder of our discussion focuses on the property and casualty insurance operations of NLASCO and its subsidiaries.

Insurance Operations

NLASCO specializes in providing fire and limited homeowners insurance for low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO has expanded its product line to include enhanced homeowners products offering higher coverage limits. NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites, which we believe will generate underwriting profits.

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. Both NLIC and ASIC carry a financial strength rating of A (Excellent) by A.M. Best.

The Insurance Industry

The property and casualty insurance industry provides protection from pre-specified loss events, such as damage to property or liability claims by third parties. Property and casualty insurance can be broadly classified into two lines; personal lines, in which insurance is provided to individuals, and commercial lines, in which insurance is provided to business enterprises. In the U.S., personal and commercial insurance products are written in admitted and non-admitted markets, also known as the excess and surplus lines market. NLASCO provides insurance products in the personal line and the commercial line markets.

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In the admitted market, insurers are authorized by state insurance departments to do business, insurance rates and forms are generally highly regulated and coverage tends to be standardized. Within the admitted market, NLASCO focuses on underserved segments that do not fit into the standard underwriting criteria of national insurance companies due to several factors, such as type of business, location and the amount of premium per policy. This portion of the market tends to have limited competition. Therefore, NLASCO believes it has greater flexibility in pricing and product design relative to most admitted market risks.

The non-admitted market focuses on harder-to-place risks that admitted insurers typically do not write. In this market, risks are underwritten with more flexible policy forms and rates, resulting in more restrictive and expensive coverage. NLASCO writes in this market for its dwelling fire, homeowner, and mobile home business in Louisiana.

The property and casualty insurance industry, historically, has been subject to cyclical fluctuations in pricing and availability of insurance coverage. Soft markets are often characterized by excess underwriting capital and involve intense price competition, erosion of underwriting discipline and poor operating performance. These market conditions usually lead to a period of diminished underwriting capacity after insurance companies exit unprofitable lines and exhibit greater underwriting discipline and increase premium rates. This latter market condition is called a hard market. The insurance market may not always be hard or soft; rather, it could be hard for one line of business and soft for another. The market at the start of 2012 is likely to be characterized as soft for property risks in NLASCO s operating area; however, in coastal areas, due to the hurricane activity in recent years, those markets are considered hard.

Product Lines

Personal and Commercial Lines

The NLASCO companies specialize in writing fire and homeowners insurance coverage for low value dwellings and manufactured homes. The vast majority of NLASCO s property coverage is written on policies that provide actual cash value payments, as opposed to replacement cost. Under actual cash value policies, the insured is entitled to receive only the cost of replacing or repairing damaged or destroyed property with comparable new property, less depreciation. Additionally, most of NLASCO s property policies exclude coverage for water and mold damage.

In 2010, NLASCO expanded its homeowners insurance products to include replacement cost coverage, which also includes limited water coverage. These new products are being marketed and sold in various states; however, the primary market is Texas. The development and implementation of these new products has contributed to the premium growth at NLASCO in 2011.

NLASCO s business is conducted with two product lines, its personal lines and its commercial lines. The personal lines include homeowners, dwelling fire, manufactured home, flood and vacant policies. The commercial lines include commercial, builders risk, builders risk renovation, sports liability and inland marine policies.

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Set forth below is certain financial data broken down by line of business (in millions):

	For The Year Ended December 31, 2011	2010	2009
Gross Premiums Written			
Personal lines	$ 151.7	$ 136.5	$ 129.5
Commerical lines	8.7	7.9	6.7
Total	$ 160.4	$ 144.4	$ 136.2
Net Operating income			
Personal lines	$ 0.1	$ 4.9	$ 5.9
Commerical lines		2.3	0.8
Total	$ 0.1	$ 7.2	$ 6.7
Total Assets			
Personal lines	$ 290.2	$ 297.5	$ 256.3
Commerical lines	26.7	27.4	23.6
Total	$ 316.9	$ 324.9	$ 279.9

Geographic Markets

The following table sets forth NLASCO s total gross written premiums by state for the periods shown (in millions):

	For The Year Ended December 31, 2011	2010	2009
Gross Written Premiums			
Texas - Flood	$ 6.1	$ 5.9	$ 5.9
Texas - North	24.9	26.2	20.7
Texas - South	30.6	29.6	34.4
Texas - Central	16.0	9.6	9.4
Texas - West	14.0	15.5	13.0
Texas - Panhandle	7.3	7.1	6.8
Texas - East	18.0	14.1	13.4
Texas - Total	116.9	108.0	103.7
Arizona	12.4	11.3	11.3
Tennessee	9.5	8.6	7.8
Oklahoma	10.8	6.8	5.1
Georgia	4.4	3.3	1.6
Louisiana	3.0	3.0	3.0
Missouri	1.2	1.2	1.4
Nevada	1.0	1.0	1.1
All other states	1.2	1.2	1.2
TOTAL	$ 160.4	$ 144.4	$ 136.2

NLASCO underwrites insurance coverage primarily in Texas. It also underwrites in other states in the south and southwest regions.

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Distribution

NLASCO distributes its insurance products through a broad network of independent agents in 23 states and a select number of managing general agents, referred to as MGAs. NLASCO has a preference for doing business with agents that desire a long-term relationship that will result in mutual profitability and value for both parties. NLASCO believes that relationship agents are more oriented to the long-term and desire a meaningful relationship with their customers and the insurers they represent. NLASCO s top ten agents accounted for only 10.8%, 9.9% and 9.9% of direct premiums written in 2011, 2010 and 2009, respectively, and as of December 31, 2011, the average tenure of the top 25 agencies was over 13 years.

Underwriting and Pricing

NLASCO applies its regional expertise, underwriting discipline and a risk-adjusted, return-on-equity based approach to capital allocation to primarily offer short-tail insurance products in its target markets. NLASCO s underwriting process involves securing an adequate level of underwriting information from its independent agents, identifying and evaluating risk exposures and then pricing the risks it chooses to accept.

NLASCO employs a disciplined underwriting approach that incorporates the continuously refined stratification of its target markets to permit it to tailor its policies to individual risks and adopt pricing structures that will be supported in the applicable market. NLASCO utilizes underwriting principles and processes that reflect the knowledge and experience it has acquired during its 40-plus year history of underwriting risks. NLASCO believes that this comprehensive process capitalizes on its knowledge and expertise and results in better underwriting decisions.

Pricing levels are established by NLASCO s senior management with the assistance of a consulting actuary. Pricing balances NLASCO s return requirements along with the legal/regulatory environment in each particular geographic region. Management reviews pricing on an ongoing basis to monitor any emerging issues. NLASCO s statistical database allows this analysis to be performed on a specific coverage or geographic territory. In 2011, ASIC increased premium rates in Arizona and NLIC increased rates in Georgia, Oklahoma, Texas and Tennessee.

Catastrophe Exposure

NLASCO maintains a comprehensive risk management strategy, which includes actively monitoring its catastrophe prone territories by zip code to ensure a diversified book of risks. NLASCO utilizes software and risk support from its reinsurance brokers to analyze its portfolio and catastrophe exposure. Biannually, NLASCO has its entire portfolio analyzed by its reinsurance broker who utilizes hurricane models to predict risk. Based on this information and management s active role in risk management, NLASCO makes decisions on what geographic areas to write risks. Over the years, NLASCO has adjusted its business based on its perceived risk of catastrophe losses. For example, in 2005, ASIC withdrew from the Mississippi market to mitigate its catastrophe exposure in that area, and in 2006, it stopped writing new policies that cover wind damage along the seacoast of Louisiana. In 2009, NLASCO decided not to renew wind policies for properties within the Texas seacoast. All policies in coastal areas excluded wind by the end of February 2011.

In recent years, NLASCO s catastrophe exposure primarily resulted from property policies in Cameron, Harris, Jefferson and Nueces Counties in Texas, which include the densely populated Houston metropolitan area and the cities extending from the northern tip to the southern point on the Texas Gulf Coast. All of this territory is exposed to potential wind storm activity from the Gulf of Mexico. By not renewing wind policies on the Texas seacoast, which is exposed to the majority of potential wind storm activity, NLASCO s primary catastrophe exposure will be limited to property policies in Harris County. NLASCO also is exposed to hail and other catastrophic events in the Texas panhandle and plains states.

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Terrorism Risk Insurance Act of 2002, Terrorism Risk Insurance Extension Act of 2005 and Terrorism Risk Insurance Program Reauthorization Act of 2007

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 was enacted into Federal law and established the Terrorism Risk Insurance Program, or the Program. The Program is a Federal program that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism or war. The Program was scheduled to terminate on December 31, 2005. On December 22, 2005, the Terrorism Risk Insurance Extension Act of 2005 was enacted into Federal law, reauthorizing the Program through December 31, 2007, while reducing the Federal role under the Program. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act, or the Reauthorization Act, was enacted into Federal law, reauthorizing the Program through December 31, 2014 and implementing several changes to the Program.

In order for a loss to be covered under the Program, as presently constituted, aggregate industry losses of $100 million must be satisfied. Further, the losses must be the result of an event that is certified as an act of terrorism by the U.S. Secretary of the Treasury, Secretary of State and Attorney General. The original Program excluded from participation certain of the following types of insurance: Federal crop insurance, private mortgage insurance, financial guaranty insurance, medical malpractice insurance, health or life insurance, flood insurance and reinsurance. The 2005 Act exempted from coverage certain additional types of insurance, including commercial automobile, professional liability (other than directors and officers), surety, burglary and theft and farm-owners multi-peril. In the case of a war declared by Congress, only workers compensation losses are covered by the Program. The Program generally requires that all commercial property and casualty insurers licensed in the United States participate in the Program. Under the Program, a participating insurer is entitled to be reimbursed by the Federal government for a percentage of subject losses, after an insurer deductible, subject to an annual cap. The Federal reimbursement percentage was fixed by the Reauthorization Act at 85%. The deductible is calculated by applying the deductible percentage to the insurer s direct earned premiums for covered lines. The deductible under the Program is fixed at 20%. NLASCO s deductible under the Program was $1.6 million for 2011 and is estimated to be $1.6 million in 2012. The annual cap limits the amount of aggregate subject losses for all participating insurers to $100 billion. Once subject losses have reached $100 billion aggregate amount during a Program year, there is no additional reimbursement from the U.S. Treasury and an insurer that has met its deductible for the program year is not liable for any losses that exceed the $100 billion cap. When insured losses under the Program exceed the $100 billion cap, the insured losses are subject to pro-rata sharing based upon regulations promulgated by the U.S. Treasury. Additionally, under the Reauthorization Act, the timing of mandatory recoupment of the Federal reimbursement through policyholder surcharges was accelerated.

On December 14, 2009, two final rules with respect to the Program were published in the Federal Register. The first rule describes how the Treasury will calculate the amounts to be recouped from insurers and establishes procedures for insurers to use in collecting Federal Terrorism Policy Surcharges and remitting them to the Treasury. The second rule describes how the Treasury intends to determine the pro rata share of insurance losses under the Program when losses otherwise would exceed the annual monetary cap. NLASCO had no terrorism-related losses in 2011.

Reinsurance

NLASCO purchases reinsurance to reduce its exposure to liability on individual risks and claims and to protect against catastrophe losses. NLASCO s management believes that less volatile, yet reasonable returns are in the long-term interest of NLASCO and, as a result, maintains a conservative reinsurance program. NLASCO generated direct premiums written totaling $154.3 million, net of flood policies, in 2011 and paid approximately $11.8 million in catastrophe reinsurance premiums prior to any reinstatement premiums.

Reinsurance involves an insurance company transferring, or ceding, a portion of its risk to another insurer, the reinsurer. The reinsurer assumes the exposure in return for a portion of the premium. The ceding of risk to a reinsurer does not legally discharge the primary insurer from its liability for the full amount of the policies on which it obtains reinsurance. Accordingly, the primary insurer remains liable for the entire loss if the reinsurer fails to meet its obligations under the reinsurance agreement, and as a result, the primary insurer is exposed to the risk of non-payment by its reinsurers.

We believe that NLASCO s financial stability is substantially protected from catastrophic events through several excess of loss reinsurance contracts that combine to provide a mix of coverage against various types and combinations of catastrophe losses. As noted in the section titled Risk Factors, NLASCO is exposed to catastrophic losses that could exceed the limits of reinsurance and negatively impact its financial position and results of operations. The Company purchases catastrophe excess of loss reinsurance to a limit that exceeds the Hurricane 200-year return time as modeled by RMS Risk Link v. 11.0 and exceeds the Hurricane 500-year return time as modeled by AIR Classic v 13.0.

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In formulating its reinsurance programs, NLASCO believes that it is selective in its choice of reinsurers and considers numerous factors, the most important of which are the financial stability of the reinsurer, its history of responding to claims and its overall reputation. In an effort to minimize exposure to the insolvency of reinsurers, NLASCO evaluates the acceptability, and continuously monitors the financial condition, of each reinsurer. NLASCO enters into reinsurance agreements only with reinsurers that have an A.M. Best financial strength rating of A- (Excellent) (fourth highest of 16 categories) or better, or at least an A rating by Standard & Poors. If a reinsurer rating subsequently drops below A- (Excellent), NLASCO can cancel or replace the reinsurer. As of December 31, 2011, 100% of NLASCO s paid loss recoverables were from reinsurers rated A- (Excellent) or better by A.M. Best. To further minimize exposure to reinsurer insolvency, NLASCO spreads reinsurance treaties among many reinsurers. NLASCO reviews retention levels each year to maintain a balance between the growth in surplus and the cost of reinsurance. NLASCO had no losses from unrecoverable reinsurance in 2011.

NLASCO s ten largest net receivable balances from reinsurers as of, and for the year ended, December 31, 2011 were as follows (in millions):

		Year Ended December 31, 2011			
	A.M. Best Financial Strength Rating	Ceded Premiums	Balances Due from Reinsurance Companies	Prepaid Reinsurance Premiums	Net Receivable Balance(1)
Federal Emergency Management Agency	N/A	$ 6.1	$ 1.1	$ 5.1	$ 6.2
Endurance Specialty Insurance Ltd	A		3.3		3.3
Ariel Reinsurance Company Limited	A-	0.6	1.1		1.1
Platinum Underwriters Reinsurance, Inc.	A	0.4	2.4		2.4
Munich Reinsurance America, Inc.	A+	1.1	1.6		1.6
MS Frontier Reinsurance Limited	A	0.1	1.6		1.6
Arch Reinsurance Company	A	1.4	1.3		1.3
Validus Reinsurance Ltd	A		1.2		1.2
Paladin Catastrophe Management LLC	A+		1.1		1.1
Amlin AG	A	0.7	1.1		1.1

(1) The net receivable balance includes balances due from reinsurance companies, contingent commissions, prepaid reinsurance premiums and ceded contingent commissions, less balances due to reinsurance companies.

As of December 31, 2011, NLASCO had five layers of catastrophic excess of loss reinsurance coverage up to $170 million of losses per event in excess of $1 million retention by ASIC and $8 million retention by NLIC. The reinsurance from $8 million to $50 million loss is comprised of two layers of protection: $17 million in excess of $8 million loss; $25 million in excess of $25 million loss. The third layer provides coverage for $50 million in excess of $50 million loss; the fourth layer provides coverage of $50 million in excess of $100 million loss and the fifth layer provides coverage of $20 million in excess of $150 million loss. The fifth layer is not fully subscribed, with participants accounting for 79% of the total layer. Accordingly, NLASCO retains 21% of the losses in the fifth layer. NLIC and ASIC retain no participation in any of the other layers, beyond the first $8 million and $1.0 million, respectively.

As of January 1, 2012, the Company renewed its reinsurance contract for its first and second layers of reinsurance. Per the contract renewal, NLASCO changed its underlying coverage at ASIC to $6.5 million in excess of $1.5 million retention. The reinsurance in excess of $8 million is comprised of five layers of protection: $17 million in excess of $8 million retention; $25 million in excess of $25 million loss; $50 million in excess of $50 million loss; $50 million in excess of $100 million loss and $20 million in excess of $150 million loss. The fifth layer is not fully subscribed, with participants accounting for 79% of the total layer. NLIC and ASIC retain no participation in any of the layers, other than the first $8 million and $1.5 million retention, respectively. The projected premiums on these treaties for NLIC and ASIC are $10.1 and $2.8 million, respectively, in 2012.

As of December 31, 2011, total retention for any one catastrophe that affects both NLIC and ASIC is limited to $8 million in the aggregate.

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In addition to the catastrophe reinsurance noted above, both NLIC and ASIC participate in an excess of loss program with General Reinsurance Corporation. The General Reinsurance Corporation program is limited to each risk with respect to property and liability in the amount of $800,000 for each of NLIC and ASIC. Each of NLIC and ASIC retain $200,000 in this program. On January 1, 2012, the program will limit each risk for property and liability in the amount of $775,000 for each NLIC and ASIC, with the retention increasing to $225,000.

Liabilities for Unpaid Losses and Loss Adjustment Expenses

NLASCO s liabilities for losses and loss adjustment expenses include liabilities for reported losses, liabilities for incurred but not reported, or IBNR, losses and liabilities for loss adjustment expenses, or LAE, less a reduction for reinsurance recoverables related to those liabilities. The amount of liabilities for reported claims is based primarily on a claim-by-claim evaluation of coverage, liability, injury severity or scope of property damage, and any other information considered relevant to estimating exposure presented by the claim. The amounts of liabilities for IBNR losses and LAE are estimated on the basis of historical trends, adjusted for changes in loss costs, underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors that are subject to significant variation. Liabilities for LAE are intended to cover the ultimate cost of settling claims, including investigation and defense of lawsuits resulting from such claims. Based upon the contractual terms of the reinsurance agreements, reinsurance recoverables offset, in part, NLASCO s gross liabilities.

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer and the insurer s payment of that loss. NLASCO s liabilities for unpaid losses represent the best estimate at a given point in time of what it expects to pay claimants, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known and, consequently, it often becomes necessary to refine and adjust the estimates of liability.

The table below presents one-year development information on changes in the liability for losses and LAE and a reconciliation of liabilities on a direct premiums written and net premiums written basis for the twelve months ended December 31, 2011 and 2010 (in thousands):

	2011	2010
Balance at January 1,	$ 58,882	$ 33,780
Less reinsurance recoverables	(43,773)	(21,102)
Net balance at January 1,	15,109	12,678
Incurred related to:		
Current Year	97,742	69,044
Prior Period	(1,008)	1,899
Total incurred	96,734	70,943
Payments related to:		
Current Year	(83,266)	(59,560)
Prior Year	(8,825)	(8,952)
Total payments	(92,091)	(68,512)
Net balance at December 31,	19,752	15,109
Plus reinsurance recoverables	25,083	43,773
Balance at December 31,	$ 44,835	$ 58,882

The decrease in reserves for the twelve months ended December 31, 2011, as compared to the same period in 2010, of $14.0 million is due to a decrease in reinsurance recoverables of $18.7 million. Reinsurance recoverables decreased due to settling reserves and paying claims related to Hurricane Ike, Hurricane Dolly and the 2010 Arizona Storm. Incurred related to current year increased $28.7 million for the twelve months ended December 31, 2011, as compared to the same period in 2010, due to increases in frequency and severity of fire losses and wind and hail losses, as well as the effects of five storms that occurred in Texas in April and May 2011. Incurred amounts related to prior years indicate that we had favorable IBNR development as of December 31, 2010, resulting in a benefit in the twelve months ended December 31, 2011. This redundancy is due to favorable development on our homeowners and fire products for the 2008 and 2009 accident years, offset by unfavorable development for the 2010 accident year.

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For the twelve months ended December 31, 2011 and 2010, the reserve for losses and loss adjustment expenses includes amounts related to losses incurred prior to the purchase of NLASCO. All losses and payments related to events that occurred prior to the purchase of NLASCO were the responsibility of the sellers. In March 2011, we made a final settlement with the sellers and going forward all losses are the responsibility of the Company.

Loss Development

NLASCO estimates the aggregate amount of losses and LAE ultimately required to settle all claims for a given period. The following tables present the development of estimated liability for losses and LAE, net of reinsurance, for the years 2001 through 2010 of NLIC and ASIC. These tables present accident or policy year development data. The first line of the table shows, for the years indicated, net liability, including IBNR, as originally estimated. For example, as of December 31, 2002, NLIC estimated that $18.1 million would be a sufficient net liability to settle all unsettled claims retained by it that had occurred prior to December 31, 2002, whether reported or unreported. The next section of the table sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. For example, as indicated in that section of the table, the original net liability of $18.1 million was re-estimated to be $17.3 million at December 31, 2006 (four years later). The decrease in the original estimate is caused by a combination of factors, including: (1) claims being settled for amounts different than originally estimated; (2) the net liability being increased or decreased for claims remaining open as more information becomes known about those individual claims; and (3) more or fewer claims being reported after December 31, 2002 than had occurred prior to that date. The bottom section of the table shows, by year, the cumulative amounts of net losses and LAE paid as of the end of each succeeding year. For example, with respect to the liability for net losses and LAE of $18.1 million as of December 31, 2002, by the end of 2006 (four years later), $17.2 million had actually been paid in settlement of the claims.

The net cumulative redundancy (deficiency) represents, as of December 31, 2011, the difference between the latest re-estimated net liability and the net liability as originally estimated for losses and LAE retained by us. A redundancy means the original estimate was higher than the current estimate; and a deficiency means that the original estimate was lower than the current estimate. For example, as of December 31, 2011 and based upon updated information, NLIC re-estimated that the net liability that was established as of December 31, 2002 was $0.8 million redundant.

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The following tables are presented net of reinsurance recoverable.

National Lloyds Insurance Company
Analysis of Loss Reserve Development
(Dollars in Thousands)

	Year Ended December 31,									
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Original Reserve*	18,141	35,061	33,951	41,282	47,684	44,613	65,592	60,392	55,482	81,589
1 year later	17,852	32,887	28,106	36,332	43,640	44,064	64,864	62,337	54,987	
2 years later	17,281	32,559	27,593	40,391	43,465	44,134	65,070	62,014		
3 years later	17,357	31,614	25,747	41,231	43,394	43,950	64,702			
4 years later	17,340	31,030	25,712	39,735	43,387	43,788				
5 years later	17,312	31,088	25,579	39,699	43,366					
6 years later	17,332	31,072	25,582	39,675						
7 years later	17,321	31,066	25,568							
8 years later	17,307	31,056								
9 years later	17,306									
Net cumulative redundancy (deficiency)	835	4,005	8,383	1,607	4,318	825	890	(1,622)	495	
Cumulative amount of net liability paid as of:										
1 year later	16,836	30,867	24,747	32,871	42,301	42,478	63,761	59,977	53,387	
2 years later	17,160	30,818	25,149	34,625	42,668	43,245	64,203	60,517		
3 years later	17,209	30,875	25,388	36,157	43,140	43,495	64,391			
4 years later	17,231	30,989	25,462	39,533	43,361	43,563				
5 years later	17,287	31,026	25,521	39,646	43,365					
6 years later	17,300	31,030	25,538	39,674						
7 years later	17,301	31,029	25,564							
8 years later	17,302	31,051								
9 years later	17,302									

* Including amounts paid in respective year.

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American Summit Insurance Company
Analysis of Loss Reserve Development
(Dollars in Thousands)

	Year Ended December 31,									
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Original Reserve*	11,873	6,235	8,297	11,041	13,003	9,351	12,769	9,773	12,486	14,829
1 year later	11,983	5,322	7,388	9,932	13,014	9,154	12,009	9,423	13,153	
2 years later	11,963	5,512	6,999	9,918	12,998	9,335	11,943	9,088		
3 years later	11,554	5,563	6,859	9,918	13,435	9,235	11,880			
4 years later	11,749	5,401	6,772	9,797	13,216	9,200				
5 years later	11,775	5,396	6,714	9,820	13,195					
6 years later	11,799	5,394	6,787	9,815						
7 years later	11,804	5,396	6,743							
8 years later	11,833	5,417								
9 years later	11,821									
Net cumulative redundancy (deficiency)	52	818	1,554	1,226	(192)	151	889	685	(667)	
Cumulative amount of net liability paid as of:										
1 year later	10,909	4,987	6,566	9,341	12,429	8,732	11,560	8,800	12,390	
2 years later	11,284	5,612	6,610	9,578	12,639	9,095	11,637	8,803		
3 years later	11,647	5,756	6,682	9,679	13,326	9,193	11,726			
4 years later	11,727	5,393	6,699	9,740	13,161	9,196				
5 years later	11,747	5,393	6,714	9,813	13,188					
6 years later	11,759	5,394	6,720	9,813						
7 years later	11,764	5,394	6,723							
8 years later	11,821	5,417								
9 years later	11,821									

* Including amounts paid in respective year.

Please refer to Note 8 in the notes to consolidated financial statements for a reconciliation of the reserves presented in the tables above to the reserves for losses and loss adjustment expenses set forth in the balance sheet at December 31, 2011 and 2010.

Current loss reserve development has been favorable with the exception of accident years 2009 and 2010. In the accident years 2007 and 2008, the developed reserves as of December 31, 2011 were $1.0 million and $1.8 million, respectively, less than the initial carried reserve for each year. During accident year 2009, however, loss development was unfavorable by $0.9 million due to unfavorable development at NLIC of $1.6 million. The unfavorable development at NLIC in accident year 2009 is due to adverse development on our homeowners and fire products of $1.0 million and $0.5 million, respectively. During accident year 2010, the loss development was unfavorable by $0.2 million due to unfavorable development at ASIC of $0.7 million. The unfavorable development at ASIC in accident year 2010 is due to adverse development on homeowners products of $0.4 million. For the accident years 2002 through 2006, the reserves were $22.6 million favorable. Starting in 2002, IBNR loss reserves were strengthened, contributing to the favorable development in accident years 2002, 2003 and 2004. This strengthening of reserves was due to increases in direct premium written and increased net premium written from reductions in quota share reinsurance, a form of pro rata insurance.

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The following table is a reconciliation of the gross liability to net liability for losses and loss adjustment expenses (dollars in thousands).

	Year Ended December 31, *									
	2002	2003	2004	2005	2006	2007**	2008	2009	2010	2011
Gross unpaid losses										
Consolidated balance sheet	n/a	n/a	n/a	n/a	n/a	$ 18,091	$ 34,023	$ 33,780	$ 58,882	$ 44,835
Reinsurance recoverable	n/a	n/a	n/a	n/a	n/a	(2,692)	(14,613)	(21,102)	(43,773)	(25,083)
Net unpaid losses	n/a	n/a	n/a	n/a	n/a	$ 15,399	$ 19,410	$ 12,678	$ 15,109	$ 19,752

* Information is not presented for periods prior to January 31, 2007, as that is the date Hilltop Holdings Inc. acquired the insurance operations.

** Only includes eleven months, as the insurance operations were acquired on January 31, 2007.

Ratings

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. The ratings for NLIC and ASIC of A (Excellent) were affirmed by A.M. Best in April 2011. An A rating is the third highest of 16 rating categories used by A.M. Best. In evaluating a company s financial and operating performance, A.M. Best reviews a company s profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its liabilities for losses and LAE, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. This rating is intended to provide an independent opinion of an insurer s ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best s expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and LAE, and is subject to revocation or revision at any time at the sole discretion of A.M. Best. NLASCO cannot ensure that NLIC and ASIC will maintain their present ratings.

Investments

HTH s primary investment objectives, as a holding company, are to preserve capital and possess available cash resources to utilize in making opportunistic acquisitions. Accordingly, HTH, parent only, has $533.4 million in short-term cash equivalents, $10.1 million in equity securities and $60.4 million in other investments as of December 31, 2011. HTH s management regularly monitors investment performance.

Our insurance operating subsidiary, NLASCO, has primary investment objectives to preserve capital and manage for a total rate of return. The investment strategy of NLASCO s insurance subsidiaries is to purchase securities in sectors that represent what is expected to possess the most attractive relative value. Bonds, cash and short-term investments constituted $197.2 million, or 95.7%, of NLASCO s investments at December

31, 2011, of which $7.3 million represents an investment in HTH Senior Exchangeable Notes, and is, therefore, eliminated in consolidation. NLASCO insurance subsidiaries have custodial agreements with A.G. Edwards and Wells Fargo Bank and an investment management agreement with DTF Holdings, LLC.

NLASCO s investment guidelines reflect the desire and intent to assure the prudent investment of capital and surplus, keeping in mind the long-term nature of some insurance reserves, while recognizing the uncertainty of expected cash flows, the shorter term characteristics of and the desire to supplement insurance underwriting gains and offset losses with portfolio income and realized gains in order to maintain adequate capital and surplus. All investments are made in compliance with all state and Federal laws and regulations applicable to such investments and the company involved. State insurance laws and regulations limit the amount of investments in asset classes below certain quality levels. NLASCO currently maintains a quality structure exceeding the minimum requirements imposed on the portfolio by state insurance laws and regulations, which is known as the Investment of Insurer s Model Act, or National Association of Insurance Commissioners Act. Currently, NLASCO has no investments in subprime mortgages.

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Liquidity and preservation of policyholder surplus can be limiting factors in achieving a favorable return on invested assets, as sufficient funds need to be maintained to meet ongoing near term financial obligations. Funds not immediately needed to offset withdrawals may be invested in short-term securities on a continuous basis. A maturity structure must be maintained to invest cash flows from operations and reinvest investment income, as well as to provide a source of liquidity and flexibility to meet changing market, tax and other operating considerations.

Notwithstanding the above, the underlying objective of NLASCO s investment policy is to obtain a favorable total return on invested assets to augment the growth of surplus from operations. Total return comes both from income and capital growth, so a portion of the funds are invested in assets other than fixed income securities, including common stocks and growth oriented preferred stocks. In managing these investment choices, market volatility, the absolute level of NLASCO s capital and surplus relative both to existing liabilities and the level of premium revenue, as well as to total assets, are the limiting factors that influence the portion of assets invested in assets other than fixed income investments.

Performance is measured by comparing the total return, for each period, of each major sector of NLASCO s investment portfolio to an appropriate market index, as well as comparing the total return of NLASCO s investment portfolio to an average of the market indices, weighted by the portfolio s average exposure to each other particular sector during the period. The assets are managed with volatility of return similar to or less than the indices.

HTH s investment committee meets regularly to review the portfolio performance and investment markets in general. NLASCO s management generally meets monthly to review the performance of investments and monitor market conditions for investments that would warrant any revision to investment guidelines.

The following table sets forth information concerning the composition of the investment portfolio at December 31, 2011 (in thousands):

	December 31, 2011			
	Cost/Amortized Cost	**Fair Value**	**Carrying Value**	**Percent of Carrying Value**
Available-for-sale securities:				
Fixed maturities:				
Government securities	$ 27,729	$ 29,165	$ 29,165	13.0%
Residential mortgage-backed securities	11,708	12,652	12,652	5.6%
Commercial mortgage-backed securities	2,277	2,303	2,303	1.0%
Corporate debt securities	93,452	100,681	100,681	44.9%
	135,166	144,801	144,801	
Equity securities	16,813	19,022	19,022	8.5%
	151,979	163,823	163,823	
Other investments:				
Note receivable	38,641	38,588	38,588	17.2%
Warrants	12,068	21,789	21,789	9.7%
	$ 202,688	$ 224,200	$ 224,200	100.0%

At December 31, 2011, NLASCO s fixed maturity portfolio had a fair value of approximately $144.8 million. All of the fixed maturity investments are rated as investment grade. As a result, the market value of these investments may fluctuate in response to changes in interest rates. In addition, we may experience investment losses to the extent our liquidity needs require disposition of fixed maturity securities in unfavorable interest rate environments.

The equity securities of $19.0 million consist of $10.1 million in common stocks held by HTH and $8.9 million in common and preferred stocks held by NLASCO. Other investments represent the value of the note receivable and warrants held at HTH.

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The amortized cost (original cost for equity securities and other investments), gross unrealized holding gains and losses, and fair value of available-for-sale securities by major security type and class of security at December 31, 2011 for the investment portfolio were as follows (in thousands).

	December 31, 2011			
	Cost/Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Available-for-sale securities:				
Fixed maturities:				
Government securities	$ 27,729	$ 1,439	$ (3)	$ 29,165
Residential mortgage-backed securities	11,708	944		12,652
Commercial mortgage-backed securities	2,277	36	(10)	2,303
Corporate debt securities	93,452	7,406	(177)	100,681
	135,166	9,825	(190)	144,801
Equity securities	16,813	2,462	(253)	19,022
	151,979	12,287	(443)	163,823
Other investments:				
Note receivable	38,641		(53)	38,588
Warrants	12,068	9,721		21,789
	$ 202,688	$ 22,008	$ (496)	$ 224,200

For the twelve months ended December 31, 2011, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, our analysis and experience indicate that these investments generally do not present a great risk of other-than-temporary-impairment, as fair value should recover over time. Factors considered in our analysis include the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the duration of the loss position are not believed to be significant enough to warrant other-than-temporary impairment of the securities. The Company does not intend, nor is it likely that the Company will be required, to sell these securities before the recovery of the cost basis; and, therefore, we do not believe any other-than-temporary impairment exist as of December 31, 2011.

During 2010 and 2009, the Company took other-than-temporary impairments and recognized a loss in earnings of $70,000 and $0.8 million, respectively.

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The following table presents the maturity profile of the fixed maturity investments as of December 31, 2011. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities available-for-sale at December 31, 2011 by contractual maturity is as follows (in thousands).

	December 31, 2011	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	$ 12,608	$ 12,942
Due after one year through five years	69,594	73,300
Due six years through ten years	38,065	42,766
Due after ten years	914	838
Mortgage-backed securities	13,985	14,955
	$ 135,166	$ 144,801
Other Investments:		
Due after one year through five years	$ 50,709	$ 60,377
	$ 50,709	$ 60,377

We are subject to various market risk exposures, including interest rate risk and equity price risk. Our primary risk exposure is to changes in interest rates. We manage market risk through our investment committee and through the use of an outside professional investment management firm. We are vulnerable to interest rate changes, like other insurance companies, because we invest primarily in fixed maturity securities, which are interest-sensitive assets. Mortgage-backed securities, which make up approximately 10.3% of our available-for-sale fixed maturities, are particularly susceptible to interest rate changes.

The value of our equity investments is dependent upon general conditions in the securities markets and the business and financial performance of the individual companies in the portfolio. Values are typically based on future economic prospects that are perceived by investors in the equity market.

Competition

NLASCO competes with a large number of other companies in its selected lines of business, including major U.S. and non-U.S. insurers, regional companies, mutual companies, specialty insurance companies, underwriting agencies and diversified financial services companies. The personal lines market in Texas is dominated by a few large carriers and their subsidiaries and affiliates, including State Farm, Zurich Insurance Group, Allstate and USAA. According to the Texas Department of Insurance, the top ten insurers writing homeowners insurance accounted for approximately 81.6% of the market for the trailing twelve months at September 30, 2011. NLASCO competes for business on the basis of a number of factors, including price, coverages offered, customer service, relationships with agents (including ease of doing business, service provided and commission rates paid), size and financial strength ratings. In its personal lines business, NLASCO s competitors include Republic Companies Group, Inc., Columbia Lloyds, Foremost, American Modern Home Group and American Reliable. In its commercial lines business, NLASCO s competitors include Travelers, Safeco and Republic. NLASCO seeks to distinguish itself from its competitors by targeting underserved market segments that provide NLASCO with the best opportunity to obtain favorable policy terms, conditions and pricing.

Regulation of Insurance Activities

NLASCO s insurance subsidiaries, NLIC and ASIC, are subject to regulation and supervision in each state where they are licensed to do business. This regulation and supervision is vested in state agencies having broad administrative power over the various aspects of the business of NLIC and ASIC.

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State insurance holding company regulation

NLASCO controls two operating insurance companies, NLIC and ASIC, and is subject to the insurance holding company laws of Texas, the state in which those insurance companies are domiciled. These laws generally require NLASCO to register with the Texas Department of Insurance and periodically to furnish financial and other information about the operations of companies within its holding company structure. Generally under these laws, all transactions between an insurer and an affiliated company in its holding company structure, including sales, loans, reinsurance agreements and service agreements, must be fair and reasonable and, if satisfying a specified threshold amount or of a specified category, require prior notice and approval or non-objection by the Texas Department of Insurance.

Changes of control

Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the Texas Department of Insurance. Prior to granting approval of an application to acquire control of an insurer, the Texas Department of Insurance will consider the following factors, among others:

- the financial strength of the applicant;
- the integrity and management experience of the applicant s board of directors and executive officers;
- the acquirer s plans for the management of the domestic insurer;
- the acquirer s plans to declare dividends, sell assets or incur debt;
- the acquirer s plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and

- any anti-competitive results that may arise from the consummation of the acquisition of control.

Pursuant to the Texas insurance holding company statutes, control means the possession, direct or indirect, of the power to direct, or cause the direction of, the management and policies of the company, whether through the ownership of voting securities, by contract (except a commercial contract for goods or non-management services) or otherwise. Control is presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote 10% or more of the voting securities of the company; however, the state s insurance department, after notice and a hearing, may determine that a person or entity that directly or indirectly owns, controls or holds with the power to vote less than 10% of the voting securities of the company nonetheless controls the company. Because a person acquiring 10% or more of HTH s common stock would indirectly control the same percentage of the stock of ASIC and two affiliated corporations controlling NLIC, the change of control laws of the State of Texas would apply to such a transaction.

These laws may discourage potential acquisition proposals and may delay, deter or prevent change of control transactions, including those that some or all of the Company s stockholders might consider to be desirable.

National Association of Insurance Commissioners

The National Association of Insurance Commissioners, or NAIC, is a group consisting of state insurance commissioners that discuss issues and formulates policy with respect to regulation, reporting and accounting for insurance companies. Although the NAIC has no legislative authority and insurance companies are at all times subject to the laws of their respective domiciliary states and, to a lesser extent, other states in which they conduct business, the NAIC is influential in determining the form in which such laws are enacted. Certain Model Insurance Laws, Regulations and Guidelines, or Model Laws, have been promulgated by the NAIC as a minimum standard by which state regulatory systems and regulations are measured. Adoption of state laws that provide for substantially similar regulations to those described in the Model Laws is a requirement for accreditation by the NAIC.

The NAIC provides authoritative guidance to insurance regulators on current statutory accounting issues by promulgating and updating a codified set of statutory accounting practices in its Accounting Practices and Procedures Manual. The Texas Department of Insurance has generally adopted these codified statutory accounting practices.

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Texas also has adopted laws substantially similar to the NAIC s risk based capital, or RBC laws, which require insurers to maintain minimum levels of capital based on their investments and operations. Domestic property and casualty insurers are required to report their RBC based on a formula that attempts to measure statutory capital and surplus needs based on the risks in the insurer s mix of products and investment portfolio. The formula is designed to allow the Texas Department of Insurance to identify potential inadequately capitalized companies. Under the formula, a company determines its RBC by taking into account certain risks related to its assets (including risks related to its investment portfolio and ceded reinsurance) and its liabilities (including underwriting risks related to the nature and experience of its insurance business). Among other requirements, an insurance company must maintain capital and surplus of at least 200% of the RBC computed by the NAIC s RBC model (known as the Authorized Control Level of RBC). At December 31, 2011, NLIC and ASIC capital and surplus levels exceeded the minimum RBC requirements that would trigger regulatory attention. In their 2011 statutory financial statements, both NLIC and ASIC complied with the NAIC s RBC reporting requirements.

The NAIC s Insurance Regulatory Information System, or IRIS, was developed to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies. IRIS identifies twelve industry ratios and specifies a range of usual values for each ratio. Departure from the usual values on four or more of these ratios can lead to inquiries from state insurance commissioners as to certain aspects of an insurer s business. For 2011, all ratios for both NLIC and ASIC were within the usual values.

The NAIC adopted an amendment to its Model Audit Rule in response to the passage of the Sarbanes-Oxley Act of 2002, or SOX. The amendment is effective for financial statements for accounting periods after January 1, 2010. This amendment addresses auditor independence, corporate governance and, most notably, the application of certain provisions of Section 404 of SOX regarding internal control reporting. The rules relating to internal controls apply to insurers with gross direct and assumed written premiums of $500 million or more, measured at the legal entity level (rather than at the insurance holding company level), and to insurers that the domiciliary commissioner selects from among those identified as in hazardous condition, but exempts SOX compliant entities. Neither NLIC nor ASIC currently has direct and assumed written premiums of at least $500 million, but it is conceivable that this may change in the future; however, NLASCO must be SOX compliant because it is wholly-owned by HTH, a public company subject to SOX.

Legislative changes

From time to time, various regulatory and legislative changes have been, or are, proposed that would adversely affect the insurance industry. Among the proposals that have been, or are being, considered are the possible introduction of Federal regulation in addition to, or in lieu of, the current system of state regulation of insurers and proposals in various state legislatures (some of which proposals have been enacted) to conform portions of their insurance laws and regulations to various Model Laws adopted by the NAIC. NLASCO is unable to predict whether any of these laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on its financial condition or results of operations.

In 2002, in response to the tightening supply in certain insurance and reinsurance markets resulting from, among other things, the September 11, 2001 terrorist attacks, the Terrorism Risk Insurance Act, or TRIA, was enacted. TRIA was modified and extended by the Terrorism Risk Insurance Extension Act of 2005 and extended again by the Terrorism Risk Insurance Program Reauthorization Act of 2007. These Acts created a Federal Program designed to ensure the availability of commercial insurance coverage for terrorist acts in the United States. This Program helped the commercial property and casualty insurance industry cover claims related to terrorism-related losses and requires such companies to offer coverage for certain acts of terrorism. As a result, NLASCO is prohibited from adding certain terrorism exclusions to the policies written by its insurance company subsidiaries. The 2005 Act extended the Program through 2007, but eliminated commercial auto, farm-owners and certain other commercial coverages from its scope. The Reauthorization Act further extended the Program through December 31, 2014 and fixed the reimbursement percentage at 85% and the deductible at 20%. Although NLASCO is protected by federally funded terrorism reinsurance as provided for in the TRIA, there is a substantial deductible that must be met, the payment of which could have an adverse effect on its financial condition and results of operations. NLASCO s deductible for 2011 was $1.6 million. Potential future changes to the TRIA could also adversely affect NLASCO by causing its reinsurers to increase prices or withdraw from certain markets where terrorism coverage is required.

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In 2003, legislation was passed in Texas that significantly changed the regulation of homeowners insurance, and, to a lesser extent, automobile insurance. Prior to 2003, certain types of insurers, including insurance companies that participate in Lloyd s, reciprocals, county mutuals and farm mutuals that wrote these lines of insurance were generally exempt from rate regulation. The 2003 legislation eliminated, or severely reduced, these exemptions, and imposed a new rate regulation regime for all insurers writing these lines of insurance. This legislation also included limitations on the use of credit scoring and territorial distinctions in underwriting and rating risks. Further, the Texas Commissioner of Insurance has been given broader authority under the law to order refunds to policyholders when rates charged have been deemed excessive or unfairly discriminatory.

State insurance regulations

State insurance authorities have broad powers to regulate U.S. insurance companies. The primary purposes of these powers are to promote insurer solvency and to protect individual policyholders. The extent of regulation varies, but generally has its source in statutes that delegate regulatory, supervisory and administrative power to state insurance departments. These powers relate to, among other things, licensing to transact business, accreditation of reinsurers, admittance of assets to statutory surplus, regulating unfair trade and claims practices, establishing actuarial requirements and solvency standards, regulating investments and dividends, and regulating policy forms, related materials and premium rates. State insurance laws and regulations require insurance companies to file financial statements prepared in accordance with accounting principles prescribed by insurance departments in states in which they conduct insurance business, and their operations are subject to examination by those departments.

As part of the broad authority that state insurance commissioners hold, they may impose periodic rules or regulations related to local issues or events. An example is the State of Louisiana s prohibition on the cancellation of policies for nonpayment of premium in the wake of Hurricane Katrina. Due to the extent of damage and displacement of people, inability of mail to reach policyholders and inaccessibility of entire neighborhoods, the State of Louisiana prohibited insurance companies from canceling policies for a period of time following that named storm.

Periodic financial and market conduct examinations

The insurance departments in every state in which NLASCO s insurance companies do business may conduct on-site visits and examinations of its insurance companies at any time to review the insurance companies financial condition, market conduct and relationships and transactions with affiliates. In addition, the Texas Department of Insurance will conduct comprehensive examinations of insurance companies domiciled in Texas every three to five years. Examinations are generally carried out in cooperation with the insurance departments of other licensing states under guidelines promulgated by the NAIC.

The Texas Department of Insurance completed their last examinations of NLIC and ASIC through December 31, 2006 in examination reports dated June 13, 2008 and June 1, 2008, respectively. These contained no information of any significant compliance issues. In 2010, ASIC and NLIC were notified by the Texas Department of Insurance that a statutory examination had been scheduled to be performed during the calendar years 2011/2012. The examinations are as of December 31, 2010, and cover the period since the last examination, which was as of December 31, 2006. We have received drafts of the examination reports and there is no indication of any significant changes to our financial statements as a result of the examinations by the domiciliary state.

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State dividend limitations

The Texas Department of Insurance must approve any dividend declared or paid by an insurance company domiciled in the state if the dividend, together with all dividends declared or distributed by that insurance company during the preceding twelve months, exceeds the greater of (1) 10% of its policyholders surplus as of December 31 of the preceding year or (2) 100% of its net income for the preceding calendar year. The greater number is known as the insurer s extraordinary dividend limit. As of December 31, 2011, the extraordinary dividend limit for NLIC and ASIC is $9.4 million and $2.5 million, respectively. In addition, NLASCO s insurance companies may only pay dividends out of their earned surplus.

Statutory accounting principles

Statutory accounting principles, or SAP, are a comprehensive basis of accounting developed to assist insurance regulators in monitoring and regulating the solvency of insurance companies. SAP rules are different from generally accepted accounting principles in the United States of America, or GAAP, and are intended to reflect a more conservative view of the insurer. SAP is primarily concerned with measuring an insurer s surplus to policyholders. Accordingly, SAP focuses on valuing assets and liabilities of insurers at financial reporting dates in accordance with insurance laws and regulatory provisions applicable in each insurer s domiciliary state.

While GAAP is concerned with a company s solvency, it also stresses other financial measurements, such as income and cash flows. Accordingly, GAAP gives more consideration to appropriate matching of revenues and expenses and accounting for management s stewardship of assets than does SAP. As a direct result, different assets and liabilities and different amounts of assets and liabilities will be reflected in financial statements prepared in accordance with GAAP as opposed to SAP. SAP, as established by the NAIC and adopted by Texas regulators, determines the statutory surplus and statutory net income of the NLASCO insurance companies and, thus, determines the amount they have available to pay dividends.

Guaranty associations

In Texas, and in all of the jurisdictions in which NLIC and ASIC are, or in the future may be, licensed to transact business, there is a requirement that property and casualty insurers doing business within the jurisdiction must participate in guaranty associations, which are organized to pay limited covered benefits owed pursuant to insurance policies issued by impaired, insolvent or failed insurers. These associations levy assessments, up to prescribed limits, on all member insurers in a particular state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. States generally permit member insurers to recover assessments paid through full or partial premium tax offsets.

NLASCO did not incur any levies in 2011, 2010 or 2009. Property and casualty insurance company insolvencies or failures may, however, result in additional guaranty fund assessments at some future date. At this time NLASCO is unable to determine the impact, if any, that these assessments may have on its financial condition or results of operations. NLASCO has established liabilities for guaranty fund assessments with respect to insurers that are currently subject to insolvency proceedings.

National Flood Insurance Program

NLASCO voluntarily participates as a Write Your Own carrier in the National Flood Insurance Program, or NFIP. The NFIP is administered and regulated by the Federal Emergency Management Agency (FEMA). NLASCO operates as a fiscal agent of the Federal government in the selling and administering of the Standard Flood Insurance Policy. This involves writing the policy, the collection of premiums and the paying of covered claims. All pricing is set by FEMA and all collections are made by the Company.

The Company cedes 100% of the policies written by the Company on the Standard Flood Insurance Policy to FEMA; however, if FEMA were unable to perform, the Company would have a legal obligation to the policyholders. The terms of the reinsurance agreement are standard terms, which require the Company to maintain its rating criteria, determine policyholder eligibility, issue policies on the Company s paper, endorse and cancel policies, collect from insureds and process claims. NLASCO receives ceding commissions from NFIP for underwriting administration, claims management, commission and adjuster fees.

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Participation in involuntary risk plans

NLASCO s insurance companies are required to participate in residual market or involuntary risk plans in various states where they are licensed that provide insurance to individuals or entities that otherwise would be unable to purchase coverage from private insurers. If these plans experience losses in excess of their capitalization, they may assess participating insurers for proportionate shares of their financial deficit. These plans include the Georgia Underwriting Association, Texas FAIR Plan Association, Texas Windstorm Insurance Agency, or TWIA, the Louisiana Citizens Property Insurance Corporation, the Mississippi Residential Property Insurance Underwriting Association and the Mississippi Windstorm Underwriting Association. For example in 2005, following Hurricanes Katrina and Rita, the above plans levied collective assessments totaling $10.4 million on NLASCO s insurance subsidiaries. Additional assessments, including emergency assessments, may follow. In some of these instances, NLASCO s insurance companies should be able to recover these assessments through policyholder surcharges, higher rates or reinsurance. The ultimate impact hurricanes have on the Texas and Louisiana facilities is currently uncertain and future assessments can occur whenever the involuntary facilities experience financial deficits.

Other

Insurance activities are subject to state insurance laws and regulations as determined by the particular insurance commissioner for each state in accordance with the McCarran-Ferguson Act, as well as subject to the Gramm-Leach-Bliley Act and the privacy regulations promulgated by the Federal Trade Commission.

Changes in any of the laws governing our conduct could have an adverse impact on our ability to conduct our business or could materially affect our financial position, operating income, expense or cash flow.

SWS Group, Inc.

SWS Group, Inc., or SWS, is a Dallas-based company offering a broad range of investment and financial services through its subsidiaries. SWS s common stock is listed on the New York Stock Exchange under the symbol SWS. SWS subsidiaries include Southwest Securities, Inc., a national clearing firm, registered investment adviser and registered broker-dealer; SWS Financial Services, Inc., a registered investment adviser and a registered broker-dealer serving independent securities brokers and their clients; and Southwest Securities, FSB, one of the largest banks headquartered in the Dallas-Fort Worth metropolitan area.

On March 20, 2011, Hilltop entered into a Funding Agreement with SWS, Oak Hill Capital Partners III, L.P. and Oak Hill Capital Management Partners III, L.P. (together, Oak Hill and, collectively with Hilltop, the Investors). As contemplated by the Funding Agreement, on July 29, 2011, the Investors entered into a Credit Agreement with SWS that provides for a five-year unsecured term loan of $100 million in the aggregate. The loan proceeds were deposited in an account at SWS for further credit to Southwest Securities, FSB, unless otherwise agreed by the Investors. Interest is payable at 8% per year, and SWS is permitted to prepay all or a portion of the loans under certain circumstances after three years.

In connection with the Funding Agreement and the loans made by the Investors under the Credit Agreement, on July 29, 2011, SWS issued a warrant to Hilltop to purchase up to 8,695,652 shares of common stock of SWS (Warrant). The Warrant represents approximately a 17% equity interest in SWS (assuming each Investor exercises its respective Warrant in full). The Warrant is exercisable for five years, but will expire to the extent that SWS makes prepayments on the loans and the Investors do not promptly exercise a corresponding portion of the Warrants. To the extent that the exercise of a Warrant by a holder would cause the holder to be deemed to control SWS under applicable regulations, SWS will issue the holder newly issued non-voting Series A Preferred Stock (the Series A Preferred Stock). Subject to applicable regulations, in limited circumstances, shares of Series A Preferred Stock will be convertible into shares of SWS common stock.

On July 29, 2011, the Investors also entered into an Investor Rights Agreement with SWS that provides the Investors with certain rights with respect to the common stock that may be issued upon the exercise of the Warrants or upon the conversion of the Series A Preferred Stock if a holder exercises its Warrants for shares of Series A Preferred Stock instead of common stock, including certain preemptive rights and registration rights. Pursuant to the Investor Rights Agreement, each Investor was granted the right to designate one representative to the SWS s Board of Directors for so long as that Investor continues to beneficially own 9.9% of SWS s outstanding common stock. SWS s Board of Directors elected Mr. Gerald J. Ford and Mr. J. Taylor Crandall as directors of the Company, effective July 29, 2011. In addition, under the Investor Rights Agreement each Investor was granted the right to appoint an observer to attend all meetings of the Board of Directors of SWS for so long as that Investor continues to beneficially own 4.9% of SWS s outstanding common stock. Hilltop has designated Mr. Jeremy Ford as its observer, effective July 29, 2011.

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Additionally, from September 2011 through November 2011, Hilltop purchased additional shares of SWS common stock in open market and block transactions. Accordingly, as of March 1, 2012, Hilltop beneficially owns 10,171,039 shares of SWS common stock, or 24.6% of the outstanding common stock of SWS.

Employees

As of December 31, 2011, we had 135 full-time equivalent employees. Of these 135 employees, five work for HTH, and the remaining 130 work for NLASCO. The NLASCO employees perform underwriting, claims, marketing, and administrative functions for the insurance business. We consider our employee relations to be good.

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ITEM 1A. RISK FACTORS

The following risk factors identify important factors, including material risks and uncertainties, which could cause actual results to differ materially from those reflected in forward-looking statements or in our historical results. Each of the following risk factors, among others, could adversely affect our ability to meet the current expectations of our management.

Risks Related to Our Substantial Cash Position and Related Strategies for its Use

We intend to use a substantial portion of our available cash to make acquisitions or effect a business combination.

We are endeavoring to make opportunistic acquisitions or effect a business combination with a substantial portion of our available cash. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or effect a combination or, if consummated, successfully integrate personnel and operations. Even if we identify suitable targets, we may not be able to make acquisitions or effect a combination on commercially acceptable terms, if at all. The success of any acquisition or combination will depend upon, among other things, the ability of management and our employees to integrate personnel, operations, products and technologies effectively, to retain and motivate key personnel and to retain customers and clients of targets. In addition, any acquisition or combination we undertake may involve certain other risks, including consumption of available cash resources, potentially dilutive issuances of equity securities and the diversion of management s attention from other business concerns. We also may need to make further investments to support the acquired or combined company and may have difficulty identifying and acquiring the appropriate resources. There can be no assurance that any acquisition or combination we undertake will perform as expected. We may enter, on our own and through acquisitions or a combination, into new lines of business or initiate new service offerings, whether related or unrelated to our insurance business. Our success in any such endeavor will depend upon, among other things, the ability of management to identify suitable opportunities, successfully implement sound business strategies and avoid the legal and business risks of any new line of business or service offering and/or an acquisition related thereto. There can be no assurance that we will be able to do any of the foregoing. In addition, any such undertakings may result in additional costs without an immediate increase in revenues and may divert management s attention from the operation and growth of our current lines of business.

Since we have not definitively selected a particular target business to acquire or combine with, you will be unable to ascertain the merits or risks of the industry or business in which we may ultimately primarily operate.

We may consummate an acquisition of, or effect a business combination with, a company in any industry and are not limited to any particular type of business. Accordingly, there is no basis for you to evaluate the possible merits or risks of the particular industry in which we may ultimately conduct our primary ongoing operations or the target business that we may ultimately acquire. To the extent that we complete an acquisition of, or effect a business combination with, a financially unstable company or an entity in its development stage, we may be affected by numerous risks inherent in the business operations of those entities. If we complete an acquisition of, or effect a business combination with, an entity in an industry characterized by a high level of risk, we may be affected by the unascertainable risks of that industry. Although our management will endeavor to evaluate the risks inherent in a particular industry or target business, we cannot assure you that we will properly ascertain or assess all of the significant risk factors. Even if we properly assess those risks, some of them may be outside of our control or ability to affect.

We may change our primary lines of business without stockholder approval, which may result in riskier lines of business than our current lines of business.

Depending on the structure of an acquisition or business combination, it may result in us conducting our primary operations in lines of business that are different from, and possibly more risky than, our current business without stockholder approval.

Resources could be expended in researching acquisitions that are not consummated, which could materially adversely affect subsequent attempts to locate and acquire or merge with another business.

It is anticipated that the investigation of each specific target business and the negotiation, drafting and execution of relevant agreements, disclosure documents and other instruments will require substantial management time and attention and substantial costs for accountants, attorneys and others. If a decision is made not to complete a specific acquisition or business combination, the costs incurred up to that point for the proposed transaction likely would not be recoverable. Furthermore, even if an agreement is reached relating to a specific target business, we may fail to consummate our acquisition or combination for any number of reasons, including those beyond our control, such as if the target s stockholders do not approve the transaction. Any such event will result in a loss to us of the related costs incurred, which could materially adversely affect subsequent attempts to locate and acquire or merge with another business.

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Existing circumstances may result in several of our directors having interests that may conflict with our interests.

A director who has a conflict of interest with respect to an issue presented to our board will have no inherent legal obligation to abstain from voting upon that issue. We do not have provisions in our bylaws or charter that require an interested director to abstain from voting upon an issue, and we do not expect to add provisions in our charter and bylaws to this effect. Although each director has a duty to act in good faith and in a manner he or she reasonably believes to be in our best interests, there is a risk that, should interested directors vote upon an issue in which they or one of their affiliates has an interest, their vote may reflect a bias that could be contrary to our best interests. In addition, even if an interested director abstains from voting, the director s participation in the meeting and discussion of an issue in which they have, or companies with which they are associated have, an interest could influence the votes of other directors regarding the issue.

Difficult market conditions have adversely affected the yield on our available cash.

Our primary objective is to preserve and maintain the liquidity of our available cash, while at the same time maximizing yields without significantly increasing risk. The capital and credit markets have been experiencing volatility and disruption for a prolonged period. This volatility and disruption reached unprecedented levels, resulting in dramatic declines in interest rates and other yields relative to risk. This downward pressure has negatively affected the yields we receive on our available cash. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will receive any significant yield on our available cash. Further, given current market conditions, no assurance can be given that we will be able to preserve our available cash.

Competition from other motivated purchasers may hinder our ability to consummate an acquisition in the near term.

We expect to encounter intense competition from entities having a business objective similar to ours, including venture capital funds, special purpose acquisition companies, private equity funds, leveraged buyout funds, opportunity funds and other operating businesses competing for acquisitions. Many of these entities are well established and have extensive experience in identifying and effecting acquisitions or business combinations directly or through affiliates. Many of these competitors possess greater technical, human and other resources than we do and our financial resources may be relatively limited when contrasted with those of many of these competitors. While we believe that there are numerous potential target businesses that we could acquire with our available cash, our ability to compete in acquiring certain sizable target businesses may be limited by our available financial resources. This inherent competitive limitation gives others an advantage in pursuing the acquisition of certain target businesses. For these reasons, we cannot assure you that we will be able to effectuate an acquisition or business combination in the near term.

Following the consummation of an acquisition or business combination, we may be required to take write-downs or write-offs or restructuring, impairment or other charges that could have a significant negative effect on our financial condition, results of operations and our stock price.

Even if we conduct extensive due diligence on a target business that we acquire or with which we merge, we cannot assure you that this diligence will surface all material issues that may be present inside a particular target business, that it would be possible to uncover all material issues through a customary amount of due diligence, or that factors outside of the target business and outside of our control will not later arise. As a result of these factors, we may be forced to later write-down or write-off assets, restructure our operations or incur impairment or other charges that could result in us reporting losses. Even if our due diligence successfully identifies certain risks, unexpected risks may arise and previously known risks may materialize in a manner inconsistent with our preliminary risk analysis. Even though these charges may be non-cash items and not have an immediate impact on our liquidity, the fact that we report charges of this nature could contribute to negative market perceptions about us or our securities.

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We may issue shares of preferred stock or additional shares of common stock to complete an acquisition or effect a combination or under an employee incentive plan after consummation of an acquisition or combination, which would dilute the interests of our stockholders and likely present other risks.

The issuance of shares of preferred stock or additional shares of common stock:

- may significantly dilute the equity interest of our stockholders;
- may subordinate the rights of holders of common stock if preferred stock is issued with rights senior to those afforded our common stock;
- could cause a change in control if a substantial number of shares of common stock are issued, which may affect, among other things, our ability to use our net operating loss carry forwards; and
- may adversely affect prevailing market prices for our common stock.

We may be unable to obtain additional financing to complete an acquisition or business combination or to fund the operations and growth of a target business, which could compel us to restructure or abandon a particular acquisition or business combination.

Although we believe that our available cash will be sufficient to allow us to consummate an acquisition or effect a business combination, we cannot ascertain the exact capital requirements for any particular transaction because we have not yet definitively selected a target business. If our available cash is insufficient, either because of the size of the acquisition or business combination or the depletion of available funds in search of a target business, we may be required to seek additional financing. We cannot assure you that such financing will be available on acceptable terms, if at all. To the extent that additional financing proves to be unavailable, if and when needed, to consummate an acquisition or effect a business combination, we would be compelled to either restructure the transaction or abandon that particular acquisition or business combination and seek an alternative target business candidate. Even if we do not need additional financing to consummate an acquisition or effect a business combination, we may require such financing to fund the operations or growth of the target business. The failure to secure additional financing could have a material adverse effect on the continued development or growth of the target.

There may be tax consequences with respect to an acquisition or business combination that adversely affect us.

While we expect to undertake any merger or acquisition so as to minimize taxes, both to the acquired business and/or asset and us, such acquisition or business combination might not meet the statutory requirements of a tax-free reorganization, or the parties might not obtain the intended tax-free treatment upon a transfer of shares or assets. A non-qualifying reorganization could result in the imposition of substantial taxes.

Our net operating loss and other carryovers may be limited if we undergo an ownership change. Generally, an ownership change occurs if certain persons or groups increase their aggregate ownership in us by more than 50 percentage points looking back over the prior three-year period. If an ownership change occurs, our ability to use our net operating losses, or NOLs, to reduce income taxes is limited to an annual amount, or a Section 382 limitation, equal to the fair market value of our common stock immediately prior to the ownership change multiplied by the long term tax-exempt interest rate, which is published monthly by the Internal Revenue Service, or IRS. In the event of an ownership change, NOLs that exceed the Section 382 limitation in any year will continue to be allowed as carryforwards for the remainder of the carryforward period and such excess NOLs can be used to offset taxable income for years within the carryforward period subject to the Section 382 limitation in each year. Whether or not an ownership change occurs, the carryforward period for NOLs is either 15 or 20 years from the year in which the losses giving rise to the NOLs were incurred. If the carryforward period for any NOL were to expire before that NOL had been fully utilized, the unused portion of that NOL would be lost.

Based on our knowledge of stockholder ownership of Hilltop, we do not believe that an ownership change has occurred since our initial public offering, or IPO, that would limit our post-IPO NOLs. Accordingly, we believe that there is not a Section 382 limitation imposed on our use of post-IPO NOLs to reduce future taxable income.

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The determination of whether an ownership change has occurred, or will occur, is complicated, and therefore, no assurance can be provided as to whether an ownership change has occurred or will occur. We have not obtained, and currently do not plan to obtain, an IRS ruling or opinion of counsel regarding our conclusions as to whether the pre-IPO NOLs or post-IPO NOLs are subject to any such limitations. In addition, limitations imposed by Section 382 may prevent us from issuing additional shares of common stock to raise capital or to acquire businesses or properties. To the extent not prohibited by our charter, we may decide in the future that it is necessary or in our best interest to take certain actions that could result in an ownership change.

If Hilltop is determined to control SWS Group, Inc., Hilltop will be required to become a regulated holding company.

As a general matter, an investor is deemed to control a depository institution or other company if the investor owns or controls 25% or more of any class of voting stock. Subject to rebuttal, an investor may be presumed to control a depository institution or other company if the investor owns or controls ten percent or more of any class of voting stock. As of March 1, 2012, Hilltop beneficially owned 24.6% of the outstanding common stock of SWS Group, Inc. In connection with the transactions entered into with SWS Group, Inc., Hilltop filed a Rebuttal of Control, which the Office of Thrift Supervision accepted based upon the facts represented by Hilltop. The transaction documents also provide for mechanisms to prevent Hilltop from being deemed to control SWS Group, Inc. through voting control. Notwithstanding, in the event that Hilltop was determined to control SWS Group, Inc., Hilltop would have to register as a savings and loan holding company and become subject to the laws and regulations thereof, including, without limitation, supervision, examination, permissible activities, capital requirements and dividend restrictions.

In addition, it is a policy of the Board of Governors of the Federal Reserve System, or Federal Reserve, that a bank holding company should serve as a source of financial and managerial strength to the depository institutions that it controls. This was not a policy of the Office of Thrift Supervision, the primary regulator of thrifts and savings and loan holding companies, or SLHCs, prior to July 2011, with respect to the obligations of a SLHC to a depository institution that it controls. Given that the Federal Reserve became the primary federal regulator of SLHCs, the policy for SLHCs on this subject likely will be altered to align more closely with those for bank holding companies. The regulators may require certain financial and other action by a regulated holding company in support of controlled depository institutions even if such action is not in the best interests of the regulated holding company or its shareholders.

If we are deemed to be an investment company, we may be required to institute burdensome compliance requirements and our activities may be restricted, which may make it difficult for us to complete strategic acquisitions or effect combinations.

We do not plan to operate as an investment fund or investment company, or to be engaged in the business of investing, reinvesting or trading in securities. Our primary plan is to acquire, hold, operate and grow for the long-term, one or more operating businesses.

If we were deemed to be an investment company under the Investment Company Act of 1940, or the 1940 Act, we would be required to become registered under the 1940 Act (or liquidate) and our activities would be subject to a number of restrictions, including, among others:

- corporate governance requirements and requirements regarding mergers and share exchanges;
- restrictions on the nature of our investments;

- restrictions on our capital structure and use of multiple classes of securities; and
- restrictions on our use of leverage and collateral, each of which may make it difficult for us to consummate strategic acquisitions or effect a combination.

In addition, we may have imposed upon us burdensome requirements, including:

- registration as an investment company;
- adoption of a specific form of corporate structure; and
- reporting, record keeping, voting, proxy and disclosure requirements and other rules and regulations,
- compliance with which would reduce the funds that we have available to consummate strategic acquisitions or a combination.

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In order not to be regulated as an investment company under the 1940 Act, unless we can qualify for an exclusion, we must ensure that we are engaged primarily in an initial business other than investing, reinvesting or trading of securities and that our activities do not include investing, reinvesting, owning, holding or trading investment securities. Our primary business, in addition to our insurance operations, will be to identify and consummate an acquisition or effect a business combination and, thereafter, to operate the acquired business or businesses for the long term. We do not believe that our anticipated principal activities will subject us to the 1940 Act. If we were deemed to be subject to the 1940 Act, compliance with these additional regulatory burdens would require additional expense for which we have not accounted.

If we fail to maintain an effective system of internal controls over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Effective internal controls are necessary for us to provide timely and reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. If we fail to maintain the adequacy of our internal controls, our financial statements may not accurately reflect our financial condition. Inadequate internal controls over financial reporting could impact the reliability and timeliness of our financial reports and could cause investors to lose confidence in our reported financial information, which could have a negative effect on our business and the value of our securities.

Risks Related to NLASCO s Business and NLASCO s Industry

The occurrence of severe catastrophic events may have a material adverse effect on NLASCO, particularly because NLASCO conducts business in a concentrated geographic area.

NLASCO expects to have large aggregate exposures to natural and man-made disasters, such as hurricanes, hail, tornados, windstorms, wildfires and acts of terrorism. NLASCO expects that its loss experience, generally, will include infrequent events of great severity. Hurricanes Dolly, Gustav and Ike, which occurred in 2008, are examples. The risks associated with natural and man-made disasters are inherently unpredictable, and it is difficult to predict the timing of these events with statistical certainty or estimate the amount of loss any given occurrence will generate. Although NLASCO may attempt to exclude certain losses, such as terrorism and other similar risks, from some coverage that NLASCO writes, it may be prohibited from, or may not be successful in, doing so. The extent of losses from a catastrophe is a function of both the total amount of policyholder exposure in the geographic area affected by the event and the severity of the event. The occurrence of losses from catastrophic events may have a material adverse effect on NLASCO s ability to write new business and on its financial condition and results of operations. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and NLASCO expects that these factors will increase the severity of losses in the future. Factors that may influence NLASCO s exposure to losses from these types of events, in addition to the routine adjustment of losses, include, among others:

- exhaustion of reinsurance coverage;
- increases in reinsurance rates;
- unanticipated litigation expenses;
- unrecoverability of ceded losses;

- impact on independent agent operations and future premium income in areas affected by catastrophic events;
- unanticipated expansion of policy coverage or reduction of premium due to regulatory, legislative and/or judicial action following a catastrophic event; and
- unanticipated demand surge related to other recent catastrophic events.

NLASCO s insurance subsidiaries write insurance primarily in the States of Texas, Arizona, Tennessee, Oklahoma, Georgia and Louisiana. In 2011, Texas accounted for 72.0%, Arizona accounted for 8.0%, Oklahoma accounted for 7.0%, Tennessee accounted for 6.1%, Georgia accounted for 2.8%, Louisiana accounted for 1.9% and the other states we do business in accounted for the other 2.2% of our premiums. As a result, a single catastrophe, destructive weather pattern, wildfire, terrorist attack, regulatory development or other condition or general economic trend affecting these regions or significant portions of these regions could adversely affect NLASCO s financial condition and results of operations more significantly than other insurance companies that conduct business across a broader geographic area. Although NLASCO purchases catastrophe reinsurance to limit its exposure to these types of catastrophes, in the event of one or more major catastrophes resulting in losses to it in excess of $170.0 million, NLASCO s losses would exceed the limits of its reinsurance coverage.

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NLASCO is exposed to claims related to severe weather and the occurrence of severe weather may result in an increase in claims frequency and exposure amount that could materially adversely affect its financial condition.

NLASCO is subject to claims arising out of severe weather, such as hurricanes, tornados, rainstorms, snowstorms, hailstorms, windstorms and ice storms, which may have a significant effect on its financial condition and results of operations. The majority of its business is written in Texas, Arizona, Tennessee and Oklahoma, and Texas experienced two major hurricanes in 2008. The incidence and severity of weather conditions are inherently unpredictable. Some forecasters predict that the world is currently in a cycle of increased frequency of, and more severe, hurricanes and destructive weather patterns.

Generally, NLASCO s insured risks exhibit higher losses in the second and third calendar quarters due to a seasonal concentration of weather-related events in its primary geographic markets. Although weather-related losses (including hail, high winds, tornadoes and hurricanes) can occur in any calendar quarter, the second calendar quarter, historically, has experienced the highest frequency of losses associated with these events. For the last five years, the contribution of weather-related catastrophes to the second quarter loss ratio was on average approximately 25 percentage points greater than the average contribution of such catastrophes in the other three quarters. Hurricanes, however, are more likely to occur in the third calendar quarter of the year.

NLASCO experienced redundancy of $7.0 million (including loss adjustment expenses) in gross catastrophic related losses for the year ended December 31, 2011. During 2011, NLASCO s net catastrophic loss experience was $0.1 million after reinsurance and decreases in net premiums earned due to reinsurance reinstatement premiums. NLASCO incurred $33.4 million (including loss adjustment expenses) in gross catastrophic related losses for the year ended December 31, 2010. During 2010, NLASCO s net catastrophic loss experience was $3.5 million after reinsurance and decreases in net premiums earned due to reinsurance reinstatement premiums. A substantial portion of the expense in 2010 relates to claims being paid or reserved on hail and windstorms occurring in Oklahoma and Arizona, respectively.

Due to the inherent inability to accurately predict the severity and frequency of catastrophic losses, higher than expected catastrophic losses could materially adversely affect NLASCO s financial condition.

NLASCO utilizes catastrophe modeling to assess its probable maximum insurance losses from hurricane and other wind/hail perils and to structure its catastrophe reinsurance program to minimize its exposure to high severity/high frequency types of losses. Hurricanes Ike, Katrina and Rita highlighted the challenges inherent in predicting the impact of catastrophic events. The catastrophe models, generally, failed to adequately project the financial impact of Hurricanes Ike, Katrina and Rita. This experience highlights the limitations inherent in the use of modeling as a means of risk assessment/abatement. If the exposure amount and frequency of catastrophe losses are higher than predicted under NLASCO s modeling, NLASCO s financial condition may be materially adversely affected.

NLASCO s investment performance has suffered, and may further suffer, as a result of adverse capital market developments and other factors, which affect its financial results.

NLASCO invests the premiums it receives from policyholders until they are needed to pay policyholder claims or other expenses. At December 31, 2011, NLASCO s invested assets consisted of $152.1 million in fixed maturity securities and $8.9 million in equity securities. During the year ended December 31, 2011, NLASCO had $6.3 million of net investment income, representing 4.3% of NLASCO s total revenues. Although NLASCO s investment policies stress diversification of risks, conservation of principal and liquidity, its investments are subject to a variety of investment risks, including those relating to general economic conditions, market volatility, interest rate fluctuations, liquidity risk and credit and default risk. In particular, the volatility of NLASCO s claims may force it to liquidate securities, which may cause it to incur capital losses. If NLASCO s investment portfolio is not appropriately matched with its insurance liabilities, it may be forced to liquidate investments prior to maturity at a significant loss to cover these liabilities. Investment losses could significantly decrease its asset base and statutory surplus, thereby adversely affecting its ability to conduct business and potentially its A.M. Best financial strength rating. Further, developments in the world s financial and capital markets have adversely impacted the performance of NLASCO s investments. Additionally, inflation could increase beyond investment income.

The capital and credit markets have been experiencing volatility and disruption for more than three years. This volatility and disruption has reached unprecedented levels, resulting in dramatic declines in prices. This downward pressure has negatively affected the performance of NLASCO s investments, which has resulted in the write down of several of those investments in 2010 and 2009. These write-downs, when determined to be other-than-temporary, reduce NLASCO s earnings for that period. If current levels of market disruption and volatility continue or worsen, there can be no assurances that we will not experience additional losses on our investments and reductions in our earnings.

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NLASCO s investment results may be adversely affected by interest rate changes.

NLASCO s operating results are affected, in part, by the performance of its investment portfolio. NLASCO s investment portfolio contains instruments, such as bonds, that may be adversely affected by increases in interest rates. Because bond trading prices decrease as interest rates rise, a significant increase in interest rates could have a material adverse effect on NLASCO s financial condition and results of operations. On the other hand, decreases in interest rates could have an adverse effect on NLASCO s investment income and results of operations. For example, if interest rates decline, investment of new premiums received and funds reinvested will earn less. Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions and other factors beyond NLASCO s control.

With respect to fixed-income investments, the fair market value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose NLASCO to prepayment risks on these investments. When interest rates fall, mortgage-backed securities typically are prepaid more quickly and the holder must reinvest the proceeds at lower interest rates. NLASCO s mortgage-backed securities currently consist of securities with features that reduce the risk of prepayment, but NLASCO can make no assurances that it will invest in other mortgage-backed securities that contain this protection. In periods of increasing interest rates, mortgage-backed securities typically are prepaid more slowly, which may require NLASCO to receive interest payments that are below the then prevailing interest rates for longer time periods than expected.

If NLASCO cannot price its business accurately, its profitability and the profitability of its insurance companies could be materially adversely affected.

NLASCO s results of operations and financial condition depend on its ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay losses, loss adjustment expenses and underwriting expenses and to earn a profit. To price its products accurately, NLASCO must:

- collect and properly analyze a substantial amount of data;
- develop, test and apply appropriate pricing techniques;
- closely monitor and recognize changes in trends in a timely manner; and
- project both severity and frequency of losses with reasonable accuracy.

NLASCO s ability to undertake these efforts successfully, and price its products accurately, is subject to a number of risks and uncertainties, some of which are outside its control, including:

- the availability of sufficient reliable data and NLASCO s ability to properly analyze available data;

- changes in applicable legal liability standards and in the civil litigation system generally;
- NLASCO s selection and application of appropriate pricing techniques;
- NLASCO s ability to obtain regulatory approval, where necessary;
- the uncertainties that inherently characterize estimates and assumptions; and
- NLASCO s ability to obtain adequate premium rates to offset higher reinsurance costs.

Consequently, NLASCO could under-price risks, which would adversely affect its profit margins, or it could overprice risks, which could reduce its competitiveness and sales volume. In either case, its profitability and the profitability of its insurance companies could be materially adversely affected.

If NLASCO s actual losses and loss adjustment expenses exceed its loss and expense estimates, its financial condition and results of operations could be materially adversely affected.

NLASCO s financial condition and results of operations depend upon its ability to assess accurately the potential losses associated with the risks that it insures. NLASCO establishes reserve liabilities to cover the payment of all losses and loss adjustment expenses incurred under the policies that it writes. These liability estimates include case estimates, which are established for specific claims that have been reported to NLASCO, and liabilities for claims that have been incurred but not reported, or IBNR. Loss adjustment expenses represent expenses incurred to investigate and settle claims. To the extent that losses and loss adjustment expenses exceed estimates, NLIC and ASIC will be required to increase their reserve liabilities and reduce their income before income taxes in the period in which the deficiency is identified. In addition, increasing reserves causes a reduction in policyholders surplus and could cause a downgrade in the ratings of NLIC and ASIC. This, in turn, could diminish its ability to sell insurance policies.

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The liability estimation process for NLASCO s casualty insurance coverage possesses characteristics that make case and IBNR reserving inherently less susceptible to accurate actuarial estimation than is the case with property coverages. Unlike property losses, casualty losses are claims made by third-parties of which the policyholder may not be aware and, therefore, may be reported a significant time after the occurrence, including sometimes years later. As casualty claims most often involve claims of bodily injury, assessment of the proper case estimates is a far more subjective process than claims involving property damage. In addition, in determining the case estimate for a casualty claim, information develops slowly over the life of the claim and can subject the case estimation to substantial modification well after the claim was first reported. Numerous factors impact the casualty case reserving process, such as venue, the amount of monetary damage, legislative activity, the permanence of the injury and the age of the claimant.

The effects of inflation could cause the severity of claims from catastrophes or other events to rise in the future. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and NLASCO expects that these factors will increase the severity of losses in the future. As NLASCO observed in 2008, the severity of some catastrophic weather events, including the scope and extent of damage and the inability to gain access to damaged properties, and the ensuing shortages of labor and materials and resulting demand surge, provide additional challenges to estimating ultimate losses. NLASCO s liabilities for losses and loss adjustment expenses include assumptions about future payments for settlement of claims and claims handling expenses, such as medical treatments and litigation costs. To the extent inflation causes these costs to increase above liabilities established for these costs, NLASCO expects to be required to increase its liabilities, together with a corresponding reduction in its net income in the period in which the deficiency is identified.

Estimating an appropriate level of liabilities for losses and loss adjustment expense is an inherently uncertain process. Accordingly, actual loss and loss adjustment expenses paid will likely deviate, perhaps substantially, from the liability estimates reflected in NLASCO s consolidated financial statements. Claims could exceed NLASCO s estimate for liabilities for losses and loss adjustment expenses, which could have a material adverse effect on its financial condition and results of operations.

If NLASCO cannot obtain adequate reinsurance protection for the risks it underwrites, NLASCO may be exposed to greater losses from these risks or may reduce the amount of business it underwrites, which may materially adversely affect its financial condition and results of operations.

NLASCO uses reinsurance to protect itself from certain risks and to share certain risks it underwrites. During 2011 and 2010, NLASCO s personal lines ceded 12.0% and 16.3%, respectively, of its direct premiums written (primarily through excess of loss, quota share and catastrophe reinsurance treaties) and its commercial lines ceded 4.9% and 7.3%, respectively, of its direct premiums written (primarily through excess of loss and catastrophe reinsurance treaties). The total cost of reinsurance, inclusive of per risk excess and catastrophe, decreased 26.6% in the year ended December 31, 2011, which is primarily attributable to lower reinstatement premiums in 2011 of $2.4 million. Reinsurance cost will likely materially increase, in part due to the frequency and severity of hurricanes and the lack of capacity in the reinsurance market.

From time to time, market conditions have limited, and in some cases have prevented, insurers from obtaining the types and amounts of reinsurance that they have considered adequate for their business needs. Accordingly, NLASCO may not be able to obtain desired amounts of reinsurance. Even if NLASCO is able to obtain adequate reinsurance, it may not be able to obtain it from entities with satisfactory creditworthiness or negotiate terms that it deems appropriate or acceptable. Although the cost of reinsurance is, in some cases, reflected in NLASCO s premium rates, NLASCO may have guaranteed certain premium rates to its policyholders. Under these circumstances, if the cost of reinsurance were to increase with respect to policies for which NLASCO guaranteed the rates, NLASCO would be adversely affected. In addition, if NLASCO cannot obtain adequate reinsurance protection for the risks it underwrites, it may be exposed to greater losses from these risks or it may be forced to reduce the amount of business that it underwrites for such risks, which will reduce NLASCO s revenue and may have a material adverse effect on its results of operations and financial condition.

NLASCO could face unanticipated losses from war, terrorism and political unrest, and these or other unanticipated losses could have a material adverse effect on NLASCO s financial condition and results of operations.

NLASCO has exposure to unexpected losses resulting from future man-made catastrophic events, such as acts of terrorism and political instability. These risks are inherently unpredictable. It is difficult to predict the timing of such events with statistical certainty or to estimate the amount of loss that any given occurrence will generate. In certain instances, NLASCO specifically insures risks resulting from acts of terrorism. Even in cases where NLASCO attempts to exclude losses from terrorism and certain other similar risks from some coverage it writes, NLASCO may be prohibited from, or may not be successful in, doing so. Irrespective of the clarity and inclusiveness of policy language, a court or arbitration panel may limit the enforceability of policy language or otherwise issue a ruling adverse to NLASCO. Accordingly, while NLASCO believes that its reinsurance programs, together with the coverage provided under the Terrorism Risk Insurance Act of 2002, the

Terrorism Risk Insurance Extension Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007, or, collectively, the Terrorism Act, are sufficient to reasonably limit its net losses relating to potential future terrorist attacks, its reserves may not be adequate to cover losses when they materialize. Under the Terrorism Act, after an act of terrorism is certified by the Secretary of the Treasury, NLASCO may be entitled to be reimbursed by the Federal government for a percentage of subject losses, after an insurer deductible and subject to an annual cap. The Terrorism Act covers an insurance company s operations for up to 85% of its losses, subject to certain mandatory deductibles. The deductible is calculated by applying the deductible percentage to the insurer s direct earned premiums for covered lines from the calendar year immediately prior to the applicable year. Although the Terrorism Act provides benefits in the event of certain acts of terrorism for losses in 2005 through 2014, the Terrorism Act may not be extended beyond 2014 or its benefits may be reduced. It is not possible to completely eliminate NLASCO s exposure to unforecasted or unpredictable events, and to the extent that losses from such risks occur, NLASCO s financial condition and results of operations could be materially adversely affected.

If NLASCO s reinsurers do not pay losses in a timely fashion, or at all, NLASCO may incur substantial losses that could materially adversely affect its financial condition and results of operations.

At December 31, 2011, NLASCO had $25.9 million in reinsurance recoverables, including ceded paid loss recoverables, ceded losses and loss adjustment expense recoverables and ceded unearned premiums. NLASCO expects to continue to purchase substantial reinsurance coverage in the foreseeable future. Since NLASCO remains primarily liable to its policyholders for the payment of their claims, regardless of the reinsurance it has purchased relating to those claims, in the event that one of its reinsurers becomes insolvent or otherwise refuses to reimburse NLASCO for losses paid, or delays in reimbursing NLASCO for losses paid, its liability for these claims could materially and adversely affect its financial condition and results of operations. As an example, if one of NLASCO s catastrophe reinsurers experienced financial difficulties following one of the major hurricanes in 2005 and had been unable to meet its obligations to NLASCO, NLASCO could have experienced difficulty in meeting its obligations to its policyholders.

NLASCO relies on independent insurance agents to distribute its products, and if the agents do not promote NLASCO s products successfully, NLASCO s results of operations and financial condition could be adversely affected.

NLASCO s business depends, in large part, on the efforts of independent insurance agents to market its insurance products and on its ability to offer insurance products and services that meet the requirements of their customers. While NLASCO strives to offer products that its agents require, NLASCO competes for business with other carriers based on the scope of coverage provided in its products, services, commissions and rates. NLASCO s competitors may offer coverage that is more attractive to particular customers than it offers for a specific product, may price their insurance products more aggressively, may offer higher agent commissions and may devote additional resources to improve their services. Accordingly, NLASCO s agents may find it easier to promote the programs of NLASCO s competitors rather than NLASCO s. If NLASCO s agents fail to, or choose not to, market NLASCO s insurance products successfully, NLASCO s growth may be limited and its financial condition and results of operations may be adversely affected. Additionally, rather than utilizing an independent agent to buy their insurance, consumers may elect to deal with direct-writers or mass marketers that utilize the Internet to advertise and/or underwrite their business. Industry developments that centralize and commoditize insurance products could be detrimental to NLASCO s agency distribution model of doing business.

Because NLASCO relies on managing general agents to underwrite some of its products and to administer claims, such managing general agents could expose NLASCO to liability or allocate business away from NLASCO, which could cause NLASCO s financial condition and results of operations to be adversely affected.

NLASCO has developed programs with managing general agents, or MGAs, whereby the MGA will, within the guidelines established by NLASCO, underwrite insurance policies on NLASCO s insurance subsidiaries behalf with oversight by NLASCO. A MGA is a person, firm or corporation that has supervisory responsibility for the local agency and field operations of an insurer in the state where it is organized or that is authorized by an insurer to accept or process, on the insurer s behalf, insurance policies produced and sold by other agents. While NLASCO exercises care in the selection of its MGA relationships and regularly audits the performance of its MGAs, NLASCO is at risk for their conduct as a result of the authority it has delegated to them. If one of NLASCO s MGAs binds NLASCO s insurance subsidiaries to policies that expose it to unexpected losses or fails to appropriately report claims, NLASCO s financial condition and results of operations could be adversely affected. For example, if a terminated MGA fails to continue to appropriately report claims during the runoff period, then liabilities for losses and loss adjustment expenses could be deficient, which would impact NLASCO s results of operations in future periods. Furthermore, subject to contractual limitations, MGAs have the ability to change carriers or increase or decrease the allocation to a particular carrier. A MGA might choose to change carriers or allocations for many reasons, such as pricing, service, conditions in the reinsurance market or a change in ownership of an MGA.

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A decline in NLIC s or ASIC s financial strength ratings by A.M. Best could cause either of their sales or earnings, or both, to decrease.

Ratings have become an increasingly important factor in establishing the competitive position of insurance companies. A.M. Best maintains a letter scale rating system ranging from A++ (Superior) to F (In Liquidation) to rate the financial strength of insurance enterprises. NLIC and ASIC have been rated A (Excellent) by A.M. Best, which is the third highest of sixteen rating levels.

Each of NLIC s and ASIC s financial strength rating is subject to periodic review by, and may remain the same, be revised downward or upward or be revoked at the sole discretion of, A.M. Best. A decline in either NLIC s or ASIC s rating or an announced negative outlook on the rating can cause concern about their viability among agents, brokers and policyholders, resulting in a movement of business away from NLASCO and its insurance company subsidiaries to more highly-rated carriers. In addition, the errors and omissions insurance coverage of many of NLASCO s independent agents does not provide coverage if the covered agents sell policies from insurers with an A.M. Best financial strength rating of B+ (Very Good) or below. As a result, the loss of NLIC s or ASIC s A.M. Best financial strength rating, or a reduction to B+ (Very Good) or worse, may adversely impact NLASCO s ability to retain or expand its policyholder base. Periodically, A.M. Best changes its rating methodology and practices. Any change to the methodologies and practices could result in a reduction of NLIC s or ASIC s A.M. Best rating.

The failure of any of the loss limitation methods NLASCO employs could have a material adverse effect on its financial condition and results of operations.

At the present time, NLASCO employs a variety of endorsements to its policies that limit its exposure to known risks, such as exclusions for mold losses and water damage. NLASCO s policies also are not designed to provide coverage for claims related to exposure to potentially harmful products or substances, including, among others, lead paint and silica. NLASCO s homeowners policies, other than policies specifically written for flood coverage, specifically exclude coverage for losses caused by flood, but generally provide coverage for damage caused by wind. In addition, NLASCO s policies contain conditions requiring the prompt reporting of claims and its right to decline coverage due to late claim reporting. NLASCO s policies also include limitations restricting the period during which a policyholder may bring a breach of contract or other claim against it, which in many cases is shorter than the applicable statutory limitations for such claims. It is possible that a court or regulatory authority could nullify or void, or legislation could be enacted modifying or barring, the use of endorsements and limitations in a way that would adversely affect NLASCO s loss experience, which could have a material adverse effect on its financial condition and results of operations.

The effects of emerging claim and coverage issues on NLASCO s business are uncertain.

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect NLASCO s business by either extending coverage beyond its underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until long after NLASCO has issued insurance policies that are affected by the changes. As a result, the full extent of liability under NLASCO s insurance policies may not be known until after a contract is issued. Changes in other legal theories of liability under NLASCO s insurance policies or the failure of any loss limitation it applies also could adversely impact NLASCO s financial condition and results of operations.

Because NLASCO s main source of premiums written is in Texas, unfavorable changes in the economic or regulatory environment in that state may have a material adverse effect on its financial condition and results of operations.

Texas accounted for approximately 72.0% and 73.2% of NLASCO s direct premiums written in 2011 and 2010, respectively. The Texas legislature, frequently reviews insurance regulation, which will likely result in changes to those regulations. The loss of a significant amount of NLASCO s premiums written in Texas, whether due to an economic downturn, competitive changes, regulatory or legislative developments or other reasons, could have a material adverse effect on its financial condition and results of operations.

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If NLASCO is unsuccessful in competing against other competitors in the insurance industry, its financial condition and results of operations could be adversely affected.

The insurance industry is highly competitive and has, historically, been characterized by periods of significant price competition, alternating with periods of greater pricing discipline during which competitors focus on other factors. In the current market environment, competition in NLASCO s industry is based primarily on the following:

- products offered;
- service;
- experience;
- the strength of agent and policyholder relationships;
- reputation;
- speed and accuracy of claims payment;
- perceived financial strength;
- ratings;
- scope of business;
- commissions paid; and
- policy and contract terms and conditions.

NLASCO competes with many other insurers, including large national companies who have greater financial, marketing and management resources than NLASCO. Many of these competitors also have better ratings and market recognition than NLASCO. NLASCO seeks to distinguish itself from its competitors by providing a broad product line and targeting those market segments that provide the best opportunity to earn an underwriting profit.

NLASCO also faces competition from entities that self-insure, primarily in the commercial insurance market. From time to time, established and potential customers may examine the benefits and risks of self-insurance and other alternatives to traditional insurance.

In addition, a number of new, proposed or potential industry developments also could increase competition in NLASCO s industry. These developments include, but are not necessarily limited to, changes in practices and other effects caused by the Internet (including direct marketing campaigns by NLASCO s competitors in established and new geographic markets), which have led to greater competition in the insurance business and increased expectations for customer service. These developments could prevent NLASCO from expanding its book of business.

NLASCO also faces competition from new entrants into the insurance market. New entrants do not have historic claims or losses to address and, therefore, may be able to price policies on a basis that is not favorable to NLASCO. New competition could reduce the demand for NLASCO s insurance products, which could have a material adverse effect on its financial condition and results of operations.

The debt agreements of NLASCO and its controlled affiliates contain financial covenants and impose restrictions on its business.

The indenture governing NLASCO s LIBOR plus 3.40% notes due 2035 contains restrictions on its ability to, among other things, declare and pay dividends and merge or consolidate. In addition, this indenture contains a change of control provision, which provides that (i) if a person or group becomes the beneficial owner, directly or indirectly, of 50% or more of NLASCO s equity securities and (ii) if NLASCO s ratings are downgraded by a nationally recognized statistical rating organization (as defined in the Securities Exchange Act of 1934), then each holder of the notes governed by such indenture has the right to require that NLASCO purchase such holder s notes, in whole or in part, at a price equal to 100% of the then outstanding principal amount.

The surplus indentures governing NLIC s LIBOR plus 4.10% notes due 2033 and ASIC s LIBOR plus 4.05% notes due 2034 contain restrictions on dividends and mergers and consolidations. In addition, NLASCO has other credit arrangements with its affiliates and other third-parties.

NLASCO s ability to comply with these covenants may be affected by events beyond its control, including prevailing economic, financial and industry conditions. The breach of any of these restrictions could result in a default under the loan agreements or indentures governing the notes or under its other debt agreements. An event of default under its debt agreements would permit some of its lenders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. If NLASCO were unable to repay debt to its secured lenders, these lenders could proceed against the collateral securing that debt. In addition, acceleration of its other indebtedness may cause NLASCO to be unable to make interest payments on the notes.

Other agreements that NLASCO or its insurance company subsidiaries may enter into in the future may contain covenants imposing significant restrictions on their respective businesses that are similar to, or in addition to, the covenants under their respective existing agreements. These restrictions may affect NLASCO s ability to operate its business and may limit its ability to take advantage of potential business opportunities as they arise.

The regulatory system under which NLIC and ASIC operate, and potential changes to that system, could have a material adverse effect on their respective business activities.

NLIC and ASIC are subject to comprehensive regulation and supervision in those states in which they are domiciled and write insurance policies. Though NLIC and ASIC currently write most of their policies in Texas, Arizona, Tennessee, Oklahoma, Georgia and Louisiana, as of December 31, 2011, NLIC is licensed in 24 states and ASIC is licensed in 37 states. Laws and regulations pertaining to NLIC and ASIC are generally administered by state insurance departments and relate to, among other things:

- standards of solvency, including risk-based capital measurements;
- restrictions on the nature, quality and concentration of investments;
- required methods of accounting;
- rate and policy form regulation and other market conduct; and
- potential assessments for the provision of funds necessary for covered claims under certain policies provided by impaired, insolvent or failed insurance companies.

These state insurance departments also conduct periodic examinations of insurance companies and require the filing of annual and other reports relating to financial condition, holding company issues and other matters. Current or future regulatory requirements may adversely affect or inhibit each of the insurance company s ability to achieve some or all of its business objectives.

NLIC and ASIC may not be able to obtain or maintain necessary licenses, permits, authorizations or accreditations in states where they are currently licensed or in new states they intend to enter, or they may be able to do so only at a significant cost. In addition, they may not be able to comply fully with, or obtain appropriate exemptions from, the wide variety of laws and regulations applicable to insurance companies and insurance holding companies, which could result in restrictions on their operating flexibility and could subject them to fines and other sanctions that may have a material adverse effect on their business.

Significant changes in the political and regulatory climate could result in changes in applicable laws and regulations and could make it more expensive or less profitable to manage our business. In recent years, the United States insurance regulatory framework has come under increased federal scrutiny, and some state legislators have considered, or enacted, laws that may alter or increase state regulation of insurance and reinsurance companies and holding companies. Moreover, the National Association of Insurance Commissioners, or NAIC, and state insurance regulators regularly reexamine existing laws and regulations and develop new laws. Changes in laws and regulations, or their interpretation, could have a material adverse effect on the insurance companies financial condition and results of operations.

The activities of the insurance companies MGAs are subject to licensing requirements and regulation under the laws of the states in which they operate. The insurance companies MGAs businesses depend on the validity of, and continued good standing under, the licenses and approvals pursuant to which they operate, as well as compliance with pertinent laws and regulations.

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Licensing laws and regulations vary from jurisdiction to jurisdiction. In all jurisdictions, the applicable licensing laws and regulations are subject to amendment or interpretation by regulatory authorities. Generally, these authorities are vested with relatively broad discretion to grant, renew and revoke licenses and approvals for various reasons, including the violation of law and conviction of crimes. Other sanctions may include the suspension of individual employees, limitations on engaging in a particular business for specified periods of time, revocation of licenses, censures, redress to policyholders and fines. Although NLASCO and its insurance subsidiaries endeavor to follow practices based on good faith interpretations of laws and regulations, or those generally followed by the industry, these practices may prove to be different from those that the regulatory authorities require.

If the states in which NLIC and ASIC write insurance increase the assessments that insurance companies are required to pay, NLASCO s and their financial condition and results of operations will suffer.

NLIC and ASIC are subject to a variety of taxes, fines, levies, license fees, tariffs and other assessments that may, from time to time, be material. These assessments are made by the states in which NLIC and ASIC operate and include participation in residual market or involuntary risk plans in various states that provide insurance coverage to individuals or entities that otherwise are unable to purchase such coverage from private insurers. Due to this participation, NLIC and ASIC may be exposed to material losses. They also are subject to assessments in the states in which they write insurance for various purposes, including the provision of funds necessary to fund the operations of various insurance guaranty associations, which pay covered claims under certain policies issued by impaired, insolvent or failed insurance companies. These assessments are generally set based on an insurer s percentage of the total premiums written in the relevant state within a particular line of business for the relevant time period. For the years ended December 31, 2011, 2010 and 2009, NLASCO paid no assessments. If NLIC s and ASIC s total premiums written grow, NLASCO s share of any assessments may increase, as well. NLASCO, however, cannot predict with certainty the amount of future assessments, because these assessments depend on factors outside NLASCO s control, such as the insolvencies of other insurance companies, the market shares of other insurance companies writing in a particular state and the degree to which other companies write in coastal areas.

NLASCO is subject to assessments from the Georgia Underwriting Association, Louisiana Citizens Property Insurance Corporation, or LCPIC, Mississippi Windstorm Underwriting Association, or MWUA, the Texas FAIR Plan Association and the Texas Windstorm Insurance Association, or TWIA.

LCPIC, MWUA and TWIA have estimated plan losses from the hurricanes that struck Louisiana and Texas in the third quarter of 2005 and 2008, and are thereby able to levy regular and emergency assessments to participating companies and policyholders, respectively. NLASCO does not expect that these assessments will have a net financial statement impact, as all these assessments are recoverable (subject to treaty limits) under its reinsurance treaties. Further, NLASCO may be able to recoup a regular assessment through a surcharge to policyholders. These recoupments will be refunded to reinsurers as the related premiums are written and collected. NLASCO is required to collect emergency assessments directly from residential property policyholders and remit them to LCPIC as they are collected.

NLASCO continues to monitor developments with respect to various state facilities, such as the Georgia Underwriting Association, LCPIC, MWUA, the Texas FAIR Plan Association and the TWIA. The ultimate impact of Hurricanes Katrina, Rita, Dolly and Ike on these facilities is currently uncertain, but could result in the facilities recognizing a financial deficit different than the level currently estimated. They may, in turn, have the ability to assess participating insurers when financial deficits occur. NLASCO will not, however, incur any net expense or loss from any of these assessments due to reinsurance recoveries.

NLASCO may be subject to high retaliatory taxes in several states as a result of its multistate operations, which could have a material adverse impact on its financial condition and results of operations.

Nearly all states impose a retaliatory tax on insurers operating in their state that are domiciled in another state. Retaliatory taxes are based on the principle that if the aggregate taxes, fees and obligations imposed by an insurer s domiciliary state are greater than the aggregate taxes, fees and obligations imposed by the taxing state, then the difference is payable to the taxing state as a retaliatory tax. For example, the State of Texas imposes various premium-based taxes that, in the aggregate, total approximately 2.0% of gross written premiums in Texas. The State of Illinois imposes various premium-based taxes that, in the aggregate, total approximately 0.5% of gross written premiums in Illinois. The Illinois retaliatory tax provisions would require a Texas-domiciled insurer operating in Illinois to pay the 0.5% aggregate Illinois taxes plus a 1.5% incremental amount, which represents the difference between the Texas effective rate and the Illinois effective rate. Thus, a Texas-domiciled insurer would pay a 2.0% effective tax in Illinois, while an Illinois-domiciled insurer would only pay a 0.5% effective tax. Insurance companies with multistate operations, like NLASCO, may find themselves subject to high retaliatory taxes in several states, which could have a material adverse impact on NLASCO s financial condition and results of operations.

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NLASCO s ability to meet ongoing cash requirements and pay dividends may be limited by its holding company structure and regulatory constraints.

NLASCO operates as a holding company. Dividends and other permitted payments from its operating subsidiaries are expected to be its primary source of funds to meet ongoing cash requirements, including any future debt service payments and other expenses, and to pay dividends, if any, to Hilltop. NLIC and ASIC are subject to significant regulatory restrictions and limitations under debt agreements limiting their ability to declare and pay dividends, which could, in turn, limit NLASCO s ability to meet its ongoing cash requirements, including any future debt service payments and other expenses, or to pay dividends.

Current legal and regulatory activities, investigations, litigation proceedings or other activities relating to the insurance industry could affect NLASCO s business, financial condition and results of operations.

The insurance industry has experienced share price volatility as a result of litigation, investigations and regulatory activity by various insurance, governmental and enforcement authorities concerning certain practices within the insurance industry. NLASCO is unable to predict the potential effects, if any, that these investigations may have upon the insurance markets and industry business practices in general or what, if any, changes may be made to laws and regulations regarding the industry and financial reporting. Any of the foregoing could materially and adversely affect its business, financial condition and results of operations.

NLIC and ASIC are subject to periodic financial and market conduct examinations by state insurance departments. If these examinations identify significant findings or recommend significant changes to its operations, either insurance company could lose its licenses or its financial condition and results of operations could be affected.

The insurance departments in every state in which NLASCO s insurance companies do business may conduct on-site visits and examinations at any time and generally for any purpose, including the review of NLASCO s insurance companies financial condition, market conduct and relationships and transactions with affiliates. In addition, the Texas Department of Insurance will conduct comprehensive examinations of NLASCO s insurance companies every three to five years. The Texas Department of Insurance completed their last examinations of NLIC and ASIC through December 31, 2006 in examination reports dated June 13, 2008 and June 1, 2008, respectively, which contained no information of any significant compliance issues. In 2010, ASIC and NLIC were notified by the Texas Department of Insurance that a statutory examination had been scheduled to be performed during the calendar years 2011/2012. The examinations are as of December 31, 2010, and cover the period since the last examination, which was as of December 31, 2006. We have received drafts of the examination reports and there is no indication of any significant changes to our financial statements as a result of the examinations by the domiciliary state.

While there were no material adverse findings or recommended changes to NLASCO s or its insurance company subsidiaries operations identified in the last completed or draft report of financial examinations conducted by the departments of insurance, there can be no assurance that there will not be adverse findings or recommended changes identified by other state insurance departments in future examinations. In addition, significant adverse findings could lead to a revocation of NLASCO s or its insurance company subsidiaries licenses. Any adverse findings or recommended changes resulting from such financial examinations, or from any future examinations, could have a material adverse effect on NLASCO s or its insurance company subsidiaries financial condition and results of operations.

Departure of key personnel would deprive us of the institutional knowledge, expertise and leadership they provide.

Operating an insurance company is complex. The insurance industry is highly competitive and has historically been characterized by periods of significant price competition, alternating with periods of greater pricing discipline during which competitors focus on other factors. In addition, insurance companies are subject to comprehensive regulation and supervision in those states in which they write insurance policies and in which they are domiciled. Significant changes in the political and regulatory climate could result in changes in these laws and regulations and could make it more expensive or less profitable for us to manage an insurance company. The loss of key personnel may result in us encountering difficulties in operating an insurance company and complying with regulatory requirements applicable to insurance companies.

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NLASCO is in the process of implementing a new information technology system that could cause substantial business interruption.

We are in the process of designing and implementing a new information technology system and are investing significant financial and personnel resources into this project. There is no assurance, however, that the design will meet our current and future business needs or that it will operate as designed. We are heavily dependent on computer systems, and any significant failure or delay in the system implementation, if encountered, would cause a substantial interruption to our business and additional expense that could result in an adverse impact on our operating results, cash flows and financial condition.

Failures in NLASCO s current electronic underwriting system could adversely affect its financial condition and results of operations.

NLASCO s Internet-based Policy Agency Claim System, or PACS, was primarily developed in-house. PACS is fully integrated and is able to process quotes, policy issuance, billings, payments and claims. The system is designed for ease of use by agents and employees. PACS has been an integral part of NLASCO s success. Almost all applications are submitted online. Problems or errors of which NLASCO is not currently aware may have occurred in connection with the installation, upgrading or maintenance of this system or any of its other systems or may result from a major physical disaster or other calamity that causes damage to NLASCO s systems generally. A loss of PACS or any of NLASCO s other systems for a sustained period of time could have an adverse impact on its financial condition and results of operations.

Failure to develop an adequate knowledge transfer or a succession plan for NLASCO s information technology personnel could adversely affect its financial condition and results of operations.

The success of PACS and NLASCO s new and other systems depend heavily on the incumbent information technology team that developed or implemented the system. A loss of key members of this team without adequate knowledge transfer or a succession plan could disrupt NLASCO s operations and adversely affect its results of operations.

Security breaches, cyber attacks or fraudulent activity could result in damage to the Company s operations or lead to reputational damage.

A security breach or cyber attack of the Company s computer systems could interrupt or damage the Company s operations or harm its reputation. Despite the implementation of security measures, the Company s systems may still be vulnerable to data theft, computer viruses, programming errors, attacks by third parties or similar disruptive problems.

If the Company were to experience a security breach or cyber attack, it could be required to incur substantial costs and liabilities, including, among other things, the following:

- expenses to rectify the consequences of the security breach or cyber attack;

- liability for stolen assets or information;
- costs of repairing damage to the Company s systems;
- lost revenue and income resulting from any system downtime caused by such breach or attack;
- increased costs of cyber security protection;
- costs of incentives the Company may be required to offer to its policyholders to retain their business, and
- damage to the Company s reputation causing policyholders, acquisition targets and investors to lose confidence in the Company.

In addition, any compromise of security or a cyber attack could deter consumers from entering into transactions that involve transmitting confidential information to the Company s systems. Further, if confidential policyholder information or information belonging to persons other than the Company is misappropriated from the Company s computer systems, the Company could be sued by those who assert the Company did not take adequate precautions to safeguard its systems and confidential data, which could subject the Company to liability and result in significant legal fees and expenses of defending these claims. As a result, any compromise of security of the Company s computer systems or cyber attack could have a material adverse effect on the Company s business, prospects, results of operations and financial condition.

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Claims by third-parties that NLASCO infringes their proprietary technology could adversely affect NLASCO s financial condition and results of operations.

If NLASCO discovers that any of its products, or technology that it licenses from third-parties, violates third-party proprietary rights, NLASCO may not be able to reengineer its products or obtain a license on commercially reasonable terms to continue using the products or technology without substantial reengineering, or to otherwise modify programs. In addition, product and technology development is inherently uncertain in a rapidly evolving technology environment in which there may be numerous patent applications pending for similar technologies, many of which are confidential when filed. In addition, much of the software used by NLASCO may be used subject to a licensing agreement, and NLASCO s failure to comply with the terms for usage under any such licensing agreement could subject it to claims that could adversely impact its business. Although NLASCO sometimes may be indemnified by third-parties against claims that licensed third-party technology infringes proprietary rights of others, this indemnity may be limited, unavailable or, where the third party lacks sufficient assets or insurance, ineffective. NLASCO currently does not have liability insurance to protect against the risk that its technology or future licensed third-party technology infringes the proprietary rights of others. Any claim of infringement, even if invalid, could cause NLASCO to incur substantial costs defending against the claim and could distract its management from the business. Furthermore, a party making such a claim could secure a judgment that requires NLASCO to pay substantial damages. A judgment also could include an injunction or other court order that could prevent NLASCO from using the products and technologies. Any of these events could have a material adverse effect on NLASCO s business, operating results and financial condition.

Acquisitions could result in operating difficulties and other harmful consequences.

From time to time, NLASCO may engage in discussions regarding potential acquisitions, including potential acquisitions that could be material to its financial condition and results of operations. NLASCO may acquire whole businesses or books of business that fit its underwriting competencies from insurance companies, MGAs and other agents. In addition, NLASCO may expand its business, product offerings and policyholder base by acquiring businesses in areas in which NLASCO has limited operating experience. The process of integrating an acquired company or book of business may create unforeseen operating difficulties and expenditures. In particular:

- NLASCO has achieved its prior success by applying a disciplined approach to underwriting and pricing in select markets that are not well served by its competitors. NLASCO may not be able to successfully implement its underwriting, claims management, pricing and product strategies in companies or books of business it acquires;

- NLASCO may not be able to retain the agents associated with acquired businesses and, as a result, may fail to realize the anticipated potential benefits of the acquisition;

- NLASCO could be required to implement or remediate controls, procedures and policies for an acquired privately-held company that prior to acquisition may not have been required;

- An acquisition could present cultural challenges associated with integrating employees from the acquired company into the organization, which could result in a loss of employees from the businesses NLASCO acquires and other adverse consequences;

- NLASCO s management may have to divert its time and energy from operating the business to integration challenges;

- NLASCO could have no prior experience operating the type of business that it acquires, which could create difficulties and result in NLASCO failing to realize many of the anticipated potential benefits of the acquisition; and

- An acquisition could dilute NLASCO s book value per share or after-tax return on average equity.

The anticipated benefits of any acquisition may not materialize. Future acquisitions could result in the incurrence of debt or an assumption of inadequate liabilities for losses and loss adjusted expenses or claims management structures, any of which could harm NLASCO s financial condition. Future acquisitions may require NLASCO to obtain additional financing, which may not be available on favorable terms or at all.

Risks Related to the Securities Markets and Ownership of Our Common Stock

Our charter and insurance laws contain provisions that could discourage acquisition bids or merger proposals, which may adversely affect the market price of our common stock.

Ownership Limit. In order to reduce the risk of an ownership change in the future, our charter restricts certain acquisitions of our securities in order to preserve the benefit of our NOLs. The charter generally prohibits any direct or indirect sale, transfer, assignment, conveyance, pledge or other disposition of shares of our stock or warrants, rights or options to purchase

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our stock or any other interests that would be treated as our stock under the income tax regulations promulgated under the Internal Revenue Code of 1986, as amended, if as a result of such sale, transfer, assignment, conveyance, pledge or other disposition any person or group would beneficially own five percent or more of the market value of the total outstanding shares of our common stock or the percentage of our common stock owned by a five percent or greater stockholder would be increased. Beneficial ownership is determined utilizing Treasury Regulation Section 1.382-2T(g). The transfer restrictions were implemented in January 2007, and we expect to maintain these provisions for the foreseeable future. We cannot assure you, however, that these restrictions will prevent an ownership change. If any of our stockholders increase their beneficial ownership percentage in our common stock through future acquisitions, there is an increased possibility that the provisions under the charter may be triggered. Any attempted transfer of shares in violation of the charter prohibitions will be void, and the intended transferee will not acquire any right in those shares. We have the right to take any lawful action that we believe is necessary or advisable to ensure compliance with these ownership and transfer restrictions, including refusing to recognize any transfer of stock in violation of our charter. These ownership and transfer restrictions of our charter may have the effect of discouraging or preventing a third party from attempting to gain control of us without the approval of our board of directors. Accordingly, it is less likely that a change in control, even if beneficial to stockholders, could be effected without the approval of our board of directors.

Authority to Issue Additional Shares. Under our charter, our board of directors may issue up to an aggregate of ten million shares of preferred stock without stockholder action. The preferred stock may be issued, in one or more series, with the preferences and other terms designated by our board of directors that may delay or prevent a change in control of us, even if the change is in the best interests of stockholders. As of December 31, 2010, no shares of preferred stock were designated or outstanding.

Insurance Laws. NLIC and ASIC are domiciled in the State of Texas. Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the Texas Department of Insurance. Acquisition of control would be presumed on the acquisition, directly or indirectly, of ten percent or more of Hilltop s outstanding voting stock, unless the regulators determine otherwise. Prior to granting approval of an application to acquire control of a domestic insurer, the Texas Department of Insurance will consider several factors, such as:

- the financial strength of the acquirer;
- the integrity and management experience of the acquirer s board of directors and executive officers;
- the acquirer s plans for the management of the insurer;
- the acquirer s plans to declare dividends, sell assets or incur debt;
- the acquirer s plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and
- any anti-competitive results that may arise from the consummation of the acquisition of control.

These laws may discourage potential acquisition proposals of Hilltop and may delay, deter or prevent a change of control of Hilltop, including transactions that some or all of our stockholders might consider desirable.

We previously announced a stock repurchase program approved by our board of directors whereby we are authorized to repurchase shares of our common stock.

Such purchases may be limited, suspended, or terminated at any time without prior notice. There can be no assurance that we will buy shares of our common stock under our stock repurchase program or that any future repurchases will have a positive impact on the trading price of our common stock or earnings per share. Important factors that could cause us to limit, suspend or terminate our stock repurchase program include, among others, unfavorable market conditions, the trading price of our common stock, the nature of other investment or strategic opportunities presented to us from time to time, the rate of dilution of our equity compensation programs and the availability of adequate funds, our ability to make appropriate, timely, and beneficial decisions as to when, how, and whether to purchase shares under the stock repurchase program. If we limit, suspend or terminate our stock repurchase program, our stock price may be negatively affected.

Future issuances of shares of common stock may adversely affect the price of our common stock.

The future issuance of a substantial number of shares of common stock into the public market, or the perception that such issuance could occur, could adversely affect the prevailing market price of our common stock. A decline in the price of our common stock could make it more difficult to raise funds through future offerings of our common stock or securities convertible into common stock.

Our common stock price may experience substantial volatility, which may affect your ability to sell our common stock at an advantageous price.

Price volatility of our common stock may affect your ability to sell our common stock at an advantageous price. Market price fluctuations in our common stock may arise due to acquisitions, dispositions or other material public announcements, including those regarding dividends or changes in management, along with a variety of additional factors, including, without limitation, other risks identified in Forward-looking Statements and these Risk Factors. In addition, the stock markets in general, including the NYSE, have experienced extreme price and trading fluctuations. These fluctuations have resulted in volatility in the market prices of securities that often have been unrelated or disproportionate to changes in operating performance. These broad market fluctuations may adversely affect the market price of our common stock.

Our rights and the rights of our stockholders to take action against our directors and officers are limited.

We are organized under Maryland law, which provides that a director or officer has no liability in that capacity if he or she performs his or her duties in good faith, in a manner he or she reasonably believes to be in our best interests and with the care that an ordinarily prudent person in a like position would use under similar circumstances. In addition, our charter eliminates our directors and officers liability to us and our stockholders for money damages, except for liability resulting from actual receipt of an improper benefit or profit in money, property or services or active and deliberate dishonesty established by a final judgment and that is material to the cause of action. Our bylaws require us to indemnify our directors and officers for liability resulting from actions taken by them in those capacities to the maximum extent permitted by Maryland law. As a result, our stockholders and we may have more limited rights against our directors and officers than might otherwise exist under common law. In addition, we may be obligated to fund the defense costs incurred by our directors and officers.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Not applicable.

ITEM 3. LEGAL PROCEEDINGS

We are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows taken as a whole.

ITEM 4. MINE SAFETY

Not applicable.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Securities, Stockholder and Dividend Information

Our common stock is listed on the New York Stock Exchange under the symbol HTH . Our common stock has no public trading history prior to February 12, 2004. The initial public offering price of our common stock on February 12, 2004 was $19.00 per share. Our common stock closed at $8.00 on March 8, 2012. As of March 9, 2012, there were 56,502,246 shares of our common stock outstanding with approximately 170 stockholders of record.

Prior to full redemption of our Series A Cumulative Redeemable Preferred Stock on September 6, 2010, it was listed on the New York Stock Exchange under the symbol HTHPRA . Our Series A preferred stock has no public trading history prior to February 12, 2004.

We have not paid, and do not intend to pay in the foreseeable future, cash dividends on our common stock. Any declaration of dividends on our common stock will be at the discretion of our Board of Directors and will depend on the earnings, financial condition, capital requirements, contractual restrictions with respect to payment of dividends and other factors. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Restrictions on Dividends and Distributions.

The following table sets forth the cash dividends declared and paid in 2010 with respect to our Series A Preferred Stock:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Series A Preferred Stock				
2010				
Date of declaration	March 17, 2010	July 8, 2010	August 6, 2010	N/A
Date of record	April 15, 2010	July 15, 2010	September 6, 2010	N/A
Date paid	April 30, 2010	July 30, 2010	September 6, 2010	N/A
Distribution per unit	$ 0.5156	$ 0.5156	$ 0.2063	N/A
Total dollars (in thousands)	$ 2,578	$ 2,578	$ 1,032	N/A

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The following table discloses the high and low sales prices per quarter for our common and preferred stock during 2011 and 2010. Quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	Common Stock		Series A Preferred Stock	
December 31, 2011	**High**	**Low**	**High**	**Low**
First Quarter	$ 10.13	$ 9.01	N/A	N/A
Second Quarter	$ 10.09	$ 8.60	N/A	N/A
Third Quarter	$ 9.01	$ 7.12	N/A	N/A
Fourth Quarter	$ 8.60	$ 6.88	N/A	N/A

December 31, 2010	**High**	**Low**	**High**	**Low**
First Quarter	$ 12.41	$ 11.29	$ 25.86	$ 24.48
Second Quarter	$ 12.20	$ 9.90	$ 26.58	$ 24.90
Third Quarter	$ 10.77	$ 9.31	$ 26.70	$ 25.08
Fourth Quarter	$ 10.52	$ 9.47	N/A	N/A

As of December 31, 2011, we had no warrants outstanding.

Issuances of Unregistered Securities

All issuances of unregistered securities have previously been reported.

Equity Compensation Plan Information

The following table sets forth as of December 31, 2011, information concerning our equity compensation plans, including the number of shares issued and available for issuances under our plans, options, warrants and rights; weighted average exercise price of outstanding options, warrants and rights; and the number of securities remaining available for future issuance.

Equity Compensation Plan Information

Plan Category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in first column)**
	700,000	$ 8.32	423,831

Equity compensation plans approved by security holders*				
Total	700,000	$	8.32	423,831

*Excludes shares of restricted stock granted, as all of these shares are vested. No exercise price is required to be paid upon the vesting of the restricted shares of common stock granted. These shares are issuable under our 2003 equity incentive plan, which provides for the grant of equity-based incentives, including restricted shares of our common stock, stock options, grants of shares and other equity-based awards, to our directors, officers and other employees and those of our subsidiaries selected by our Compensation Committee for participation in the plan. At inception, 1,992,387 shares were authorized for grant pursuant to this plan. All shares outstanding, whether vested or unvested, are entitled to receive dividends and to vote, unless forfeited. No participant in our 2003 equity incentive plan may be granted awards in any fiscal year covering more than 500,000 shares of our common stock.

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ITEM 6. SELECTED FINANCIAL AND OPERATING DATA

Our historical consolidated balance sheet data as of December 31, 2011 and 2010 and our consolidated statement of operations data for the years ended December 31, 2011, 2010 and 2009 have been derived from our audited historical financial statements included elsewhere in this Form 10-K. The following table shows our selected historical financial data for the periods indicated (in thousands, except per share data). You should read our selected historical financial data, together with the notes thereto, in conjunction with the more detailed information contained in our financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this Form 10-K.

	Year Ended December 31,				
	2011	2010	2009	2008	2007
Income Statement Data:					
Direct premium written	$ 155,054	$ 139,290	$ 131,309	$ 132,642	$ 122,708
Net premium written	141,737	121,691	114,743	113,285	118,357
Net premium earned	134,048	117,192	115,153	115,247	96,804
Net investment income	10,538	7,664	6,458	27,143	24,829
Net realized gain (loss)	817	137	307	(45,992)	3,205
Other income, net	6,785	6,744	6,917	6,147	6,445
Total revenue	152,188	131,737	128,835	102,545	131,283
Net loss and loss adjustment expense	96,734	70,943	70,295	80,435	52,074
Policy acquisition and other expense	58,008	53,378	52,333	53,726	42,397
Interest expense	8,985	8,971	9,668	10,528	11,539
Total expenses	163,728	133,292	132,296	144,689	106,010
(Loss) Income from continuing operations before federal income tax expense	(11,540)	(1,555)	(3,461)	(42,144)	25,273
Federal income taxes benefit (expense) for continuing operations	5,009	1,007	1,349	19,559	(10,635)
Net (loss) income from continuing operations	$ (6,531)	$ (548)	$ (2,112)	$ (22,585)	$ 14,638
Selected Balance Sheet Data:					
Total investments	224,200	148,965	129,968	138,568	191,024
Total assets	925,424	939,641	1,040,752	1,048,770	1,085,491
Total liabilities	270,042	286,586	256,975	257,315	261,306
Stockholders equity	655,382	653,055	783,777	791,455	824,185
Other Data:					
Net loss and LAE ratio	72.2%	60.5%	61.0%	69.8%	53.8%
Expense ratio	34.0%	36.0%	35.7%	35.6%	29.2%
GAAP Combined ratio	106.2%	96.5%	96.8%	105.4%	83.0%
Statutory surplus	$ 118,708	$ 119,297	$ 117,063	$ 108,478	$ 124,892
Statutory premiums to surplus ratio	119.4%	102.0%	98.0%	104.4%	94.8%
Per Share Data:					
Basic (loss) earnings per share attributable to common stockholders	$ (0.12)	$ (0.24)	$ (0.22)	$ (0.58)	$ 5.10
Diluted (loss) earnings per share attributable to common stockholders	$ (0.12)	$ (0.24)	$ (0.22)	$ (0.58)	$ 5.02
Weighted average share information					
Basic shares outstanding	56,499	56,492	56,474	56,453	55,421
Diluted shares outstanding	56,511	56,492	56,474	56,453	56,326

Cash dividends declared per share of unit:					
Series A preferred stock dividends	$	$ 1.24	$ 2.06	$ 2.06	$ 2.06

(1) Series A preferred stock was redeemed in September 2010.

(2) All years have been adjusted to reflect the disposal of our manufactured home community properties and related business, except for NLASCO.

(3) Statutory surplus includes combined surplus of NLIC and ASIC.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated historical financial statements and notes appearing elsewhere in this Form 10-K and the financial information set forth in the tables below. All dollar amounts in the following discussion are in thousands, except per share amounts.

Unless the context otherwise indicates, all references in this Management s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, to the Company, Hilltop, HTH, we, us, our or ours or similar words are to Hilltop Holdings Inc.(formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.

OUR GENERAL STRUCTURE

At December 31, 2011, HTH is a holding company that owns all of the outstanding shares of NLASCO, Inc., or NLASCO. NLASCO, in turn, owns National Lloyds Insurance Company, or NLIC, and American Summit Insurance Company, or ASIC, both of which are licensed property and casualty insurers operating in multiple states. In addition, NLASCO also owns the NALICO GA, a general agency that operates in Texas. NLIC commenced business in 1949 and currently operates in 15 states, with its largest market being the state of Texas. NLIC carries a financial strength rating of A (Excellent) by A.M. Best. ASIC was formed in 1955 and currently operates in 13 states, its largest market being the state of Arizona. ASIC carries a financial strength rating of A (Excellent) by A.M. Best. Both of these companies are regulated by the Texas Department of Insurance.

Beginning in 1995, we were founded as several companies under the name Affordable Residential Communities or ARC, now known as Hilltop Holdings Inc., for the purpose of engaging in the business of acquiring, renovating, repositioning and operating manufactured home communities, as well as certain related businesses. In 1998 we formed a Maryland corporation for the purpose of acting as the investment vehicle for, and a co-general partner of, our operating partnership, HTH Operating Partnership LP, formerly known as Affordable Residential Communities LP. In May 2002, we completed a reorganization in which we acquired substantially all the other real property partnerships and other related businesses we had previously organized and operated.

Through the year ended December 31, 2005, we were organized as a fully-integrated, self-administered and self-managed equity real estate investment trust, or REIT, for U.S. Federal income tax purposes. In 2006, we revoked our election as a REIT for U. S. Federal income tax purposes.

In January 2007, we acquired NLASCO. NLASCO was incorporated in Delaware in 2000 but its origins trace back to 1948 through one of its subsidiaries, NLIC. In 1964, C. Clifton Robinson, who is currently the Chairman of NLASCO and a member of our Board of Directors, along with other investors, purchased NLIC and moved its headquarters from San Antonio, Texas to Waco, Texas. Following various acquisitions and dispositions of equity in NLIC by Mr. Robinson and others, including the re-acquisition of NLIC along with the acquisition of ASIC in 2000, Mr. Robinson held 100% of NLASCO and its subsidiaries, NLIC and ASIC, from 2001 until we acquired NLASCO in 2007.

On July 31, 2007, we sold substantially all of the operating assets used in our manufactured home communities business and our retail sales and financing business to American Residential Communities LLC. We received gross proceeds of approximately $890 million in cash, which represents the aggregate purchase price of $1.794 billion, less the indebtedness assumed by the buyer. After giving effect to expenses, taxes and our continued outstanding preferred stock and senior notes, our net cash balance was approximately $550 million. We used a portion of the proceeds from this transaction for general working capital, liquidation of our operating partnership units and to repay certain outstanding obligations. We intend to make opportunistic acquisitions with certain of the remaining proceeds from this transaction, and, if necessary or appropriate, from additional equity or debt financing sources.

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DEVELOPMENTS DURING 2011

We extended a senior unsecured loan to SWS Group, Inc .

On July, 29, 2011, the Company extended SWS Group, Inc., or SWS, a $50 million term loan, which bears interest at 8% per annum, is prepayable by SWS subject to certain conditions after three years, and has a maturity of five years. SWS issued us a warrant to purchase 8,695,652 shares of SWS common stock, $0.10 par value per share, exercisable at a price of $5.75 per share subject to anti-dillution adjustments.

We had an extension to our loan agreement.

On October 27, 2011, NLASCO renewed its line of credit with a financial institution. The line allows for borrowings by NLASCO up to $5.0 million and is secured by substantially all of NLASCO s assets. The line of credit bears interest equal to a base rate, plus 3.75% (5.01% at December 31, 2011), which is due quarterly. This line of credit will expire in October 2012. As of December 31, 2011, there was no outstanding balance on the note.

OVERVIEW OF RESULTS

For the year ended December 31, 2011, net loss attributable to common stockholders was $6.5 million, or $0.12 per share, as compared to a net loss attributable to common stockholders of $13.5 million, or $0.24 per share, for the year ended December 31, 2010, and a net loss attributable to common stockholders of $12.4 million, or $0.22 per share, for the year ended December 31, 2009.

Segments

NLASCO operates through its wholly-owned subsidiaries, NLIC and ASIC. Given the homogenous nature of our products, the regulatory environments in which we operate, the nature of our customers and our distribution channels, we now monitor, control and manage our business lines as an integrated entity offering fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. Accordingly, we only have insurance company segment information to disclose.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We have prepared our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, or GAAP, which requires us to make certain estimates and assumptions that affect the recorded amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates. We have provided a summary of our significant accounting policies in Note 1 to the accompanying consolidated financial statements as of, and for the year ended, December 31, 2011. We have summarized below those accounting policies that require our most difficult, subjective or complex judgments and that have the most significant impact on our financial condition and results of operations. Our management evaluates these estimates on an ongoing basis. These estimates are based on information currently available to management and on various other assumptions management believes are reasonable.

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Losses and Loss Adjustment Expenses. The liability for losses and loss adjustment expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported. Separately for each of NLIC and ASIC and each line of business, our actuaries estimate the liability for unpaid losses and loss adjustment expenses, or LAE, by first estimating ultimate losses and LAE amounts for each year, prior to recognizing the impact of reinsurance. There are several methods that our actuaries utilize to estimate ultimate loss and LAE amounts, including:

- Paid Loss Development Method;
- Reported Loss Development Method;
- Paid Bornhuetter-Ferguson Method; and
- Reported Bornhuetter-Ferguson Method.

Paid and Reported Loss Development Methods. Insured losses for a given year change in value over time as additional information on claims are received, as claim conditions change and as new claims are reported. This process is commonly referred to as loss development. To project ultimate losses and LAE, our actuaries examine the paid and reported (paid, plus case) losses and LAE and multiply these values by a loss development factor. The selected loss development factors are based upon a review of the loss development patterns indicated in the companies historical loss triangles and applicable insurance industry loss development factors.

Paid and Reported Bornhuetter-Ferguson Methods. The Bornhuetter-Ferguson, or BF, Method is a procedure that weights an expected ultimate loss and LAE amount, and the result of the loss development method. This method is useful when loss data is immature or sparse because it is not as sensitive as the loss development method to unusual variations in the paid or reported amounts. The BF method requires an initial estimate of expected ultimate losses and LAE. For each year, the expected ultimate losses and LAE is based on a review of the ultimate loss ratios indicated in the companies historical data and applicable insurance industry ultimate loss ratios. Each loss development factor, paid or reported, implies a certain percent of the ultimate losses and LAE is still unpaid or unreported. The amounts of unpaid or unreported losses and LAE by year are estimated as the percentage unpaid or unreported, times the expected ultimate loss and LAE amounts. To project ultimate losses and LAE, the actual paid or reported losses and LAE to date are added to the estimated unpaid or unreported amounts.

The results of each actuarial method performed by year are reviewed to select an ultimate loss and LAE amount for each year. In general, more weight is given to the loss development projections for more mature accident periods and more weight is given to the BF methods for less mature accident periods.

The combination of the methodologies described above is used for all lines of business, regardless of whether the line is a short-tailed or long-tailed line of business, though specific parameter selections within the methods vary to reflect the nature of the underlying line of business. ASIC and NLIC specialize in writing fire and extended coverage for low-value dwellings, mobile homes and homeowners, which generally are considered short-tailed coverages. In addition, ASIC and NLIC write a small amount of commercial risks, which are still predominantly property coverages, along with some low-limit liability coverages.

The methodology used by our actuaries is directly dependent upon the unique development characteristics of each line of business. For those lines of business with significant volume (homeowners, special property and commercial multiple peril), the selected loss development factors are derived from the historical development data for that line. For lines of business where the loss volume is small, insurance industry statistics regarding loss development for that line also are considered in selecting the loss development factors.

The estimated unpaid losses and LAE equal the estimated ultimate loss and LAE amounts, described above, less the cumulative paid amounts on known claims for each year. This estimate of unpaid losses and LAE is further segmented into case reserves on known claims and incurred-but-not-reported, or IBNR, reserves. IBNR reserves are calculated by reducing the estimate of unpaid losses and LAE by the case reserve amounts. In the normal course of operations, each case reserve is initially set at a standard amount determined from past payments for that type of loss. Individual case reserves may be adjusted based on information indicating that the loss amount is actually over, or under, the standard amount. Most case reserves are not adjusted until the receipt of documentation concerning the amount to be paid on the loss. This usually occurs within seven days of the reporting of the claim, longer in the case of large scale catastrophic events.

The reserve analysis performed by our actuaries provides preliminary central estimates of the unpaid losses and LAE. At each quarter-end, the results of the reserve analysis are summarized and discussed with our senior management. The senior management group considers many factors in determining the amount of reserves to record for financial statement purposes. These factors include the extent and timing of any recent catastrophic events, historical pattern and volatility of the actuarial indications, the sensitivity of the actuarial indications to changes in paid and reported loss patterns, the consistency of claims handling processes, the consistency of case reserving practices, changes in our pricing and underwriting, and overall pricing and underwriting trends in the insurance market.

Our recorded reserves reflect our best estimate as of a particular point in time based upon known facts, current law and our judgment. The carried reserve may differ from the actuarial central estimate as the result of our consideration of the factors noted above, as well as other factors impacting claims costs that may not be quantifiable through actuarial analysis. This process results in management s best estimate, which is then recorded as the reserve for unpaid losses and LAE.

The level of loss and LAE reserves we maintain represents our best estimate, as of a particular point in time, of the ultimate cost to settle and administer all claims based on our assessment of facts and circumstances known at that time. Reserves are not an exact calculation of liability, but instead are complex estimates that we derive, generally utilizing a variety of actuarial reserve estimation techniques, with numerous underlying assumptions and expectations about future events, both internal and external, many of which are highly uncertain.

The key assumptions fundamental to the reserving process are often different for various reserve categories and accident years. Some of these assumptions are explicit assumptions that are required of a particular method, but many assumptions are implicit and cannot be precisely quantified. An example of an explicit assumption is the pattern employed in the paid loss development method. However, the assumed pattern is itself based on several implicit assumptions, such as the impact of inflation on medical costs and the rate at which claim professionals close claims. Loss frequency is a measure of the number of claims per unit of insured exposure, and loss severity is a measure of the average size of claims. Each reserve segment has an implicit frequency and severity for each accident year as a result of the various assumptions made. As a result, the effect on reserve estimates of a particular change in assumptions usually cannot be specifically quantified, and changes in these assumptions cannot generally be tracked over time.

In light of the many uncertainties associated with establishing the estimates of ultimate losses and LAE, and making the assumptions necessary to establish recorded reserve levels, we review our reserve estimates on a regular basis and make adjustments in the period that the need for such adjustments is identified. The anticipated future emergence underlying our current estimates continues to reflect the historical patterns, and the selected development patterns have not changed significantly over the past few years.

Reserve estimates are subject to uncertainty from various sources, including, among others, changes in claim reporting patterns, claim settlement patterns, judicial decisions, legislation and economic conditions. In estimating the reserves for unpaid losses and LAE, it is necessary to project future loss and LAE payments. Actual future losses and LAE will not develop exactly as projected and may, in fact, vary significantly from the actuarially indicated projections. Further, these projections make no provision for extraordinary future emergence of new classes of losses or types of losses, which are not sufficiently represented in the companies historical data or that are not yet quantifiable. Extraordinary future emergence can arise from an unforeseen broadening of coverage instigated by regulatory actions, judicial decisions or similar developments.

The underlying process of establishing our best estimate of the liability for unpaid losses and LAE require the use of estimates, actuarial judgment and management considerations and, therefore, is an inherently uncertain process. The recorded reserves for the companies liability for unpaid losses and LAE are estimates based on long term averages. Actual loss experience in any given year may differ from what is suggested by these averages. For some lines of business, the written premium volume is small and actual results are therefore subject to an exceptionally high degree of variability. While the recorded reserves are our best estimate as of a particular point in time, these reserves should be considered best estimates within a wide range of possible outcomes.

In arriving at our best estimate of the unpaid losses and LAE, and based on management discussion with our actuaries, we would consider reasonably likely changes in the key assumptions, such as the underlying loss development pattern or the expected loss ratio, to have an impact on our best estimate by +/- 10%. As of December 31, 2011, this equates to approximately +/- $1.9 million, which represents approximately 0.3% of equity and 30.2% of calendar year 2011 losses.

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The following table presents our gross loss and LAE reserve amounts at December 31, 2011 and 2010 for each of NLIC and ASIC by line of business (dollars in thousands):

For the year ended December 31, 2011

Company	Homeowners	Special Property	Commercial Multiple Peril	Other Liability	All Lines
ASIC	$ 2,217	$ 255	$ 5	$ 1,316	$ 3,793
NLIC	26,275	11,913	1,832	1,022	41,042
Consolidated	$ 28,492	$ 12,168	$ 1,837	$ 2,338	$ 44,835

For the year ended December 31, 2010

Company	Homeowners	Special Property	Commercial Multiple Peril	Other Liability	All Lines
ASIC	$ 1,558	$ 325	$ 14	$ 1,021	$ 2,918
NLIC	37,708	15,655	1,467	1,134	55,964
Consolidated	$ 39,266	$ 15,980	$ 1,481	$ 2,155	$ 58,882

Investment Securities. At December 31, 2011, investment securities consist of U.S. Government, mortgage-backed, corporate debt and equity securities. Also included in our investment portfolio are other investments, which consist of a note receivable and warrants, held by the parent, HTH. We have the ability to categorize investments as trading, available-for-sale, and held-to-maturity. We classify our fixed maturities as either available-for-sale or held-to-maturity and equity securities as available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. As of December 31, 2011, all securities were classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Unrealized holding gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of trading and available-for-sale securities are determined on a specific-identification basis.

We regularly review our investment securities to assess whether the security is impaired and if impairment is other-than-temporary. A decline in the market value of any available-for-sale security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether impairment is other-than-temporary, we consider whether we are more likely than not to hold an investment until a market price recovery and consider whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to period end, and forecasted performance of the investee.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

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Fair Value Measurements. The Company s estimates of fair value for financial assets and financial liabilities are based on the framework established in ASC 820, *Fair Value Measurements and Disclosures*. The framework is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company s significant market assumptions. The three levels of the hierarchy are as follows:

- Level 1 **-** Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

- Level 2 **-** Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data. Based on management s understanding of the methodologies used by our pricing service, all applicable investments have been valued in accordance with GAAP valuation principles.

- Level 3 **-** Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company s own assumptions about the assumptions that market participants would use.

Fixed maturities

The Company utilizes a pricing service to estimate fair value measurements for its fixed maturities. The pricing service utilizes market quotations for fixed maturity securities that have quoted prices in active markets. Since fixed maturities other than U.S. Treasury securities generally do not trade on a daily basis, the pricing service prepares estimates of fair value measurements for these securities using its proprietary pricing applications, which include available relevant market information, benchmark curves, benchmarking of like securities, sector groupings and matrix pricing.

The pricing service evaluates each asset class based on relevant market information, relevant credit information, perceived market movements and sector news. The market inputs utilized in the pricing evaluation, listed in the approximate order of priority, include: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events. The extent of the use of each market input depends on the asset class and the market conditions. Depending on the security, the priority of the use of inputs may change or some market inputs may not be relevant. For some securities, additional inputs may be necessary.

The pricing service utilized by the Company has indicated that they will only produce an estimate of fair value if there is objectively verifiable information to produce a valuation. If the pricing service discontinues pricing an investment, the Company would be required to produce an estimate of fair value using some of the same methodologies as the pricing service but would have to make assumptions for market-based inputs that are unavailable due to market conditions.

The fair value estimates of most fixed maturity investments are based on observable market information rather than market quotes. Accordingly, the estimates of fair value for such fixed maturities, other than U.S. Treasury securities, provided by the pricing service are included in the amount disclosed in Level 2 of the hierarchy. The estimated fair value of U.S. Treasury securities is included in the amount disclosed in Level 1 as the estimates are based on unadjusted market prices.

The Company reviews the estimates of fair value provided by the pricing service and compares the estimates to the Company s knowledge of the market to determine if the estimates obtained are representative of the prices in the market. In addition, the Company has periodic discussions with the pricing service to discuss any changes in their process and reactions to overall markets. These processes have not highlighted any significant issues with the fair value estimates received from the pricing service.

Non-Fixed Maturities and Other Investments

Equities Public Common and Preferred

For public common and preferred stocks, the Company receives prices from a nationally recognized pricing service that are based on observable market transactions and includes these estimates in the amount disclosed in Level 1.

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Other Investments

The Company holds investments in SWS as a note receivable and warrants, which are reported in other investments. The $60.4 million fair value of these investments at December 31, 2011 was disclosed in Level 3. The fair value estimate is determined based on recent filings, operating results, balance sheet stability, growth and other business and market sector fundamentals. Due to the significant unobservable inputs in these valuations, the Company includes the total fair value estimate for all of these investments at December 31, 2011 in the amount disclosed in Level 3.

Deferred Acquisition Costs. Costs of acquiring insurance vary with, and are related to, the production of new and renewal business, primarily consisting of commissions, premium taxes and underwriting expenses. These costs are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs reduce applicable unamortized acquisition costs in a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Future investment income is considered in determining the recoverability of deferred acquisition costs. The Company regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. A premium deficiency, and a corresponding charge to income, is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceed related unearned premiums and anticipated investment income. At December 31, 2011, there was no premium deficiency.

Revenue Recognition. Property and liability premiums are recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums. The Company routinely evaluates the premium receivable balance to determine if an allowance for uncollectible accounts is necessary.

Other income consists of premium installment charges, which are recognized when earned, and other miscellaneous income.

Reinsurance. In the normal course of business, NLASCO seeks to reduce losses that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Net premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE are reported as assets. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

The Company accounts for reinsurance contracts under the provisions of GAAP in accounting and reporting for reinsurance. Reinsurance assumed from other companies, including assumed premiums written and earned and losses and LAE, is accounted for in the same manner as direct insurance written.

Income Taxes. We have been in a taxable loss position since our inception and, as a result, we have substantial net operating loss carry-forwards to offset taxable income and capital gains from the sale of discontinued operations. We have established a tax provision beginning on January 1, 2006.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recorded for the estimated future tax effects related to the temporary difference between the tax basis and book basis of assets and liabilities reported in the accompanying consolidated balance sheets. The provision for income tax expense or benefit differs from the amounts of income taxes currently payable because certain items of income and expense included in the consolidated financial statements are recognized in different time periods by taxing authorities.

ASC 740, specifically 740-10-25, *Recognition,* clarifies the accounting for uncertainty in income taxes recognized in financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 requires that we determine whether the benefits of our tax positions are more likely than not of being sustained upon audit based on the technical merits of the tax position. For tax positions that are more likely than not of being sustained upon audit, we recognize the largest amount of the benefit that is more likely than not of being sustained in our consolidated financial statements. For tax positions that are not more likely than not of being sustained upon audit, we do not recognize any portion of the benefits in our consolidated financial statements.

Deferred tax assets, including net operating loss and tax credit carry forwards, are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that any portion of these tax attributes will not be realized. Valuation allowances on deferred tax assets are established, if necessary, to reduce deferred tax assets to an amount expected to be recognized. In accordance with ASC 740, the Company considered all negative and positive evidence available including our cumulative pre-tax loss position since the quarter ending December 31, 2008, less any abnormal occurrences during that period, as well as future taxable income and reversals of existing taxable temporary differences. We expect to realize our current deferred tax assets through core earnings, reversal of timing differences, and to the extent necessary, through the implementation of certain tax planning strategies surrounding the Company s cash holdings. Therefore, the Company concluded there was sufficient positive evidence to outweigh the negative evidence of the prior year cumulative losses. There is no valuation allowance as of December 31, 2011.

From time to time, management must assess the need to accrue or disclose a possible loss contingency for proposed adjustments from various Federal, state and foreign tax authorities that regularly audit the company in the normal course of business. In making these assessments, management often must analyze complex tax laws of multiple jurisdictions.

Goodwill and Other Indefinite Lived Intangible Assets. HTH performs our annual goodwill impairment analysis for our reporting units during the fourth quarter of each year. Management determined that HTH has two reporting units, which are the Parent (the holding company) and NLASCO (the insurance company). Goodwill for HTH represents the excess of the cost over the fair value of the assets of NLASCO of $24.0 million. Goodwill is tested annually for impairment but is tested more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset s fair value.

The goodwill impairment analysis is a two-step test. The first step (Step #1), used to identify potential impairment involves comparing each reporting unit s estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. The Company has estimated fair values of reporting units based on a discounted cash flow analysis and market approach using historic, normalized actual and forecast results. The discounted cash flow analysis utilizes thirty years of projected cash flows for the insurance company operations. The projected financial results are created from critical assumptions and estimates based upon management s business plan and historical trends, while giving consideration to the overall economic environment. Determining fair value requires the exercise of significant judgments about appropriate discount rates, business growth rates, the amount and timing of expected future cash flows and market information relevant to our overall company value.

The second step (Step #2) involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. An impairment loss cannot exceed the carrying value of goodwill assigned to a reporting unit, and the loss establishes a new basis in the goodwill. Subsequent reversal of goodwill impairment losses is not permitted.

Next the Company reviewed the intangible assets both definite and indefinite lived. The definite lived intangibles relate to customer relationships, agency relationships, trade name and software. We believe our customer relationships to be consistent with the value given to them based on the current renewal rate being approximately 90%, slightly higher than when NLASCO was purchased. Our agent relationships remain valuable and we have experienced less than 3% turnover in our agent base since 2007. Our trade names, NLIC and ASIC, are both A rated companies with NLIC increased from A- in 2007 and ASIC in 2010. Our internally developed software, PACs, is still the main operating system of the company.

At December 31, 2011, we determined that the estimated fair value of NLASCO exceeded its carrying values and, therefore, we did not perform the second step as described above. Our fair value exceeded carrying value by 10.9% as of December 31, 2011. Consequently, we determined that no impairment existed with respect to goodwill and intangible assets at December 31, 2011.

The goodwill impairment analysis is subject to impact from uncertainties arising from such events as changes in economic or competitive conditions, the current general economic environment, material changes in the weather and hard and soft markets within the insurance industry that could positively or negatively impact anticipated future operating conditions and cash flows, and the impact of strategic decisions. If any of these factors were to material change it may require a reevaluation of our Goodwill.

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RESULTS OF OPERATIONS

Comparison of the Year Ended December 31, 2011 to the Year Ended December 31, 2010

Results of insurance operations. NLASCO s underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. NLASCO s underwriting performance is one of the most important factors in evaluating the overall results of operations given the fluctuations that can occur in loss and LAE due to weather related events, as well as the uncertainties involved in the process of estimating reserves for losses and LAE. The underwriting results and fluctuations in other revenue and expense items of NLASCO are discussed in greater detail below. The following table shows the underwriting gain or loss, as well as other revenue and expense items included in the financial results of NLASCO for the year ended December 31, 2011 and 2010 (in thousands).

	Year Ended December 31,					
NLASCO Summary of Insurance Operations		**2011**		**2010**		**Dollar**	**Percentage**
Underwriting gain (loss)							
Homeowners	$	(123)	$	(2,564)	$	2,441	95.2%
Fire		(2,057)		1,844		(3,901)	-211.6%
Mobile Home		(5,811)		845		(6,656)	-787.7%
Commercial		(2,305)		1,779		(4,084)	-229.6%
Other		185		188		(3)	-1.6%
Total underwriting (loss) gain	$	(10,111)	$	2,092	$	(12,203)	-583.3%
Other revenue (expense items)							
Net investment income		6,306		5,873		433	7.4%
Net realized gains on investments		817		137		680	496.5%
Other income		6,785		6,744		41	0.6%
Depreciation and amortization		(1,714)		(1,788)		74	4.2%
Interest (expense)		(1,904)		(1,961)		57	2.9%
Total other revenue (expense) items		10,290		9,005		1,285	14.3%
Operating income before federal income taxes		179		11,097		(10,918)	-98.4%
Federal income tax expense on operating income		129		3,934		(3,805)	-96.7%
Net income from continuing operations of NLASCO	$	50	$	7,163	$	(7,113)	-99.3%

Revenue. Revenue for the year ended December 31, 2011 was $152.5 million, compared to $131.7 million for the year ended 2010. This increase is due to net premiums earned of $134.0 for the year ended 2011, compared to $117.2 million for the year ended 2010, $10.8 million of net investment income for the year ended 2011 compared to $7.7 million for the year ended 2010, $6.8 million of other income for the year ended 2011 compared to $6.7 million in 2010 and $0.8 million in net realized investment gains for the year ended 2011 as compared to $0.1 million for the year ended 2010.

Net premiums earned are up $16.9 million for the year ended 2011 as compared to the year ended 2010 due to higher written premiums of $16.1 million and lower reinsurance costs of $4.0 million, offset by increase in unearned premiums of $3.2 million. Net investment income increased $2.9 million for the year ended 2011 as compared to the year ended 2010 due to higher investment income at the parent (HTH) of $2.5 million and $0.4 million at NLASCO.

Underwriting Results. The following table shows the components of NLASCO s underwriting gain for the year ended December 31, 2011 and 2010. NLASCO s underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

	Year Ended December 31,			
	2011	2010	Dollar	Percentage
Direct premiums written	$ 155,054	$ 139,290	$ 15,764	11.3%
Net premiums written	$ 141,737	$ 121,691	$ 20,046	16.5%
Net premiums earned	$ 134,048	$ 117,192	$ 16,856	14.4%
Loss and LAE	96,734	70,943	25,791	36.4%
Policy acquisition and other underwriting expenses	47,425	44,157	3,268	7.4%
Underwriting (loss) gain	$ (10,111)	$ 2,092	$ (12,203)	-583.3%
Agency expenses	$ (1,789)	$ (1,966)	$ 177	9.0%
Loss and LAE ratio	72.2%	60.5%	11.7%	
Policy acquisition and other underwriting less agency expense ratio	34.0%	36.0%	-2.1%	
Combined ratio	106.2%	96.5%	9.7%	

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The loss and LAE ratio is loss and LAE expenses divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense divided by net premiums earned for the same period. Combined ratio gives you the sum of both previous ratios.

Our combined ratio for the twelve months ended December 31, 2011 is 106.2%, as compared to 96.5% for the same period in 2010. The 9.7% increase in combined ratio in 2011 is primarily due to the 11.7% increase in loss and LAE ratio for the twelve months ended December 31, 2011, as compared to 2010. Loss and LAE expenses increased 36.4% in the twelve months ended 2011, as compared to 2010, due to higher incurred losses associated with wind and hail storms in Texas and additional losses associated with a 14.4% increase in earned premiums. Texas typically experiences seasonal tornado and hail storms; however, NLASCO suffered a dramatic increase in losses from five storms in April and May 2011 that created $19.3 million in incurred losses. Additionally, there were fifteen days of widely dispersed, exceptional weather related losses experienced during the three months ended June 30, 2011, which had incurred losses of $8.1 million. NLASCO also experienced an increase in the frequency and severity of fire losses, which resulted in $7.1 million in incurred losses above prior year. Policy acquisition and other underwriting expenses increased 7.4% for the twelve months ended December 31, 2011, as compared to 2010, which is a direct result of an 11.3% increase in direct written premiums.

The Company seeks to consistently generate underwriting profitability. Management evaluates NLASCO s loss and LAE ratio by bifurcating the losses to derive catastrophic and non-catastrophic loss ratios. The non-catastrophic loss ratio excludes Property Claim Services (PCS) events that exceed $1.0 million of losses to NLASCO. Catastrophic events, including those that do not exceed our reinsurance retention, affect the Company s loss ratios. For the twelve months ended December 31, 2011, catastrophic events that did not exceed our reinsurance retention accounted for $19.3 million of the total loss and loss adjustment expense, as compared to $12.3 million for the same period in 2010. Excluding catastrophic events, our combined ratios for the twelve months ended December 31, 2011 and 2010 would have been 90.9% and 86.0%, respectively.

For the twelve months ended December 31, 2011 and 2010, the Company had incurred losses related to two 2008 catastrophes, Hurricane Ike and Hurricane Dolly. The Company also incurred losses in 2011 related to a catastrophic wind and hail storm in Arizona from October 2010. Gross losses incurred from these storms had favorable development of $7.0 million for the year ended December 31, 2011, compared to $28.9 million of development for the same period in 2010. The redundancy in 2011 is primarily due to decreases in ultimate losses for Hurricane Ike and Hurricane Dolly of $9.3 million and $1.0 million, respectively, which were offset by development on the Arizona storm of $3.3 million. The losses in the year ended December 31, 2010 relate primarily to lawsuits filed in response to the pending expiration of the statute of limitations. These losses have no effect on net loss and LAE incurred because the catastrophic events exceeded our retention and are fully recoverable. The primary financial effect is additional reinstatement premium payable to the affected reinsurers. For the year ended December 31, 2011 and 2010, the Company incurred reinstatement premiums of $0.1 million and $2.5 million, respectively.

Premiums. The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures that are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy, accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

Direct premiums written by major product line for the year ended December 31, 2011 and 2010 are presented in the table below (in thousands):

	Year Ended December 31, 2011	2010	Dollar	Percentage
Direct Premiums Written:				
Homeowners	$ 70,177	$ 63,413	$ 6,764	10.7%
Fire	49,812	45,637	4,175	9.1%
Mobile Home	26,353	22,344	4,009	17.9%
Commercial	8,380	7,537	843	11.2%
Other	332	359	(27)	-7.5%
	$ 155,054	$ 139,290	$ 15,764	11.3%

Total direct premiums written increased for the year ended December 31, 2011 for all insurance products except for other due to expanded distribution of additional insurance products and growth on existing insurance products. New homeowners and commercial insurance products generated $9.0 million in direct written premiums for the twelve months ended December 31, 2011. Our existing products grew by $6.8 million in Texas, Oklahoma, Georgia, Tennessee and Arizona in the twelve months ended December 31, 2011, as compared to the same period in 2010.

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Net premiums written by major product line for the year ended December 31, 2011 and 2010 are presented in the table below (in thousands):

	Year Ended December 31, 2011	2010	Dollar	Percentage
Net Premiums Written:				
Homeowners	$ 64,150	$ 55,401	$ 8,749	15.8%
Fire	45,534	39,871	5,663	14.2%
Mobile Home	24,090	19,521	4,569	23.4%
Commercial	7,660	6,585	1,075	16.3%
Other	303	313	(10)	-3.2%
	$ 141,737	$ 121,691	$ 20,046	16.5%

Total net premiums written increased for the year ended December 31, 2011 for all lines of business, except other, due to higher direct written premiums of $15.8 million, and a decrease in ceded premiums of $4.0 million. Ceded premiums decreased primarily as a result of lower reinstatement premiums of $2.4 million and lower reinsurance costs of $1.9 million in 2011 as compared to 2010. Reinsurance costs decreased in the year ended December 31, 2011, due to the Company increasing retention by $2.0 million.

Net premiums earned by major product line for the year ended December 31, 2011 and 2010 are presented in the table below (in thousands):

	Year Ended December 31, 2011	2010	Dollar	Percentage
Net Premiums Earned:				
Homeowners	$ 60,671	$ 53,353	$ 7,318	13.7%
Fire	43,063	38,397	4,666	12.2%
Mobile Home	22,783	18,799	3,984	21.2%
Commercial	7,244	6,341	903	14.2%
Other	287	302	(15)	-5.0%
	$ 134,048	$ 117,192	$ 16,856	14.4%

Net premiums earned for the year ended December 31, 2011 increased $16.9 million as compared to 2010 due to an increase in net premiums written of $20.0 million, offset by an increase in unearned premiums of $3.2 million.

Loss and Loss Adjustment Expenses. Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. Loss and LAE for the twelve months ended December 31, 2011 was $96.7 million, as compared to $70.9 million for the same period in 2010. The $25.8 million increase is a result of wind and hail storms that occurred in 2011 in Texas, in which five storms incurred losses of $19.3 million, and fifteen days of widely dispersed, exceptional weather related losses had incurred losses of $8.1 million.

The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the year ended December 31, 2011 and 2010 was 72.2% and 60.5%, respectively.

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The Company s net loss and LAE and the gross loss and LAE ratios for the year ended December 31, 2011 and 2010 are shown in the tables below:

	Year Ended December 31, 2011	Year Ended December 31, 2010
Loss and LAE (in thousands):		
Homeowners	$ 39,329	$ 35,814
Fire	29,885	22,085
Mobile Home	20,534	10,871
Commercial	6,986	2,173
	$ 96,734	$ 70,943
Incurred Claim Count:		
Homeowners	6,838	8,010
Fire	8,413	6,273
Mobile Home	9,518	4,870
Commercial	1,162	998
	25,931	20,151
Average Loss and LAE per Claim:		
Homeowners	$ 5,752	$ 4,471
Fire	3,552	3,521
Mobile Home	2,157	2,232
Commercial	6,012	2,177
Loss and LAE Ratio:		
Homeowners	64.8%	67.1%
Fire	69.4%	57.5%
Mobile Home	90.1%	57.8%
Commercial	96.4%	34.3%

Policy Acquisition and Other Underwriting Expenses. Policy acquisition and other underwriting expenses for the year ended December 31, 2011 and 2010 were as follows (in thousands):

	Twelve Months Ended December 31,			
	2011	2010	Dollar	Percentage
Amortization of deferred policy acquisition costs	$ 34,755	$ 31,256	$ 3,499	11.2%
Other underwriting expenses	12,670	12,901	(231)	-1.8%
Total policy acquisition and other underwriting expenses	47,425	44,157	3,268	7.4%
Agency expenses	(1,789)	(1,966)	177	9.0%
Total policy acquisition and other underwriting expenses less agency expenses	$ 45,636	$ 42,191	$ 3,445	8.2%
Net premiums earned	$ 134,048	$ 117,192	$ 16,856	14.4%
Expense ratio	34.0%	36.0%	-2.0%	

Total policy acquisition and other underwriting expenses, less agency expenses, are up $3.5 million for the twelve months ended December 31, 2011, as compared to the same period in 2010, due to higher amortization of deferred policy acquisition costs (DAC). DAC increased during the year ended December 31, 2011 due to increases in direct written premiums, as compared to the year ended 2010.

General and Administrative Expense. General and administrative expense for 2011 was $8.9 million, as compared to $7.4 million for 2010, an increase of $1.5 million, or 20.3%. This increase is primarily due to increases in professional services of $1.0 million and other administrative expenses of $0.5 million. The increase in professional fees is due to an increase in acquisition activities related to due diligence activities in 2011. Other administrative expenses increased due to the premium of $0.5 million paid on the repurchase of $6.9 million of our senior exchangeable notes.

Depreciation and Amortization Expense. Depreciation and amortization expense was $1.7 million for the year ended December 31, 2011, as compared to $1.8 million in 2010.

Interest Expense. Interest expense was $9.0 million for the twelve months ended 2011 and 2010.

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Income Taxes. The Company had a $5.0 million income tax benefit for the year ended December 31, 2011, compared to $1.0 million for 2010. The benefit increased in 2011 due to pre-tax losses of $11.5 million for the year ended December 31, 2011 as compared to $1.6 million loss for the same period in 2010. Also contributing to the benefit in 2011 was the release of the allowance for uncertain tax positions on the state tax receivable at the parent of $1.0 million. We allocate income taxes in accordance with ASC 740.

Preferred Stock Dividend. On March 11, 2010 and June 10, 2010, the HTH board of directors declared quarterly cash dividends of $0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable April 30, 2010 and July 30, 2010, amounting to $2.6 million on each disbursement date. On August 6, 2010, the Company called for redemption all of the outstanding shares of its Series A Preferred Stock. The Series A Preferred Stock was redeemed on September 6, 2010, at a cash redemption price of $25.2063 per share, representing the liquidation preference of $25.00 per share, plus accrued and unpaid dividends to, and including, the date of redemption. For the twelve months ended December 31, 2011, the dividend was $0.00 per share as compared to $1.2375 per share in the twelve months ended December 31, 2010.

Net Loss Attributable to Common Stockholders. As a result of the foregoing, our net loss attributable to common stockholders was $6.5 million for 2011, as compared to $13.5 million for 2010, a decrease of $7.0 million. The majority of this difference is due to the lower underwriting profit of $12.2 million for the twelve months ended December 31, 2011, as compared to 2010.

Comparison of the Year Ended December 31, 2010 to the Year Ended December 31, 2009

Results of insurance operations. NLASCO s underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. NLASCO s underwriting performance is one of the most important factors in evaluating the overall results of operations given the fluctuations that can occur in loss and LAE due to weather related events, as well as the uncertainties involved in the process of estimating reserves for losses and LAE. The underwriting results and fluctuations in other revenue and expense items of NLASCO are discussed in greater detail below. The following table shows the underwriting gain or loss, as well as other revenue and expense items included in the financial results of NLASCO for the year ended December 31, 2010 and 2009 (in thousands).

	Year Ended December 31,			
NLASCO Summary of Insurance Operations	**2010**	**2009**	**Dollar**	**Percentage**
Underwriting gain (loss)				
Homeowners	$ (2,564)	$ (4,227)	$ 1,663	39.3%
Fire	1,844	3,556	(1,712)	-48.1%
Mobile Home	845	1,155	(310)	-26.8%
Commercial	1,779	967	812	84.0%
Other	188	209	(21)	-10.0%
Total underwriting gain(loss)	$ 2,092	$ 1,660	$ 432	-26.0%
Other revenue (expense items)				
Net investment income	5,873	6,165	(292)	-4.7%
Net realized gains (losses) on investments	137	83	54	65.1%
Other income	6,744	6,917	(173)	-2.5%
Depreciation and amortization	(1,788)	(1,981)	193	9.7%
Interest (expense)	(1,961)	(2,601)	640	24.6%
Total other revenue (expense) items	9,005	8,583	422	4.9%
	11,097	10,243	854	8.3%

Operating income (loss) before federal income taxes							
Federal income tax expense on operating income		3,934		3,578		356	-9.9%
Net income (loss) from continuing operations of NLASCO	$	7,163	$	6,665	$	498	7.5%

Revenue. Revenue for the year ended December 31, 2010 was $131.7 million, compared to $128.8 million for the year ended 2009. This increase is due to net premiums earned of $117.2 for the year ended 2010, compared to $115.2 million for the year ended 2009, $7.7 million of net investment income for the year ended 2010 compared to $6.5 million for the year ended 2009, $6.7 million of other income for the year ended 2010 compared to $6.9 million in 2009 and $0.1 million in net realized investment gains for the year ended 2010 as compared to $0.3 million for the year ended 2009.

Net premiums earned are up $2.0 million for the year ended 2010 as compared to the year ended 2009 due to higher net written premiums offset by greater change in net unearned premiums. Net investment income increased $1.2 million for the year ended 2010 as compared to the year ended 2009 due to higher yields on the cash held at the parent (HTH).

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Underwriting Results. The following table shows the components of NLASCO s underwriting gain for the year ended December 31, 2010 and 2009. NLASCO s underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

	Year Ended December 31, 2010	2009	Dollar	Percentage
Direct premiums written	$ 139,290	$ 131,309	$ 7,981	6.1%
Net premiums written	$ 121,691	$ 114,743	$ 6,948	6.1%
Net premiums earned	$ 117,192	$ 115,153	$ 2,039	1.8%
Loss and LAE	70,943	70,295	648	0.9%
Policy acquisition and other underwriting expenses	44,157	43,198	959	2.2%
Underwriting gain	$ 2,092	$ 1,660	$ 432	26.0%
Agency expenses	$ (1,966)	$ (2,051)	$ 85	4.1%
Loss and LAE ratio	60.5%	61.0%	-0.5%	
Policy acquisition and other underwriting less agency expense ratio	36.0%	35.7%	0.3%	
Combined ratio	96.5%	96.7%	-0.2%	

The loss and LAE ratio is loss and LAE expenses divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense divided by net premiums earned for the same period. Combined ratio gives you the sum of both previous ratios.

Our combined ratio for the twelve months ended December 31, 2010 is 96.5%, as compared to 96.8% for the same period in 2009. The decrease in loss and LAE ratio in 2010 is due to lower average loss per claim, offset in part by the emergence of prior year claims in 2010. The higher loss and LAE ratio in 2009 is primarily due to the incurred losses related to non-catastophic claims, specifically the wind and hail losses, which tended to be more significant than current experience.

The Company seeks to consistently generate underwriting profitability. Management evaluates NLASCO s loss and LAE ratio by bifurcating the losses to derive catastrophic and non-catastrophic loss ratios. The non-catastrophic loss ratio excludes Property Claim Services (PCS) events that exceed $250,000 of losses to NLASCO. Catastrophic events, including those that do not exceed our reinsurance retention, affect the Company s loss ratios. For the twelve months ended December 31, 2010, catastrophic events that did not exceed our reinsurance retention accounted for $12.3 million of the total loss and loss adjustment expense, as compared to $9.8 million for the same period in 2009. Excluding catastrophic events, our combined ratios for the twelve months ended December 31, 2010 and 2009 would have been 86.0% and 88.2%, respectively.

For the twelve months ended December 30, 2010 and 2009, the Company had incurred losses related to two 2008 catastrophes, Hurricane Ike and Hurricane Dolly. Gross losses incurred from these storms were $26.0 million for the year ended December 31, 2010, compared to $24.3 million for the same period in 2009. The losses in the year ended December 31, 2010 relate primarily to lawsuits filed in response to the pending expiration of the statute of limitations. These losses have no effect on net loss and LAE incurred because the catastrophic events exceeded our retention and are fully recoverable. The primary financial effect is additional reinstatement premium payable to the affected reinsurers. For the year ended December 31, 2010 and 2009, the Company incurred reinstatement premiums of $2.5 million and $1.0 million, respectively.

Premiums. The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures that are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy, accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

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Direct premiums written by major product line for the year ended December 31, 2010 and 2009 are presented in the table below (in thousands):

	Year Ended December 31, 2010	2009	Dollar	Percentage
Direct Premiums Written:				
Homeowners	$ 63,413	$ 57,356	$ 6,057	10.6%
Fire	45,637	46,815	(1,178)	-2.5%
Mobile Home	22,344	20,439	1,905	9.3%
Commercial	7,537	6,318	1,219	19.3%
Other	359	381	(22)	-5.8%
	$ 139,290	$ 131,309	$ 7,981	6.1%

Total direct premiums written increased for the year ended December 31, 2010 for all insurance products except for fire and other due to the development of additional insurance products and a new channel of distribution in Oklahoma for our products. New homeowners insurance products generated $8.3 million in direct written premiums for the twelve months ended December 31, 2010. For the same period in 2010, direct written premiums in Oklahoma increased $1.7 million. In 2010, the Company began non-renewing policies in the first tier of the Texas sea coast and no longer writes full wind coverage along the Texas sea coast due to high losses and reinsurance costs. This has caused a decrease in homeowners and fire direct premiums written of $4.4 million for the twelve months ended December 31, 2010. Mobile home products increased $1.9 million due to increased production in Oklahoma, Georgia, Tennessee and Texas. Commercial products increased $1.2 million due to new insurance product for owners of rental property. Most of the growth associated with this new commercial product occurred in the Texas market.

Net premiums written by major product line for the year ended December 31, 2010 and 2009 are presented in the table below (in thousands):

	Year Ended December 31, 2010	2009	Dollar	Percentage
Net Premiums Written:				
Homeowners	$ 55,401	$ 50,119	$ 5,282	10.5%
Fire	39,871	40,909	(1,038)	-2.5%
Mobile Home	19,521	17,861	1,660	9.3%
Commercial	6,585	5,521	1,064	19.3%
Other	313	333	(20)	-6.0%
	$ 121,691	$ 114,743	$ 6,948	6.1%

Total net premiums written increased for the year ended December 31, 2010 for all lines of business, except fire and other, due to higher direct written premiums of $8.0 million, offset in part by an increase in ceded premiums of $1.2 million. Ceded premiums increased as a result of higher reinstatement premiums of $1.5 million in 2010 as compared to 2009.

Net premiums earned by major product line for the year ended December 31, 2009 and 2008 are presented in the table below (in thousands):

Year Ended December 31,

	2010	2009	Dollar	Percentage
Net Premiums Earned:				
Homeowners	$ 53,353	$ 50,299	$ 3,054	6.1%
Fire	38,397	41,055	(2,658)	-6.5%
Mobile Home	18,799	17,924	875	4.9%
Commercial	6,341	5,540	801	14.5%
Other	302	335	(33)	-9.9%
	$ 117,192	$ 115,153	$ 2,039	1.8%

Net premiums earned for the year ended December 31, 2010 increased as compared to 2009 due to an increase in net premiums written of $6.9 million, offset by an increase in unearned premiums of $4.9 million.

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Loss and Loss Adjustment Expenses. Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the year ended December 31, 2010 and 2009 was 60.5% and 61.0%, respectively. The decrease in loss and LAE ratio in 2010 is due to lower average loss per claim for the 2010 accident year, offset in part by the emergence of prior year claims in 2010.

The Company s net loss and LAE and the gross loss and LAE ratios for the year ended December 31, 2010 and 2009 are shown in the tables below (in thousands, except claim count figures):

	Year Ended December 31, 2010	Year Ended December 31, 2009
Loss and LAE (in thousands):		
Homeowners	$ 35,814	$ 35,657
Fire	22,085	22,098
Mobile Home	10,871	10,045
Commercial	2,173	2,495
	$ 70,943	$ 70,295
Incurred Claim Count:		
Homeowners	8,010	10,417
Fire	6,273	7,775
Mobile Home	4,870	4,083
Commercial	998	387
	20,151	22,662
Average Loss and LAE per Claim:		
Homeowners	$ 4,471	$ 3,423
Fire	3,521	2,842
Mobile Home	2,232	2,460
Commercial	2,177	6,447
Loss and LAE Ratio:		
Homeowners	67.1%	70.9%
Fire	57.5%	53.8%
Mobile Home	57.8%	56.0%
Commercial	34.3%	45.0%

Policy Acquisition and Other Underwriting Expenses. Policy acquisition and other underwriting expenses for the year ended December 31, 2010 and 2009 were as follows (in thousands):

	Twelve Months Ended December 31, 2010	2009	Dollar	Percentage
Amortization of deferred policy acquisition costs	$ 31,256	$ 30,354	$ 902	3.0%
Other underwriting expenses	12,901	12,844	57	0.4%
Total policy acquisition and other underwriting expenses	44,157	43,198	959	2.2%
Agency expenses	(1,966)	(2,051)	85	4.1%
	$ 42,191	$ 41,147	$ 1,044	2.5%

Total policy acquisition and other underwriting expenses less agency expenses							
Net premiums earned	$	117,192	$	115,153	$	2,039	1.8%
Expense ratio		36.0%		35.7%		0.3%	

Total policy acquisition and other underwriting expenses, less agency expenses, are up $1.0 million for the twelve months ended December 31, 2010, as compared to the same period in 2009, due to higher amortization of deferred policy acquisition costs (DAC). DAC increased during the year ended December 31, 2010 due to increases in direct written premiums, as compared to the year ended 2009.

General and Administrative Expense. General and administrative expense for 2010 was $7.4 million, as compared to $7.1 million for 2009, an increase of $0.3 million, or 3.9%. This increase is primarily due to an increase in professional fees of $0.9 million, offset by decreases in salaries and benefits and management fees. The increase in professional fees is due to an increase in acquisition costs related to due diligence costs in 2010.

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Depreciation and Amortization Expense. Depreciation and amortization expense was $1.8 million for the year ended December 31, 2010, as compared to $2.0 million in 2009.

Interest Expense. Interest expense was $9.0 million for 2010, as compared to $9.7 million for 2009, a decrease of $0.7 million, or 7.2%. The decrease in interest expense is due to a decrease in the payable to the prior owner for redundant reserves as a result of a payment in February 2010.

Income Taxes. The Company had a $1.0 million income tax benefit for the year ended December 31, 2010, compared to $1.3 million for 2009. The benefit decreased in 2010 due pre-tax losses of $1.6 million for the year ended December 31, 2010 as compared to $3.5 million loss for the same period in 2009 and the recoupment of $0.6 million of state income taxes due to resolution of open state tax audits. We allocate income taxes in accordance with ASC 740, specifically 740-10-20.

Preferred Stock Dividend. On March 11, 2010 and June 10, 2010, the HTH board of directors declared quarterly cash dividends of $0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable April 30, 2010 and July 30, 2010, amounting to $2.6 million on each disbursement date. On August 6, 2010, the Company called for redemption all of the outstanding shares of its Series A Preferred Stock. The Series A Preferred Stock was redeemed on September 6, 2010, at a cash redemption price of $25.2063 per share, representing the liquidation preference of $25.00 per share, plus accrued and unpaid dividends to, and including, the date of redemption. For the twelve months ended December 31, 2010, the dividend was $1.2375 per share as compared to $2.0625 per share in the twelve months ended December 31, 2009.

Net Loss Attributable to Common Stockholders. As a result of the foregoing, our net loss attributable to common stockholders was $13.5 million for 2010, as compared to $12.4 million for 2009, an increase of $1.1 million. The majority of this difference is due higher loss and LAE of $0.6 million, higher policy acquisition and other underwriting expenses of $1.0 million and loss on redemption of preferred stock of $5.9 million, offset by higher revenues of $2.9 million and lower preferred stock dividend of $3.3 million.

LIQUIDITY AND CAPITAL RESOURCES

HTH is a holding company whose assets primarily consist of the stock of its subsidiaries and invested assets with a combined value of $925 million at December 31, 2011. HTH s primary investment objectives, as a holding company, are to preserve capital and have available cash resources to utilize in making opportunistic acquisitions, and, if necessary or appropriate, from additional equity or debt financing sources.

As of December 31, 2011, we had $578.5 million in cash and cash equivalents, consisting of $533.4 million held by the parent company and $45.1 million held by NLASCO and its subsidiaries. At December 31, 2011, we had total investments of $224.2 million, consisting of investments in available-for-sale equities with a fair value of $19.0 million, $144.8 million in fair value of fixed maturities securities and other investments consisting of a note receivable and warrants with a combined fair value of $60.4 million. HTH held $10.1 million of the investments in available-for-sale equities and $60.4 million of other investments. NLASCO held $152.1 million in available-for-sale fixed maturity securities and $8.9 million in available-for-sale equity securities.

On July, 29, 2011, the Company extended SWS a $50 million term loan, which bears interest of 8% per annum. SWS issued us warrants to purchase 8,695,652 shares of SWS common stock, $0.10 par value per share, exercisable at a price of $5.75 per share subject to anti-dillution adjustments. HTH began purchasing SWS common stock during the quarter ended September 30, 2011 and, as of December 31, 2011, has accumulated $10.1 million of the common stock at fair value.

In November 2011, NLASCO purchased $6.9 million of the HTH senior exchangeable notes at a premium of $0.5 million. In accordance with GAAP, this purchase was eliminated in consolidation. Therefore, as of December 31, 2011, we had $131.5 million of debt, consisting of $84.0 million of senior exchangeable notes and $47.5 million of debt owed by NLASCO and its subsidiaries.

Our short-term liquidity needs as of December 31, 2011 include (a) funds to pay our insurance claims of NLASCO and subsidiaries and (b) funds to service our total debt of $131.5 million.

Our insurance operating subsidiary, NLASCO, has primary investment objectives to preserve capital and manage for a total rate of return. NLASCO s strategy is to purchase securities in sectors that represent the most attractive relative value. Bonds, cash and short-term investments constituted $197.2 million, or 95.7%, of NLASCO s $206.1 million in investments at

December 31, 2011. NLASCO had $8.9 million, or 4.3% of its investments, in equity investments as of December 31, 2011. We currently do not have any significant concentration in both direct and indirect guarantor exposure. NLASCO has no investments in subprime mortgages. NLASCO has custodial agreements with A.G. Edwards and Wells Fargo Bank and an investment management agreement with DTF Holdings, LLC.

NLASCO s liquidity requirements are met primarily by positive cash flow from operations and investment activity. Primary sources of cash from insurance operations are premiums and other considerations, net investment income and investment sales and maturities. Primary uses of cash include payments of claims, operating expenses and income taxes, funds to service $47.5 million of debt and purchases of investments. NLASCO s insurance subsidiaries have regulatory restrictions on the amount of dividends they can declare.

We believe that existing cash and investment balances, when combined with anticipated cash flows from operations and dividends from our insurance companies, will be adequate to meet our expected liquidity needs for the reasonably foreseeable future. We will continue to pursue and investigate possible strategic opportunities. In that regard, we may need to secure external financing. We cannot assure you that we will be successful in obtaining any such financing or in the implementation of our business plan. See Item 1A. Risk Factors starting on page 22.

Restrictions on Dividends and Distributions

Aside from available cash and investment income on our invested assets, as a holding company we rely on dividends and other permitted distributions from our subsidiaries. The payment of dividends from our insurance subsidiaries, NLIC and ASIC, is subject to significant regulatory restrictions and limitations under debt agreements limiting their ability to declare and pay dividends.

Under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner, dividends cannot be declared or distributed that exceed the greater of ten percent of the company s surplus, as shown by its last statement on file with the Commissioner, or one hundred percent of net income for such period. The subsidiaries paid no dividends to NLASCO in 2009, $6.0 million in March 2010 and no dividends in 2011. At December 31, 2011, the maximum dividend that may be paid to NLASCO in 2012 without regulatory approval is approximately $11.9 million.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At December 31, 2011, NLASCO s insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the National Association of Insurance Commissioners, or NAIC, has adopted risk-based capital, or RBC, requirements for insurance companies that establish minimum capital requirements relating to insurance risk, credit risk, interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At December 31, 2011, the Company s insurance subsidiaries RBC ratio exceeded the level at which regulatory action would be required.

We believe that restrictions on liquidity resulting from restrictions on the payments of dividends by our subsidiary companies will not have a material impact on our ability to carry out our normal business activities, including debt payments on our senior exchangeable notes.

CASH FLOWS

Comparison of the Year Ended December 31, 2011 to the Year Ended December 31, 2010

Cash used in operations was $3.3 million in 2011, as compared to cash provided by operation of $9.9 million in 2010. The Company used $13.2 million more cash in 2011 due to higher loss from operations of $6.0 million, lower income tax receivable of $2.3 million, lower deferred income taxes of $5.4 million, changes in operating assets and liabilities of $9.1 million and lower loss and LAE reserves of $39.1 million. These negative operating results were offset by a decrease in reinsurance recoverables of $43.7 million, an increase in unearned premiums of $3.2 million, and a decrease in payable to related party of $3.4 million.

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Loss and LAE reserves and reinsurance recoverables decreased $39.1 million and $43.7 million, respectively, primarily due to settlement of claims relating to Hurricane Ike. Unearned premiums increased $3.2 million due to an increase in direct written premiums in 2011 of $15.8 million. Changes in operating assets and liabilities decreased $9.1 million due to a decrease in accounts payable and accrued expenses of $8.1 million. This is due to the changes in the reinsurance payable of $7.4 million.

Cash used in investing activities was $60.7 million in 2011, as compared to $16.7 million in 2010. The increase in cash used by investing activities of $44.0 million was primarily due to purchases of available-for-sale securities and other investments of $11.5 million and $50.0 million, respectively, lower proceeds from sales of available-for-sale securities of $11.2 million, offset by proceeds from sales of held-to-maturity securities of $7.4 million.

Cash used in financing activities was $6.9 million in 2011, as compared with $133.8 million in 2010. The decrease in cash used in financing activities was primarily due to the redemption of preferred stock in 2010 of $125 million. The cash used in 2011 is related to the repurchase of the parent held senior exchangeable notes by NLASCO.

Comparison of the Year Ended December 31, 2010 to the Year Ended December 31, 2009

Cash provided by operations was $9.9 million in 2010, as compared to $18.9 million in 2009. Cash provided by operations decreased $9.0 million primarily due to increase in deferred acquisition costs of $1.7 million, decrease in cash received from income taxes of $20.2 million, decrease in payable to related party of $4.4 million, offset by decrease in net loss of $1.6 million, increase in deferred income taxes of $0.5 million, increase in unearned premiums of $5.0 million and changes in operating assets and liabilities of $10.2 million.

The increase in deferred acquisition costs is attributable to increases in higher written premiums in the year ended December 2010 as compared to 2009. The decrease in income taxes payable is due to receiving $1.9 million in refunds on income taxes in 2010 as compared to receiving $23.4 million in refunds in 2009. Changes in operating assets and liabilities increased $10.2 million due to increases in loss and LAE reserves of $6.3 million, increases in reinstatement premiums payable of $5.4 million, decreases in investments of $0.5 million and decreases in premium and agents balances of $1.0 million.

Cash used in investing activities was $16.7 million in 2010, as compared to cash provided by investing activities of $32.1 million in 2009. The decrease in cash provided by investing activities of $48.8 million was primarily due to proceeds from maturities and purchases of available-for-sale securities decreasing $26.1 million and a decrease in restricted cash of $18.5 million.

Cash used in financing activities was $133.8 million in 2010, as compared with $10.3 million in 2009. The increase in cash used in financing activities primarily was due to the redemption of preferred stock in 2010 of $125 million.

INFLATION

Inflation in the U.S. has been relatively low in recent years and did not have a material impact on our results of operations for the years ended December 31, 2011, 2010 and 2009. Although the impact of inflation has been relatively insignificant in recent years, it remains a factor in the U.S. economy and may increase the cost of labor and utilities.

COMMITMENTS

At December 31, 2011, we had $131.5 million of outstanding indebtedness. It consists of the following: $84 million, or 64%, of our total indebtedness is fixed rate and $47.5 million, or 36%, is variable rate. At December 31, 2011, we had the following indebtedness outstanding with the following repayment obligations (in thousands):

	Principal Commitments			Interest Commitments			Total Debt Commitments		
	Fixed	**Variable**	**Total**	**Fixed**	**Variable(1)**	**Total**	**Fixed**	**Variable**	**Total**
2012	$	$	$	$ 6,296	$ 1,865	$ 8,161	$ 6,296	$ 1,865	$ 8,161
2013				6,296	2,203	8,499	6,296	2,203	8,499
2014				6,296	2,564	8,860	6,296	2,564	8,860
2015				6,296	2,934	9,230	6,296	2,934	9,230
2016				6,296	3,143	9,439	6,296	3,143	9,439
Thereafter	83,950	47,500	131,450	50,370	59,717	110,087	134,320	107,217	241,537
Commitments	$ 83,950	$ 47,500	$ 131,450	$ 81,851	$ 72,426	$ 154,277	$ 165,801	$ 119,926	$ 285,727

(1) For variable rate debt, interest commitments were calculated as expected interest payments based on the weighted average of current interest rates.

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At December 31, 2011 the following table shows our outstanding commitments for leases (in thousands).

Lease Obligations	Less than 1 year	Payments Due by Period 1-3 years	Total
Total lease obligations	$ 519	$ 1,558	$ 2,077

NLASCO s loss reserves do not have contractual maturity dates. Based on historical payment patterns, however, the following table estimates when management expects the loss reserves to be paid. The timing of payments is subject to significant uncertainty. NLASCO maintains a portfolio of investments with varying maturities to provide adequate cash flows for the payment of claims.

	Reserves in thousands
2012	$ 24,660
2013	10,178
2014	6,232
2015	3,138
2016	359
Thereafter	268
	$ 44,835

The following table sets forth certain information with respect to our indebtedness outstanding as of December 31, 2011 and 2010 excluding indebtedness related to assets held for sale (in thousands):

	Year Ended December 31, 2011	2010
Senior exchangeable notes due 2025, 7.50% per annum	$ 83,950	$ 90,850
Insurance company line of credit due October 2011, base rate less 0.5% per annum		
NLIC note payable due May 2033, three-month LIBOR plus 4.10% (4.66% at December 31, 2011)	10,000	10,000
NLIC note payable due September 2033, three-month LIBOR plus 4.05% (4.61% at December 31, 2011)	10,000	10,000
ASIC note payable due April 2034, three-month LIBOR plus 4.05% (4.61% at December 31, 2011)	7,500	7,500
Insurance company note payable due March 2035, three-month LIBOR plus 3.40% (3.96% at December 31, 2011)	20,000	20,000
	$ 131,450	$ 138,350

RECENT ACCOUNTING PROCOUNCEMENTS

Please refer to financial statement footnotes for accounting pronouncements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our future income, cash flows and fair values relevant to financial instruments are dependent upon prevalent market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. We currently do not use derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors.

As of December 31, 2011 our total debt outstanding was $131.5 million, comprised of approximately $83.9 million of indebtedness subject to fixed interest rates. Approximately $47.5 million, or 36%, of our total consolidated debt is variable rate debt.

If LIBOR and the prime rate were to increase by one eighth of one percent (0.125%), the increase in interest expense on the variable rate debt would decrease future earnings and cash flows by approximately $59,000 annually.

Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of any change in overall economic activity that could occur in that environment. Further, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

The fair value of debt outstanding as of December 31, 2011 was approximately $130.0 million.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our financial statements required by this item are submitted as a separate section of this Annual Report on Form 10-K. *See* Financial Statements, commencing on page F-1 hereof.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A. CONTROLS AND PROCEDURES

CONCLUSION REGARDING THE EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Form 10-K. Based on such evaluation, our Chief Executive Officer and principal financial officer have concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorization of our management and directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on our assessment, management concluded that, as of December 31, 2010, our internal control over financial reporting is effective.

The effectiveness of our internal control over financial reporting as of December 31, 2011, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm as stated in their report, which appears on Page F-2 of this Annual Report on Form 10-K.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There have not been any changes in our internal controls over financial reporting during the year ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information called for by this Item is contained in our definitive Proxy Statement for our 2012 Annual Meeting of Stockholders, or in Item 5 of this Annual Report on Form 10-K for the year ended December 31, 2011, and is incorporated herein by reference.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

The information called for by this Item is contained in our definitive Proxy Statement for our 2012 Annual Meeting of Stockholders, and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

The information called for by this Item is contained in our definitive Proxy Statement for our 2012 Annual Meeting of Stockholders, and is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed herewith as part of this Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

HILLTOP HOLDINGS INC.

By: /s/ JEREMY B. FORD
Jeremy B. Ford
Chief Executive Officer
(Principal Executive Officer and duly authorized officer)

MARCH 9, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

Signature	Title	Date
/s/ JEREMY B. FORD Jeremy B. Ford	President, Chief Executive Officer and Director (Principal Executive Officer)	March 9, 2012
/s/ DARREN PARMENTER Darren Parmenter	Senior Vice President (Principal Financial and Accounting Officer)	March 9, 2012
/s/ RHODES BOBBITT Rhodes Bobbitt	Director and Audit Committee Member	March 9, 2012
/s/ W. JORIS BRINKERHOFF W. Joris Brinkerhoff	Director	March 9, 2012
/s/ CHARLES R. CUMMINGS Charles R. Cummings	Director and Chairman of Audit Committee	March 9, 2012
/s/ J. MARKHAM GREEN J. Markham Green	Director and Audit Committee Member	March 9, 2012
/s/ JESS T. HAY Jess T. Hay	Director	March 9, 2012
/s/ WILLIAM T. HILL, JR. William T. Hill, Jr.	Director	March 9, 2012
/s/ W. ROBERT NICHOLS, III W. Robert Nichols, III	Director	March 9, 2012
/s/ C. CLIFTON ROBINSON	Director	March 9, 2012

C. Clifton Robinson		
/s/ KENNETH D. RUSSELL Kenneth D. Russell	Director	March 9, 2012
/s/ CARL B. WEBB Carl B. Webb	Director	March 9, 2012

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Exhibit Number	Description of Exhibit
3.1	Articles of Amendment and Restatement of Affordable Residential Communities Inc., dated February 16, 2004, as amended or supplemented by: Articles Supplementary, dated February 16, 2004; Corporate Charter Certificate of Notice, dated June 6, 2005; Articles of Amendment, dated January 23, 2007; Articles of Amendment, dated July 31, 2007; Corporate Charter Certificate of Notice, dated September 23, 2008; and Articles Supplementary, dated December 15, 2010 (filed as Exhibit 3.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2010, and incorporated herein by reference).
3.2	Second Amended and Restated Bylaws of Hilltop Holdings Inc. (filed as Exhibit 3.2 to the Registrant s Current Report on Form 8-K filed on March 16, 2009, and incorporated herein by reference).
4.1	Form of Certificate of Common Stock of Hilltop Holdings Inc. (filed as Exhibit 4.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2007, and incorporated herein by reference).
4.2	Corporate Charter Certificate of Notice, dated June 6, 2005 (filed as Exhibit 3.2 to the Registrant s Registration Statement on Form S-3 (File No. 333-12585) and incorporated herein by reference).
4.3.1	Indenture, dated August 9, 2005, by and between Affordable Residential Communities LP and U.S. Bank National Association, as Trustee, regarding the 7½% Senior Exchangeable Notes Due 2025 of Affordable Residential Communities LP (filed as Exhibit 4.7.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
4.4.2	Form of Waiver to the Indenture, dated August 9, 2005, by and between Affordable Residential Communities LP and U.S. Bank National Association, as Trustee, with respect to the 7½% Senior Exchangeable Notes Due 2025 (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on July 17, 2007, and incorporated herein by reference).
10.1.1	First Amended and Restated Agreement of Limited Partnership of Affordable Residential Communities LP, dated February 11, 2004 (filed as Exhibit 10.1.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2007 and incorporated herein by reference).
10.1.2	Amendment to the First Amended and Restated Agreement of Limited Partnership of Affordable Residential Communities LP, dated July 3, 2007 (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on July 6, 2007, and incorporated herein by reference).
10.2.1	Affordable Residential Communities Inc. 2003 Equity Incentive Plan (filed as Exhibit 10.5 to the Registrant s Registration Statement on Form S-11 (File No. 333-109816) and incorporated herein by reference).
10.2.2	Form of Restricted Stock Grant Agreement for use under the Affordable Residential Communities Inc. 2003 Equity Incentive Plan (filed as Exhibit 10.2.2 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
10.2.3	Form of Affordable Residential Communities Inc. 2003 Equity Incentive Plan Non-Qualified Stock Option Agreement (filed as Exhibit 10.2.3 to the Registrant s Annual

	Report on Form 10-K for the year ended December 31, 2010, and incorporated herein by reference).
10.3	Affordable Residential Communities Inc. Management Incentive Plan (filed as Exhibit 10.6 to the Registrant s Registration Statement on Form S-11 (File No. 333-109816) and incorporated herein by reference).
10.4	Registration Rights Agreement, dated August 9, 2005, among Affordable Residential Communities LP, Affordable Residential Communities Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated (filed as Exhibit 10.5 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
10.5	Common Stock Delivery Agreement, dated August 9, 2005, by and between Affordable Residential Communities LP and Affordable Residential Communities Inc. (filed as Exhibit 10.6 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
10.6	Registration Rights Agreement, dated January 31, 2007, by and between Affordable Residential Communities Inc. and C. Clifton Robinson. (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
10.7	Stock Purchase Agreement, dated October 6, 2006, by and between Affordable Residential Communities Inc. and Flexpoint Fund, L.P. (filed as Exhibit 4.1 to the Registrant s Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
10.8	Registration Rights Agreement, dated January 31, 2007, by and between Affordable Residential Communities Inc. and Flexpoint Fund, L.P. (filed as Exhibit 10.2 to the Registrant s Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
10.9.1	Management Services Agreement, dated April 28, 2008, but effective as of January 1, 2008, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.17 to the Registrant s Current Report on Form 8-K filed on April 30, 2008 and incorporated herein by reference).
10.9.2	First Amendment to Management Services Agreement, dated as of March 15, 2010, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.14.2 to the Registrant s Current Report on Form 8-K filed on March 17, 2010, and incorporated herein by reference).
10.9.3	Second Amendment to Management Services Agreement, dated as of April 30, 2010, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.14.3 to the Registrant s Current Report on Form 8-K filed on May 5, 2010, and incorporated herein by reference).
10.10	Employment Agreement, dated January 31, 2007, by and between NLASCO, Inc. and Greg Vanek (filed as Exhibit 10.15 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
10.11	Retirement and Release Agreement, dated December 1, 2009, by and between Hilltop Holdings Inc. and Larry D. Willard (filed as Exhibit 10.16 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).

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10.12	Compensation arrangement with Jeremy B. Ford (filed as Exhibit 10.17 to the Registrant s Current Report on Form 8-K/A (Amendment No. 1) filed on May 5, 2010, and incorporated herein by reference).
10.13.1	Funding Agreement, dated as of March 20, 2011, between SWS Group, Inc. Hilltop Holdings Inc., Oak Hill Capital Partners III, L.P. and Oak Hill Capital Management Partners III, L.P. (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on March 21, 2011, and incorporated herein by reference).
10.13.2	Credit Agreement, dated as of July 29, 2011, among SWS Group, Inc., Hilltop Holdings Inc., Oak Hill Capital Partners III, L.P. and Oak Hill Capital Management Partners III, L.P. (filed as Exhibit 10.1 to the Current Report on Form 8-K filed by SWS Group, Inc. on August 1, 2011 and incorporated herein by reference).
10.13.3	Investor Rights Agreement, dated as of July 29, 2011, among SWS Group, Inc., Hilltop Holdings Inc., Oak Hill Capital Partners III, L.P. and Oak Hill Capital Management Partners III, L.P. (filed as Exhibit 4.4 to the Current Report on Form 8-K filed by SWS Group, Inc. on August 1, 2011 and incorporated herein by reference).
10.13.4	Warrant to purchase up to 8,695,652 shares of SWS Group, Inc. common stock issued to Hilltop Holdings Inc. on July 29, 2011 (filed as Exhibit 4.1 to the Current Report on Form 8-K filed by SWS Group, Inc. on August 1, 2011 and incorporated herein by reference).
14.1	Hilltop Holdings, Inc. Code of Business Conduct and Ethics (filed as Exhibit 14.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2008, and incorporated herein by reference).
21.1*	List of subsidiaries of the Registrant.
23.1*	Consent of PricewaterhouseCoopers LLP.
31.1*	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
31.2*	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
32.1*	Certification of Chief Executive Officer of Affordable Residential Communities Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Accounting Officer of Hilltop Holdings Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

Exhibit is a management contract or compensatory plan.

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INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

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Report of Independent Registered Public Accounting Firm

To The Board of Directors and Stockholders of Hilltop Holdings Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Hilltop Holdings Inc. and its subsidiaries (the Company) at December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrf solid;"*>

$ 1,220

$ —

Distribution of assets of The Village at Riverside and other non-core assets to Predecessor owners

$ —

$ —

$ (13,845)

$ —

Distribution of liabilities of The Village at Riverside and other non-core assets to Predecessor owners

$ —

$ —

$ 11,840

$ —

Supplemental disclosure of cash flow information

Interest paid

$

	27,034
$	18,030
$	7,657
$	9,960
Income taxes paid	
$	9
$	6
$	67
$	—

See accompanying notes to consolidated and combined financial statements.

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

1. Organization and Description of Business

American Campus Communities, Inc. (the “Company”) is a real estate investment trust (“REIT”) that was incorporated on March 9, 2004 and commenced operations effective with the completion of an initial public offering (“IPO”) on August 17, 2004. Through the Company’s controlling interest in American Campus Communities Operating Partnership LP (the “Operating Partnership”) and American Campus Communities Services, Inc., (the Company’s taxable REIT subsidiary or “TRS”), the Company is one of the largest owners, managers and developers of high quality student housing properties in the United States in terms of beds owned and under management. The Company is a fully integrated, self-managed and self-administered equity REIT with expertise in the acquisition, design, financing, development, construction management, leasing and management of student housing properties.

Concurrent with the consummation of various formation transactions, the IPO consisted of the sale of 12,615,000 shares of the Company’s common stock at a price per share of $17.50, including the exercise of the underwriters’ over-allotment option. Gross proceeds to the Company were approximately $220.8 million (approximately $197.8 million net of the underwriters’ discount and offering costs). As part of the various formation transactions, the Company redeemed the ownership interests of its Predecessor owners, acquired a minority ownership interest in four owned off-campus properties, repaid certain construction and permanent indebtedness, distributed an owned off-campus property and other non-core assets to its Predecessor owners, and entered into a revolving credit facility.

On July 5, 2005, the Company completed an equity offering, consisting of the sale of 4,575,000 shares of the Company’s common stock at a price per share of $22.50, including the exercise of the underwriters’ over-allotment option. The offering generated gross proceeds of approximately $102.9 million (approximately $96.6 million net of the underwriters’ discount and offering costs).

On September 15, 2006, the Company completed an equity offering, consisting of the sale of 5,692,500 shares of the Company’s common stock at a price per share of $24.60, including the exercise of 742,500 shares issued as a result of the exercise of the underwriters’ overallotment option in full at closing. The offering generated gross proceeds of approximately $140.0 million. The aggregate proceeds to the Company, net of the underwriter’s discount and offering costs, were approximately $133.2 million.

As of December 31, 2006, the Company’s property portfolio contained 38 student housing properties with approximately 23,700 beds and approximately 7,700 apartment units, consisting of 34 owned properties that are in close proximity to colleges and universities and four on-campus participating properties operated under ground/facility leases with the related university systems. These communities contain modern housing units, offer resort-style amenities and are supported by a resident assistant system and other student-oriented programming.

Through the TRS, the Company also provides construction management and development services for student housing properties owned by colleges and universities, charitable foundations, and others. As of December 31, 2006, the Company provided third-party management and leasing services for 15 student housing properties (nine of which the Company served as the third-party developer and construction manager) that represented approximately 9,300 beds in approximately 3,200 units. Third-party management and leasing services are typically provided pursuant to multi-year management contracts that have initial terms that range from one to five years. As of December 31, 2006, the Company’s total owned and managed portfolio included 53 properties with approximately 33,000 beds in approximately 10,900 units.

2. Summary of Significant Accounting Policies

Principles of Consolidation and Combination

The accompanying consolidated financial statements include all of the accounts of the Company, the Operating Partnership and the subsidiaries of the Operating Partnership. Ownership interests contributed to the Operating Partnership by the Predecessor entities have been accounted for as a reorganization of entities under common control in a manner similar to a pooling-of-interests. Accordingly, the contributed assets and assumed liabilities were recorded at the Predecessor’s historical cost basis. This method of accounting also requires the reporting of results of operations for the period in which the reorganization occurred as though the entities had been combined at either the beginning of the period or inception. The reorganization did not require any material adjustments to conform to the accounting policies of the separate entities.

**AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND
AMERICAN CAMPUS PREDECESSOR
NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS**

The historical financial data prior to August 17, 2004 presented in this report is the historical data for the Predecessor and reflects the combined historical results of operations and financial position of the Predecessor including the operations of The Village at Riverside and certain other non-core assets which were distributed to the Predecessor owners as a part of the formation transactions. As a result, the historical results of operations and financial position prior to the IPO are not indicative of, or in some instances directly comparable to, the Company's results of operations and financial position after the IPO.

The Company consolidates entities in which it has an ownership interest and over which it exercises significant control over major operating decisions, such as budgeting, investment and financing decisions. The real estate entities included in the consolidated and combined financial statements have been consolidated or combined only for the periods that such entities were under control by the Company or the Predecessor. All significant intercompany balances and transactions have been eliminated in consolidation or combination. All dollar amounts in the tables herein, except share and per share amounts, are stated in thousands unless otherwise indicated.

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51, Consolidated Financial Statements" (FIN 46"), which was revised in December 2003. This interpretation requires certain variable interest entities ("VIEs") to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. This interpretation was effective for periods ending after March 15, 2004. As none of the Company's joint ventures meet the definition of a VIE as defined in FIN 46, the issuance of this interpretation had no effect on the Company's consolidated financial statements.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company does not expect its adoption to have a material impact on the Company's consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not expect its adoption to have a material impact on the Company's consolidated financial statements.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investments in Real Estate

Investments in real estate are recorded at historical cost. Major improvements that extend the life of an asset are capitalized and depreciated over the remaining useful life of the asset. The cost of ordinary repairs and maintenance are charged to expense when incurred. Depreciation and amortization are recorded on a straight-line basis over the estimated useful lives of the assets as follows:

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Buildings and improvements	7-40 years
Leasehold interest - on-campus participating properties	25-34 years (shorter of useful life or respective lease term)
Furniture, fixtures and equipment	3-7 years

The cost of buildings and improvements includes the purchase price of the property, including legal fees and acquisition costs. Project costs directly associated with the development and construction of an owned real estate project, which include interest, property taxes, and amortization of deferred finance costs, are capitalized as construction in progress. Upon completion of the project, costs are transferred into the applicable asset category and depreciation commences. Interest totaling approximately $3.2 million, $1.7 million and $1.8 million was capitalized during the years ended December 31, 2006, 2005, and 2004, respectively. Amortization of deferred financing costs totaling approximately $0.2 million, $0.1 million, and $0.2 million was capitalized during the years ended December 31, 2006, 2005, and 2004, respectively.

Management assesses whether there has been an impairment in the value of the Company's investments in real estate whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is recognized when estimated expected future cash flows (undiscounted and before interest charges) are less than the carrying value of the property. The estimation of expected future net cash flows is inherently uncertain and relies on assumptions regarding current and future economics and market conditions. If such conditions change, then an adjustment to the carrying value of the Company's long-lived assets could occur in the future period in which the conditions change. To the extent that a property is impaired, the excess of the carrying amount of the property over its estimated fair value is charged to earnings. The Company believes that there were no impairments of the carrying values of its investments in real estate as of December 31, 2006.

The Company allocates the purchase price of acquired properties to net tangible and identified intangible assets based on relative fair values in accordance with Statement of Financial Accounting Standard ("SFAS") No. 141, *Business Combinations*. Fair value estimates are based on information obtained from a number of sources, including independent appraisals that may be obtained in connection with the acquisition or financing of the respective property and other market data. Information obtained about each property as a result of due diligence, marketing and leasing activities is also considered. The value of in-place leases is based on the difference between (i) the property valued with existing in-place leases adjusted to market rental rates and (ii) the property valued "as-if" vacant. As lease terms are typically one year or less, rates on in-place leases generally approximate market rental rates. Factors considered in the valuation of in-place leases include an estimate of the carrying costs during the expected lease-up period considering current market conditions, nature of the tenancy, and costs to execute similar leases. Carrying costs include estimates of lost rentals at market rates during the expected lease-up period, as well as marketing and other operating expenses. The value of in-place leases is amortized over the remaining initial term of the respective leases, generally less than one year. The purchase price of property acquisitions is not expected to be allocated to tenant relationships, considering the terms of the leases and the expected levels of renewals.

Long-Lived Assets-Held for Sale

Long-lived assets to be disposed of are classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset

b. The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated

d. The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year

e. The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value

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f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Concurrent with this classification, the asset is recorded at the lower of cost or fair value, and depreciation ceases.

On-Campus Participating Properties

The Company enters into ground and facility leases ("Leases") with university systems and colleges ("Lessor") to finance, construct, and manage student housing facilities. Under the terms of the leases, the Lessor has title to the land and any improvements placed thereon. The Lease terminates upon final repayment of the construction related financing, the amortization period of which is contractually stipulated. Pursuant to EITF No. 97-10: *The Effect of Lessee Involvement in Asset Construction*, the Company's involvement in construction requires the Lessor's post construction ownership of the improvements to be treated as a sale with a subsequent leaseback by the Company. The sale-leaseback transaction has been accounted for as a financing, and as a result, any fee earned during construction is deferred and recognized over the term of the lease. The resulting financing obligation is reflected at the terms of the underlying financing, i.e., interest is accrued at the contractual rates and principal reduces in accordance with the contractual principal repayment schedules.

The Company reflects these assets subject to ground/facility leases at historical cost, less amortization. Costs are amortized, and deferred fee revenue in excess of the cost of providing the service are recognized, over the lease term.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company maintains cash balances in various banks. At times the Company's balances may exceed the $0.1 million amount insured by the FDIC. As the Company only uses money-centered financial institutions, the Company does not believe it is exposed to any significant credit risk related to its cash and cash equivalents.

Restricted Cash

Restricted cash consists of funds held in trust and invested in low risk investments, generally consisting of government backed securities, as permitted by the indentures of trusts, which were established in connection with three bond issues. Additionally, restricted cash includes escrow accounts held by lenders and resident security deposits, as required by law in certain states. Certain funds held by a trustee in a required escrow account are being invested under a forward delivery agreement in government backed securities that have a remaining maturity when purchased of six months. Restricted cash also consists of escrow deposits made in connection with potential property acquisitions and development opportunities. These escrow deposits are invested in an interest-bearing account at a federally-insured bank. Realized and unrealized gains and losses are not material for the periods presented.

Intangible Assets

In connection with property acquisitions completed in 2006 and 2005, as discussed in Note 5, the Company capitalized approximately $2.3 million and $1.1 million, respectively, related to management's estimate of the fair value of the in-place leases assumed. These intangible assets were amortized on a straight-line basis over a term of approximately six months, which represents the average remaining term of the underlying leases. These assets were fully amortized as of December 31, 2006 and 2005, respectively, and the amortization is included in depreciation expense in the accompanying consolidated and combined statements of operations for the years ended December 31, 2006 and 2005.

Deferred Financing Costs

The Company defers financing costs and amortizes the costs over the terms of the related debt using the effective interest method. Upon repayment of or in conjunction with a material change in the terms of the underlying debt agreement, any unamortized costs are charged to earnings. Accordingly, concurrent with the pay off of two mortgage loans and three construction loans in connection with the IPO, unamortized finance costs totaling approximately $0.6 million were charged to earnings for the year ended December 31, 2004.

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Amortization expense, net of amounts capitalized, approximated $1.4 million, $1.2 million, and $1.4 million for the years ended December 31, 2006, 2005, and 2004, respectively. Accumulated amortization at December 31, 2006 and 2005 approximated $4.5 million and $2.9 million, respectively. Deferred financing costs, net of amortization, are included in other assets on the accompanying consolidated balance sheets.

Debt Premiums and Discounts

Debt premiums and discounts represent fair value adjustments to account for the difference between the stated rates and market rates of debt assumed in connection with the Company's property acquisitions. The debt premiums and discounts are amortized to interest expense over the term of the related loans using the effective-interest method. As of December 31, 2006 and December 31, 2005, net unamortized debt premiums were $6.4 million and $4.4 million, respectively, and net unamortized debt discounts were $0.4 million and $-0-, respectively. Debt premiums and discounts are included in secured debt on the accompanying consolidated balance sheets.

Rental Revenues and Related Receivables

Students are required to execute lease contracts with payment schedules that vary from single to monthly payments. Receivables are recorded when billed, revenues and related lease incentives are recognized on a straight-line basis over the term of the contracts, and balances are considered past due when payment is not received on the contractual due date. Generally, the Company requires each executed contract to be accompanied by a refundable security deposit and a signed parental guaranty. Security deposits are refundable, net of any outstanding charges, upon expiration of the underlying contract.

Allowances for doubtful accounts are established when management determines that collection of receivables are doubtful. When management has determined receivables to be uncollectible, they are removed as an asset with a corresponding reduction in the allowance for doubtful accounts.

The allowance for doubtful accounts is summarized as follows:

	Balance, Beginning of Period	Charged to Expense	Write-Offs	Balance, End of Period
Year ended December 31, 2004 (1)	$ 2,057	$ 646	$ (1,851)	$ 852
Year ended December 31, 2005	$ 852	$ 808	$ (501)	$ 1,159
Year ended December 31, 2006	$ 1,159	$ 1,409	$ (410)	$ 2,158

(1) In 2004, the Company wrote off essentially all receivables that were 100% reserved.

Third-Party Development Services Revenue and Costs

Development revenues are generally recognized based on a proportionate performance method based on contract deliverables, while construction revenues are recognized using the percentage of completion method, as determined by construction costs incurred relative to total estimated construction costs. Costs associated with such projects are deferred and recognized in relation to the revenues earned on executed contracts. For projects where the Company's fee is based on a fixed price, any cost overruns incurred during construction, as compared to the original budget, will reduce the net fee generated on those projects. Incentive fees are generally recognized when the project is complete and performance has been agreed upon by all parties, or when performance has been verified by an independent third-party.

The Company also evaluates the collectibility of fee income and expense reimbursements generated through the provision of development and construction management services based upon the individual facts and circumstances, including the contractual right to receive such amounts in accordance with the terms of the various projects, and reserves any amounts that are deemed to be uncollectible.

Pre-development expenditures such as architectural fees, permits and deposits associated with the pursuit of third-party and owned development projects are expensed as incurred, until such time that management believes it is probable that the contract will be executed and/or construction will commence. Because the Company frequently incurs these pre-development expenditures before a financing commitment and/or required permits and authorizations have been obtained, the Company bears the risk of loss of these pre-development expenditures if financing cannot ultimately be arranged on acceptable terms or the Company is unable to successfully obtain the required permits and authorizations. As such, management evaluates the status of third-party and owned projects that have not yet commenced construction on a periodic basis and expenses any deferred costs related to projects whose current status indicates the commencement of construction is unlikely and/or the costs may not provide future value to the Company in the form of revenues. Such write-offs are included in third-party development and management services expenses (in the case of third-party development projects) or general and administrative expenses (in the case of owned development projects) on the accompanying consolidated and combined statements of operations. As of December 31, 2006, we have deferred approximately $3.3 million in pre-development costs related to third-party and owned development projects that have not yet commenced construction. Such costs are included in other assets on the accompanying consolidated balance sheets.

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Third-Party Management Services Revenue

Management fees are recognized when earned in accordance with each management contract. Incentive management fees are recognized when the incentive criteria are anticipated to be met.

Advertising Costs

Advertising costs are expensed during the period incurred. The Company uses no direct response advertising. Advertising expense approximated $2.0 million, $1.6 million, and $0.4 million in 2006, 2005, and 2004, respectively.

Derivative Instruments and Hedging Activities

Derivative financial instruments are reported on the balance sheet at fair value. Changes in fair value are recognized either in earnings or as other comprehensive income, depending on whether the derivative has been designated as a fair value or cash flow hedge and whether it qualifies as part of a hedging relationship, the nature of the exposure being hedged, and how effective the derivative is at offsetting movements in underlying exposure. The Company discontinues hedge accounting when: (i) it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) it is no longer probable that the forecasted transaction will occur; or (iv) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Company will carry the derivative at its fair value on the balance sheet, recognizing changes in the fair value in current-period earnings. The Company uses interest rate swaps to effectively convert a portion of its floating rate debt to fixed rate, thus reducing the impact of rising interest rates on interest payments. These instruments are designated as cash flow hedges and qualify for the short cut method under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended. The interest differential to be paid or received is accrued as interest expense. The Company's counter-parties are major financial institutions.

Common Stock Issuance Costs

In accordance with the Securities and Exchange Commission's Staff Accounting Bulletin No. 5, specific incremental costs directly attributable to the Company's equity offerings were deferred and charged against the gross proceeds of the offering. As such, underwriting commissions and other common stock issuance costs are reflected as a reduction of additional paid in capital.

Comprehensive Income (Loss)

Comprehensive income (loss) includes net income (loss) and other comprehensive income (loss), consisting of unrealized gains (losses) on derivative instruments. Comprehensive income (loss) is presented in the accompanying consolidated and combined statements of changes in stockholders' and Predecessor owners' equity, and accumulated other comprehensive income (loss) is displayed as a separate component of stockholders' equity.

Stock-Based Compensation

The Company accounts for equity based awards in accordance with SFAS No. 123 (R), *Share-Based Payment,* which the Company adopted in the first quarter of 2005. Accordingly, the Company has recognized compensation expense related to certain restricted stock awards (see Note 11) over the underlying vesting periods. The adoption of this statement did not have a material impact on the Company’s consolidated or combined financial position or results of operations and did not require any cumulative adjustments to previously reported results.

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Income Taxes

The Company has elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). To qualify as a REIT, the Company must meet a number of organizational and operational requirements, including a requirement that it currently distribute at least 90% of its adjusted taxable income to its stockholders. As a REIT, the Company will generally not be subject to corporate level federal income tax on taxable income it currently distributes to its stockholders. If the Company fails to qualify as a REIT in any taxable year, it will be subject to federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and may not be able to qualify as a REIT for the subsequent four taxable years. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local income and excise taxes on its income and property, and to federal income and excise taxes on its undistributed income.

The TRS manages the Company's non-REIT activities and is subject to federal, state and local income taxes.

Other Nonoperating Income

Other nonoperating income of $1.3 million and $0.9 million was recognized for the years ended December 31, 2005 and 2004, respectively. In December 2005, the Company recognized a gain of approximately $0.8 million related to the sale of the Company's option to acquire a 23.33% interest held by an affiliate of its Predecessor owners in Dobie Center, an off-campus student housing property. The Company received approximately $0.6 million in cash proceeds at the time of the sale of the option and the remaining hold-back portion of approximately $0.2 million in 2007. In addition, the Company also recognized a gain of approximately $0.4 million and $0.7 million in 2005 and 2004, respectively, related to insurance proceeds received for a fire that occurred at one of the Company's owned off-campus properties in 2003. A gain of approximately $0.2 million was also recognized in 2004 related to insurance proceeds received for hail damage that occurred at one of the Company's on-campus participating properties in 2003.

Financial Instruments

The Company does not hold or issue financial instruments for trading purposes. The fair value of financial instruments was estimated based on the following methods and assumptions:

Cash and Cash Equivalents, Restricted Cash, Student Contracts Receivable, Other Assets, Accounts Payable and Accrued Expenses and *Other Liabilities:* the carrying amount approximates fair value, due to the short maturity of these instruments.

Mortgage Loans: the fair value of mortgage loans is based on the present value of the cash flows at current rates through maturity. As of December 31, 2006, the Company estimated the fair value of its fixed-rate mortgage loans to be approximately $339.9 million.

Construction Loans: the fair value of the Company's construction loans approximates carrying value due to the variable interest rate feature of these instruments.

Bonds Payable: the fair value of bonds payable is based on market quotes for bonds outstanding. As of December 31, 2006, the Company estimated the fair value of its bonds payable to be approximately $65.0 million.

Derivative Instruments: these instruments are reported on the balance sheet at fair value, which is based on calculations provided by independent, third-party financial institutions and represent the discounted future cash flows expected, based on the projected future interest rate curves over the life of the instrument.

Reclassifications

Certain prior period amounts have been reclassified due to current year dispositions and discontinued operations. These reclassifications had no impact on stockholders' equity or net income (loss).

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3. Earnings per Share

Basic income per share is computed using net income and the weighted average number of shares of the Company's common stock outstanding during the period, including restricted stock units ("RSUs") issued to outside directors. RSUs are included in both basic and diluted weighted average common shares outstanding because they were fully vested on the date of grant and all conditions required in order for the recipients to earn the RSUs have been satisfied. Diluted income per share reflects weighted average common shares issuable from the assumed conversion of unvested restricted stock awards ("RSAs") granted to employees and common and preferred units of limited partnership interest in the Operating Partnership ("Common Units" and "Series A Preferred Units," respectively). See Note 9 for a discussion of Common Units and Series A Preferred Units and Note 11 for a discussion of RSUs and RSAs.

The following is a summary of the elements used in calculating basic and diluted income per share for the years ended December 31, 2006 and 2005 and for the period subsequent to the IPO (August 17, 2004 through December 31, 2004):

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period from August 17, 2004 through December 31, 2004
Basic net income per share calculation:			
Income from continuing operations	$ 1,662	$ 1,751	$ 581
Discontinued operations	20,935	7,911	1,221
Net income	$ 22,597	$ 9,662	$ 1,802
Income from continuing operations – per share	$ 0.09	$ 0.12	$ 0.05
Income from discontinued operations – per share	$ 1.11	$ 0.53	$ 0.09
Net income – per share	$ 1.20	$ 0.65	$ 0.14
Basic weighted average common shares outstanding	18,907,061	14,882,944	12,513,130
Diluted net income per share calculation:			
Income from continuing operations	$ 1,662	$ 1,751	$ 581
Series A Preferred Unit distributions	154	—	—
Income from continuing operations allocated to Common Units	(61)	30	30
Income from continuing operations, as adjusted	1,755	1,781	611
Discontinued operations	20,935	7,911	1,221
Income from discontinued operations allocated to Common Units	1,802	75	—
Income from discontinued operations, as adjusted	22,737	7,986	1,221
Net income, as adjusted	$ 24,492	$ 9,767	$ 1,832
Income from continuing operations – per share	$ 0.08	$ 0.12	$ 0.05
Income from discontinued operations – per share	$ 1.09	$ 0.53	$ 0.10
Net income – per share	$ 1.17	$ 0.65	$ 0.15

Basic weighted average common shares outstanding	18,907,061	14,882,944	12,513,130
Common Units	1,866,183	121,000	121,000
Series A Preferred Units	96,380	—	—
Restricted Stock Awards	98,322	43,258	—
Diluted weighted average common shares outstanding	20,967,946	15,047,202	12,634,130

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4. Income Taxes

Deferred income taxes result from temporary differences between the carrying amounts of assets and liabilities of the TRS for financial reporting purposes and the amounts used for income tax purposes. Significant components of the deferred tax assets and liabilities are as follows:

	December 31, 2006	December 31, 2005
Deferred tax assets:		
Fixed and intangible assets	$ 9,416	$ 10,537
Net operating loss carryforwards	1,027	584
Prepaid and deferred rent	922	1,010
Bad debt reserves	223	152
Accrued expenses and other	101	82
Stock Compensation	141	46
Total deferred tax assets	11,830	12,411
Valuation allowance for deferred tax assets	(10,662)	(11,107)
Deferred tax assets, net of valuation allowance	1,168	1,304
Deferred tax liability:		
Deferred financing costs	652	762
Net deferred tax assets	$ 516	$ 542

Significant components of the income tax (provision) benefit are as follows:

	Year Ended December 31, 2006	Year Ended December 31, 2005	Period from August 17, 2004 through December 31, 2004
Current:			
Federal	$ (1)	$ —	$ —
State	(1)	—	—
Deferred:			
Federal	6	(163)	660
State	(32)	(23)	68
Total (provision) benefit — continuing operations	$ (28)	$ (186)	$ 728

TRS earnings subject to tax consisted of an approximate $1.0 million and $1.9 million loss for the years ended December 31, 2006 and 2005, respectively, and $0.4 million of income for the period from August 17, 2004 (IPO and TRS formation date) to December 31, 2004. The reconciliation of income tax attributable to continuing operations computed at the U.S. statutory rate to income tax (provision) benefit is as follows:

Period from

	Year Ended December 31, 2006	2005	August 17, 2004 through December 31, 2004
Tax (provision) benefit at U.S. statutory rates on TRS income subject to tax	$ 228	$ 655	$ (132)
State income tax, net of federal income tax benefit	8	65	(14)
Change in the state statutory rate	(683)	—	—
Effect of permanent differences	(25)	(29)	(8)
Decrease (increase) in valuation allowance	444	(877)	217
Initial adoption of SFAS No. 109	—	—	665
Income tax (provision) benefit	$ (28)	$ (186)	$ 728

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Upon formation, the TRS became subject to federal and state income taxation and, accordingly, established deferred tax assets and liabilities. The net deferred tax asset recorded upon formation was approximately $0.7 million. The valuation allowance decreased by approximately $0.4 million during the year ended December 31, 2006 and increased by approximately $0.4 million during the year ended December 31, 2005.

At December 31, 2006, the Company had net operating loss carryforwards ("NOLs") of approximately $2.8 million for income tax purposes that begin to expire in 2025. These NOLs may be used to offset future taxable income generated by the TRS.

5. Property Acquisitions

On March 1, 2006, the Company completed the acquisition of a portfolio of 13 student housing properties (the "Royal Portfolio") pursuant to a contribution and sale agreement with contributors affiliated with Royal Properties for a contribution value of $244.3 million, which was paid as follows: (i) the issuance to certain partners of the contributors of approximately 2.1 million Common Units valued at $23.50 per unit and approximately 0.1 million Series A Preferred Units valued at $26.75 per unit (See Note 9); (ii) the assumption of $123.6 million of fixed-rate mortgage debt (see Note 10); and (iii) the remainder in cash and promissory notes. As of December 31, 2006, as anticipated, the Company has incurred an additional $4.9 million in closing costs and other external acquisition costs related to this acquisition.

The Company retained approximately $6.9 million of the contribution value, which will be utilized to satisfy indemnification obligations that may arise during a one-year survival period, with any remaining amounts to be paid to the contributors upon expiration of such one-year survival period. The retained amount is composed of Common Units, Series A Preferred Units, cash, and secured promissory notes of approximately $1.9 million, payable on February 28, 2007 together with accrued interest at 4.39% per annum.

The Royal Portfolio consists of five properties in Florida, four properties in Texas, two properties in Tennessee, and one property each in Arizona and Kentucky. The 13 properties contain approximately 1,800 units and approximately 5,700 beds.

In March 2005, the Company acquired a 396-unit, 1,044-bed off-campus student housing property (The Estates) located near the University of Florida campus in Gainesville, Florida, for a contract purchase price of $47.5 million, not including anticipated capital expenditures and initial integration expenses necessary to bring the property up to the Company's operating standards. The Company also incurred an additional $0.5 million in closing costs and other external acquisition costs related to this acquisition. In addition, as discussed in Note 10, the Company entered into a bridge loan in the amount of $37.4 million in connection with this acquisition. The bridge loan was subsequently converted into a mortgage loan with a total principal amount of $38.8 million.

In March 2005, the Company acquired a 136-unit, 418-bed off-campus student housing property (City Parc at Fry Street) located near the University of North Texas in Denton, Texas, for a contract purchase price of $19.2 million, not including anticipated capital expenditures and initial integration expenses necessary to bring the property up to the Company's operating standards. The Company also incurred an additional $0.1 million in closing costs and other external acquisition costs related to this acquisition. In addition, as discussed in Note 10, the Company assumed fixed rate mortgage debt with an outstanding principal balance of approximately $11.8 million in connection with this acquisition.

In February 2005, the Company acquired a five-property portfolio (the “Proctor Portfolio”) for a contract purchase price of approximately $53.5 million, not including anticipated capital expenditures and initial integration expenses necessary to bring the properties up to the Company’s operating standards. Four of the properties are located in Tallahassee, Florida and one property is located in Gainesville, Florida. These five communities total 53 buildings, 446 units, and 1,656 beds. The Company also incurred an additional $0.3 million in closing costs and other external acquisition costs related to this acquisition. In addition, as discussed in Note 10, the Company assumed fixed rate mortgage debt with an outstanding principal balance of approximately $35.4 million in connection with this acquisition.

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The acquired properties' results of operations have been included in the accompanying consolidated statements of operations since their respective acquisition closing dates. The following pro forma information for the years ended December 31, 2006, 2005 and 2004, present consolidated and combined information for the Company and the Predecessor as if the property acquisitions discussed above, the September 2006 and July 2005 equity offerings and IPO had occurred at the beginning of the earliest period presented. The unaudited pro forma information is provided for informational purposes only and is not indicative of results that would have occurred or which may occur in the future:

	Year Ended December 31,		
	2006	**2005**	**2004**
Total revenues	$ 124,062	$ 111,868	$ 94,145
Net income (loss)	$ 24,920	$ 12,557	$ (1,450)
Net income (loss) per share – basic	$ 1.09	$ 0.55	$ (0.06)
Net income (loss) per share – diluted	$ 1.06	$ 0.50	$ (0.06)

6. Property Disposition and Discontinued Operations

In December 2006, the Company sold The Village on University off-campus student housing property for a purchase price of $51.0 million, resulting in net proceeds of approximately $50.0 million. The resulting gain on disposition of approximately $18.6 million is included in discontinued operations in the accompanying consolidated statement of operations for the year ended December 31, 2006. Accordingly, net income for The Village on University is included in discontinued operations for all periods presented.

In November 2004, California State University - San Bernardino exercised its option to purchase from the Company the University Village at San Bernardino off-campus student housing property for an aggregate purchase price of approximately $28.3 million. This transaction was consummated in January 2005, resulting in net proceeds of approximately $28.1 million. The resulting gain on disposition of approximately $5.9 million is included in discontinued operations in the accompanying consolidated statement of operations for the year ended December 31, 2005. Accordingly, net income for University Village at San Bernardino is included in discontinued operations for the years ended December 31, 2005 and 2004.

Additionally, discontinued operations for the year ended December 31, 2004 also include The Village at Riverside and certain other non-core assets that were distributed to an affiliate of the Company's Predecessor owners in connection with the IPO and the Company's leasehold interest in Coyote Village, which was transferred to Weatherford College in April 2004, as contemplated in the structuring of the related ground lease agreement.

The related net income or loss for the afore-mentioned properties is reflected in the accompanying consolidated and combined statements of operations as discontinued operations for the periods presented in accordance with SFAS No. 144. Below is a summary of the results of operations for the properties sold or distributed through their respective sale or distribution dates:

	Year Ended December 31,		
	2006	**2005**	**2004**
Total revenues	$ 4,692	$ 4,981	$ 7,360
Total operating expenses	2,412	2,953	4,598
Operating income	2,280	2,028	2,762

Total nonoperating income (expenses)		7		—		(2,712)
Net income	**$**	**2,287**	**$**	**2,028**	**$**	**50**

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As of December 31, 2006 and 2005, assets and liabilities attributable to the properties held for sale consisted of the following:

	December 31, 2006	December 31, 2005
Cash and cash equivalents	$ —	$ 140
Other assets	$ —	$ 95
Land, buildings and improvements, and furniture, fixtures, and equipment, net of accumulated depreciation	$ —	$ 32,340
Accounts payable and accrued expenses	$ —	$ 197
Other liabilities	$ —	$ 617

7. Investments in Owned Off-Campus Properties

Owned off-campus properties consisted of the following:

	December 31, 2006	December 31, 2005
Land	$ 75,263	$ 46,510
Buildings and improvements	579,906	330,380
Furniture, fixtures and equipment	28,111	17,119
Construction in progress	56,958	18,962
	740,238	412,971
Less accumulated depreciation	(46,041)	(28,213)
Owned off-campus properties, net	**$ 694,197**	**$ 384,758**

8. On-Campus Participating Properties

The Company is a party to ground/facility lease agreements (“Leases”) with certain state university systems and colleges (each, a “Lessor”) for the purpose of developing, constructing, and operating student housing facilities on university campuses. Under the terms of the Leases, title to the constructed facilities is held by the applicable Lessor and such Lessor receives a de minimus base rent paid at inception and 50% of defined net cash flows on an annual basis through the term of the lease. The Leases terminate upon the earlier to occur of the final repayment of the related debt, the amortization period of which is contractually stipulated, or the end of the lease term.

Pursuant to the Leases, in the event the leasehold estates do not achieve Financial Break Even (defined as revenues less operating expenses, excluding management fees, less debt service), the applicable Lessor would be required to make a rental payment, also known as the Contingent Payment, sufficient to achieve Financial Break Even. The Contingent Payment provision remains in effect until such time as any financing placed on the facilities would receive an investment grade rating without the Contingent Payment provision. In the event that the Lessor is required to make a Contingent Payment, future net cash flow distributions would be first applied to repay such Contingent Payments and then to unpaid management fees prior to normal distributions. Beginning in November 1999 and December 2002, as a result of the debt financing on the facilities achieving investment grade ratings without the Contingent Payment provision, the Texas A&M University System is no longer required to make Contingent Payments under either the Prairie View A&M University Village or University College Leases. In August 2006, Texas A&M International University made a Contingent Payment to achieve Financial Break Even under the Texas A&M International

University lease. The Contingent Payment obligation continues to be in effect for the Texas A&M International University and University of Houston leases.

In the event the Company seeks to sell its leasehold interest, the Leases provide the applicable Lessor the right of first refusal of a bona fide purchase offer and an option to purchase the lessee's rights under the applicable Lease.

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In conjunction with the execution of each Lease, the Company has entered into separate five-year agreements to manage the related facilities for 5% of defined gross receipts. The five-year terms of the management agreements are not contingent upon the continuation of the Leases. Upon expiration of the initial five year terms, the agreements continue on a month-to-month basis.

On-campus participating properties are as follows:

Lessor/University	Lease Commencement	Required Debt Repayment (1)	Historical Cost - December 31, 2006	Historical Cost - December 31, 2005
Texas A&M University System / Prairie View A&M University (2)	2/1/96	9/1/23	$ 38,277	$ 38,037
Texas A&M University System / Texas A&M International	2/1/96	9/1/23	6,009	5,920
Texas A&M University System / Prairie View A&M University (3)	10/1/99	8/31/25 / 8/31/28	23,872	23,777
University of Houston System / University of Houston - (4)	9/27/00	8/31/35	34,628	34,603
			102,786	102,337
Less accumulated amortization			(26,098)	(21,967)
On-campus participating properties, net			**$ 76,688**	**$ 80,370**

(1) Represents the effective lease termination date. The Leases terminate upon the earlier to occur of the final repayment of the related debt or the end of the contractual lease term.

(2) Consists of three phases placed in service between 1996 and 1998.

(3) Consists of two phases placed in service in 2000 and 2003.

(4) Consists of two phases placed in service in 2001 and 2005.

9. Minority Interests

The Company consolidates the accounts of the Operating Partnership and its subsidiaries into its consolidated financial statements. However, the Company does not own 100% of the Operating Partnership and certain consolidated real estate joint ventures. The amounts reported as minority interests on the Company’s consolidated balance sheet reflect the portion of these consolidated entities’ equity that the Company does not own. Accordingly, the amounts reported as minority interest on the Company’s consolidated statements of operations reflect the portion of these consolidated entities’ net income or loss not allocated to the Company.

Equity interests in the Operating Partnership not owned by the Company are held in the form of Common Units and Series A Preferred Units. On March 1, 2006, approximately 2.1 million Common Units valued at $23.50 per unit and approximately 0.1 million Series A Preferred Units valued at $26.75 per unit were issued to individuals and entities affiliated with Royal Properties in connection with the acquisition of the Royal Portfolio (see Note 5). Such Common Units and Series A Preferred Units are exchangeable on or after March 1, 2007 into an equal number of shares of the

Company's common stock, or, at the Company's election, cash. A Common Unit and a share of the Company's common stock have essentially the same economic characteristics, as they effectively participate equally in the net income and distributions of the Operating Partnership. Series A Preferred Units have a cumulative preferential per annum cash distribution rate of 5.99%, payable quarterly concurrently with the payment of dividends on the Company's common stock.

Income or loss allocated to minority interests on the Company's consolidated statements of operations includes the Series A Preferred Unit distributions as well as the pro rata share of the Operating Partnership's net income or loss allocated to Common Units. The Common Unitholders' minority interest in the Operating Partnership is reported at an amount equal to their ownership percentage of the net equity of the Operating Partnership at the end of each reporting period. As of December 31, 2006, approximately 9% of the equity interests of the Operating Partnership was held by persons affiliated with Royal Properties and certain current and former members of management in the form of Common Units and Series A Preferred Units. As of December 31, 2005, approximately 0.7% of the equity interests of the Operating Partnership was held by certain current and former members of management in the form of Common Units.

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Minority interests also include the equity interests of unaffiliated joint venture partners in three joint ventures. Two of the joint ventures own and operate the Company's Callaway House and University Village at Sweet Home owned-off campus properties, which are located near the campuses of Texas A&M University and the State University of New York - Buffalo, respectively. The other joint venture was formed to develop, own, and operate the Company's University Centre owned off-campus property, which is currently under development and is located near the campuses of Rutgers University, New Jersey Institute of Technology and Essex County Community College.

Minority interests in 2004 also include a minority partner's ownership in four owned off-campus properties. As part of the IPO formation transactions, the Company redeemed the minority partner's interest.

10. Debt

A summary of the Company's outstanding consolidated indebtedness, including unamortized debt premiums, is as follows:

	December 31, 2006	December 31, 2005
Debt secured by owned off-campus properties:		
Mortgage loans payable	$ 315,044	$ 195,871
Construction loan payable	21,386	—
	336,430	195,871
Debt secured by on-campus participating properties:		
Mortgage loan payable	16,513	16,786
Construction loan payable	16,710	16,411
Bonds payable	56,675	58,215
	89,898	91,412
Unamortized debt premiums, net of discounts	5,966	4,363
Total debt	**$ 432,294**	**$ 291,646**

During the twelve months ended December 31, 2006, the following transactions occurred:

	Year Ended December 31, 2006
Balance, beginning of period	$ 291,646
Additions:	
Draws on revolving credit facility	91,900
Draws under advancing construction loans	42,146
Assumption of debt upon acquisition of properties (including debt premiums, net of discounts of approximately $2.9 million)	126,592
Deductions:	
Pay down of revolving credit facility	(91,900)
Pay off of construction loan	(20,224)
Scheduled repayments of principal	(6,527)
Amortization of debt premiums and discounts	(1,339)
	$ 432,294

Loans Assumed or Entered Into in Conjunction with Property Acquisitions

In connection with the March 1, 2006 acquisition of the Royal Portfolio (see Note 5), the Company assumed approximately $123.6 million of fixed-rate mortgage debt. At the time of assumption, the debt had a weighted average interest rate of 5.95% and an average term to maturity of 6.3 years. Upon assumption of this debt, the Company recorded debt premiums of approximately $2.9 million, net of discounts, to reflect the estimated fair value of the debt assumed. These mortgage loans are secured by the related properties.

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In connection with the March 2005 acquisition of The Estates, an owned off-campus property, the Company entered into a bridge loan in the amount of $37.4 million. The bridge loan bore interest at a fixed rate of 5.1% through the initial maturity date of September 2005. In May 2005, the Company amended the bridge loan. The amended loan is a mortgage facility with a total principal amount of $38.8 million, bearing interest at a fixed rate of 5.2% and maturing in June 2015. In connection with this amendment, the Company received approximately $1.3 million of additional proceeds, after the payment of related financing costs.

In connection with the March 2005 acquisition of City Parc at Fry Street, an owned off-campus property, the Company assumed approximately $11.8 million of fixed-rate mortgage debt. The debt bears interest at 5.96% and matures in 2014. Upon assumption of this debt, the Company recorded a debt premium of approximately $0.6 million to reflect the estimated fair value of the debt assumed.

In connection with the February 2005 acquisition of the Proctor Portfolio, the Company assumed approximately $35.4 million of fixed-rate mortgage debt. At the time of assumption, the debt had a weighted average interest rate of 7.4% and an average term to maturity of six years. Upon assumption of this debt, the Company recorded debt premiums of approximately $4.5 million to reflect the estimated fair value of the debt assumed.

Revolving Credit Facility

On August 17, 2006, the Operating Partnership amended and restated its $100 million revolving credit facility to increase the size of the facility to $115 million, which may be expanded by up to an additional $110 million upon the satisfaction of certain conditions. The maturity date was extended two years to August 17, 2009 and the Company continues to guarantee the Operating Partnership’s obligations under the facility.

Availability under the revolving credit facility is limited to an “aggregate borrowing base amount” equal to the lesser of (i) 65% of the value of certain properties, calculated as set forth in the credit facility, and (ii) the adjusted net operating income from these properties divided by a formula amount. The facility bears interest at a variable rate, at the Company’s option, based upon a base rate or one-, two-, three-, or six-month LIBOR plus, in each case, a spread based upon the Company’s total leverage. Additionally, the Company is required to pay an unused commitment fee ranging from 0.15% to 0.20% per annum, depending on the aggregate unused balance. In July 2005 and September 2006, the Company paid off the entire balance on the revolving credit facility using proceeds from its July 2005 and September 2006 equity offerings (see Note 1). As of December 31, 2006, the total availability under the facility (subject to the satisfaction of certain financial covenants) totaled approximately $113.8 million.

The terms of the facility include certain restrictions and covenants, which limit, among other items, the incurrence of additional indebtedness, liens, and the disposition of assets. The facility contains customary affirmative and negative covenants and also contains financial covenants that, among other things, require the Company to maintain certain minimum ratios of “EBITDA” (earnings before interest, taxes, depreciation and amortization) to fixed charges. The Company may not pay distributions that exceed 100% of funds from operations for any four consecutive quarters. The financial covenants also include consolidated net worth and leverage ratio tests. As of December 31, 2006, the Company was in compliance with all such covenants.

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Construction Loans and Mortgage Notes Payable

Construction loans and mortgage notes payable at December 31, 2006, excluding debt premiums and discounts, consisted of 30 loans secured by owned off-campus and on-campus participating properties consisting of:

Property	Principal Outstanding (1)	Interest Rate at December 31, 2006	Maturity Date	Amortization
Cullen Oaks – Phase I	$ 16,513	5.54% (2)	November 2008	30 years
Cullen Oaks – Phase II	16,710	7.35% (3)	November 2008	n/a
University Village at Boulder Creek	16,058	5.71%	November 2012	30 years
River Club Apartments	18,137	8.18%	August 2010	30 years
River Walk Townhomes	7,498	8.00%	September 2009	30 years
The Village at Alafaya Club	20,037	8.16%	August 2010 (4)	30 years
Northgate Lakes	11,085 (5)	7.00%	July 2009	30 years
University Club Tallahassee	13,321	7.99%	October 2010	30 years
The Grove at University Club Tallahassee	4,281	5.75%	March 2013	30 years
College Club Tallahassee	8,701	6.74%	December 2011	30 years
Royal Oaks Tallahassee	2,969 (5)	7.13%	July 2009	30 years
Royal Pavilion Tallahassee	2,481 (5)	6.92%	July 2009	30 years
Royal Village Tallahassee	3,337 (5)	6.83%	July 2009	30 years
University Club Gainesville	8,312	7.88%	November 2009	30 years
The Estates	37,963	5.20%	June 2015	30 years
Royal Village Gainesville	6,076 (5)	6.87%	July 2009	30 years
The Village at Blacksburg	20,843	7.50%	January 2011	30 years
Royal Lexington	4,761 (5)	6.86%	July 2009	30 years
The Woods at Greenland	6,138 (5)	5.69%	October 2012	30 years
Raiders Crossing	6,560 (5)	6.18%	December 2012	30 years
Villas on Apache	7,459	7.66%	June 2009	30 years
Entrada Real	9,652 (5)	5.61%	November 2012	30 years
The Outpost San Marcos	13,607 (5)	5.74%	October 2013	30 years
The Outpost San Antonio	24,069 (5)	4.99%	October 2014	30 years
City Parc at Fry Street	11,494	5.96%	September 2014	30 years
Raiders Pass - Phase I	15,621 (5)	5.91%	October 2012	30 years
Raiders Pass – Phase II	3,835 (5)	5.66%	October 2012	30 years

The Callaway House		19,227	7.10%	April 2011	30 years
Aggie Station		11,522 (5)	5.96%	October 2012	30 years
University Centre		21,386 (6)	6.85%	October 2008	n/a
Total	$	**369,653** Wtd Avg Rate	6.54%		

(1) For federal income tax purposes, the aggregate cost of the loans is equal to the carrying amount.

(2) Floating rate on this mortgage loan was swapped to a fixed rate of 5.54%. This swap terminates in November 2008, at which time the interest rate will revert back to a variable rate. The TRS has guaranteed payment of this indebtedness.

(3) In June 2006, the Company extended the maturity date of this construction loan to November 17, 2008, in which the terms of the loan were modified to require monthly payments of principal and interest beginning in July 2006. The principal payments are applied to the portion of the principal balance which bears interest at the Prime rate and the remainder of the principal balance bears interest at LIBOR plus 2.0%. The TRS has guaranteed this indebtedness, up to a limit of $4.0 million of construction loan principal plus interest and litigation fees potentially incurred by the lender. This guaranty will remain in effect until the balance on the construction loan is paid in full.

(4) Represents the Anticipated Repayment Date, as defined in the loan agreement. If the loan is not repaid on the Anticipated Repayment Date, then certain monthly payments including excess cash flow, as defined, become due through the maturity date of August 2030.

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(5) These mortgage loans were assumed or obtained in conjunction with property acquisitions in the first quarter of 2006.

(6) For each borrowing on the construction loan, the Company has the option of choosing Prime rate or one-, two-, or three-month LIBOR plus 1.50%. The loan has an initial term of 36 months and can be extended through September 2010 through the exercise of two 12-month extension periods. The loan requires payments of interest only through the original maturity date and the first extension period. The loan requires monthly principal and interest payments during the second extension period based on a 30-year amortization.

Bonds Payable

Bonds payable consist of three issues secured by student housing ground/facility leases, with interest and principal paid semi-annually and annually, respectively, through maturity. Covenants include, among other items, budgeted and actual debt service coverage ratios. The bonds are nonrecourse to the Company. Payment of regularly scheduled principal payments is guaranteed by MBIA Insurance Corporation. Bonds payable at December 31, 2006 consisted of the following:

Series	Mortgaged Facilities Subject to Leases	Original	Principal December 31, 2006	Weighted Average Rate	Maturity Through	Required Monthly Debt Service
1999	University Village-PVAMU/TAMIU	$ 39,270	$ 33,700	7.67%	September 2023	$ 302
2001	University College-PVAMU	20,995	18,935	7.37%	August 2025	158
2003	University College-PVAMU	4,325	4,040	5.84%	August 2028	28
	Total/weighted average rate	**$ 64,590**	**$ 56,675**	**7.44%**		**$ 488**

Schedule of Debt Maturities

Scheduled debt maturities (reflecting automatic extensions where applicable) for each of the five years subsequent to December 31, 2006 and thereafter, are as follows:

	Scheduled Principal	Due at Maturity	Total
2007	$ 7,466	$ —	$ 7,466
2008	7,801	52,960	60,761
2009	6,821	50,775	57,596
2010	6,241	49,040	55,281
2011	5,427	45,557	50,984
Thereafter	53,480	140,760	194,240
	$ 87,236	$ 339,092	$ 426,328

Payment of principal and interest were current at December 31, 2006. Mortgage notes and bonds payable are subject to prepayment penalties.

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11. Incentive Award Plan

The Company has adopted the 2004 Incentive Award Plan (the "Plan"). The Plan provides for the grant to selected employees and directors of the Company and the Company's affiliates of stock options, common units of limited partnership interest in the Operating Partnership (formerly profits interest units or "PIUs"), restricted stock units ("RSUs"), restricted stock awards ("RSAs"), and other stock-based incentive awards. The Company has reserved a total of 1,210,000 shares of the Company's common stock for issuance pursuant to the Plan, subject to certain adjustments for changes in the Company's capital structure, as defined in the Plan. A summary of the Company's stock-based incentive awards under the Plan, as of December 31, 2005 and 2006, respectively, and changes during the years ended December 31, 2005 and 2006 are presented below:

	Common Units	Restricted Stock Units (RSUs)	Restricted Stock Awards (RSAs)	Outperformance Bonus Plan	Total
Outstanding at December 31, 2004	121,000	7,145	—	367,682	495,827
Granted	—	7,230	55,130	—	62,360
Forfeited	—	—	(9,262)	—	(9,262)
Outstanding at December 31, 2005	121,000	14,375	45,868	367,682	548,925
Granted	—	6,180	69,966	—	76,146
Vested	—	—	(9,573)	—	(9,573)
Forfeited	—	—	(6,214)	—	(6,214)
Converted to common shares	(11,000)	—	—	—	(11,000)
Outstanding at December 31, 2006	110,000	20,555	100,047	367,682	598,284
Vested at December 31, 2006	110,000	20,555	9,573	—	140,128

Common Units

PIUs were issued to certain executive and senior officers upon consummation of the IPO. In connection with the Company's equity offering in July 2005, all 121,000 PIUs were converted to common units of limited partnership interest in the Operating Partnership, as contemplated in the OP Agreement. Each common unit is deemed equivalent to one share of the Company's common stock. Common units receive the same quarterly per unit distribution as the per share distributions on the Company's common stock. The Operating Partnership recognized approximately $2.1 million of compensation expense on the IPO date, reflecting the fair value of the PIUs issued.

Restricted Stock Units

Upon reelection to the Board of Directors at each Annual Meeting of Stockholders, each outside member of the Board of Directors is granted RSUs. No shares of stock are issued at the time of the RSU awards, and the Company is not required to set aside a fund for the payment of any such award; however, the stock is deemed to be awarded on the date of grant. Upon the Settlement Date, which is three years from the date of grant, the Company will deliver to the recipients a number of shares of common stock equal to the number of RSUs held by the recipients. In addition, recipients of RSUs are entitled to dividend equivalents equal to the cash distributions paid by the Company on one share of common stock for each RSU issued, payable currently or on the Settlement Date, as determined by the Compensation Committee of the Board of Directors. The RSUs are fully vested on the date of grant. Accordingly, the Company recognized expense of approximately $0.2 million, $0.2 million and $0.1 million for the years ended

December 31, 2006, 2005 and 2004, respectively, reflecting the fair value of the RSUs issued on the date of grant. Such expense is included in general and administrative expenses in the accompanying consolidated and combined statements of operations. The weighted-average grant-date fair value for each RSU granted during the years ended December 31, 2006, 2005, and 2004 was $24.28, $20.76, and $17.50, respectively.

Restricted Stock Awards

The Company awards RSAs to its executive officers and certain employees that vest in equal annual installments over a three to five year period. Unvested awards are forfeited upon the termination of an individual's employment with the Company. Recipients of RSAs receive dividends, as declared by the Company's Board of Directors, on unvested shares, provided that the recipients continue to be employees of the Company. In accordance with SFAS No. 123(R), the Company recognizes the value of these awards as an expense over the vesting periods, which amounted to approximately $0.6 million and $0.2 million for the years ended December 31, 2006 and 2005, respectively.

The weighted-average grant-date fair value for each RSA granted during the years ended December 31, 2006 and 2005 was $24.80 and $21.54, respectively. The weighted-average grant-date fair value for each RSA vested during the year ended December 31, 2006 was $21.54. The weighted-average grant-date fair value for each RSA forfeited during the years ended December 31, 2006 and 2005 was $24.28 and $21.54, respectively. As of December 31, 2006 and 2005, the weighted-average grant-date fair value of outstanding unvested RSAs was $23.72 and $21.54, respectively. The total fair value of RSAs vested during the year ended December 31, 2006, was approximately $0.3 million. Additionally, as of December 31, 2006, the Company had approximately $1.9 million of total unrecognized compensation cost related to these RSAs, which is expected to be recognized over a remaining weighted-average period of 3.6 years.

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Outperformance Bonus Plan

Upon consummation of the IPO, the Company granted to its executive officers and certain key employees a special award based upon the individuals' continued service and attaining certain performance measures. These awards consist of a bonus pool equal to the value on the date of vesting of 367,682 shares of common stock. No dividends or dividend equivalent payments will accrue with respect to the shares of common stock underlying this bonus pool. Vesting of the awards will occur on the third anniversary of the IPO, provided that the employees have maintained continued service and that at least one performance measure, as outlined in the Plan, has been achieved. These performance measures include (i) a total return on the Company's stock of at least 25% per annum from the IPO date through the vesting date, or (ii) a total return on the Company's stock of at least 12% per annum from the IPO date through the vesting date, and such return is at or above the 60P^{thP} percentile of the total return achieved by "peer" companies during the same period. Payments of vested awards will be made within 120 days of vesting. The Compensation Committee of the Board of Directors may, in its sole discretion, elect to pay such an award in cash or through the issuance of shares of common stock, PIUs or similar securities, valued at the date of issuance. Because the achievement of the required performance measures was not considered probable as of December 31, 2006, nothing has been reflected in the accompanying financial statements related to these awards. In the event that one of the required performance measures becomes probable, the potential charge to compensation expense could be in excess of $10.0 million. This estimate is based on the previously mentioned 25% per annum performance measure, but such valuation will be measured based on the Company's stock price on the third anniversary of the IPO.

12. Interest Rate Hedges

In connection with the December 2003 extension of a construction note payable for Cullen Oaks, an on-campus participating property, the Predecessor entered into an interest rate swap on November 19, 2003 (effective December 15, 2003 through November 15, 2008) that was designated to hedge its exposure to fluctuations on interest payments attributed to changes in interest rates associated with payments on its advancing construction note payable. Under the terms of the interest rate swap agreement, the Company pays a fixed rate of 5.54% and receives a floating rate of LIBOR plus 1.9%. The interest rate swap had an estimated fair value of approximately $0.4 million and $0.5 million at December 31, 2006 and 2005, respectively, and is reflected in other assets in the accompanying consolidated balance sheets.

Refer to Note 19 for a discussion regarding termination of the interest rate swap agreement in 2007. Ineffectiveness resulting from the Company's hedges is not material.

13. Related Party Transactions

Prior to the IPO, an affiliate of the Predecessor had an ownership interest in Dobie Center Properties, Ltd. which owns Dobie Center, a student housing facility. Pursuant to a management agreement with the Dobie Center, the Company received facility management fees representing 3% of gross receipts and 6% of qualifying capital projects, and commercial leasing fees of 4% of commercial leases. Such fees totaled approximately $0.2 million for the year ended December 31, 2004, and are reflected as third-party management services - affiliates on the accompanying consolidated and combined statements of operations. The management agreement began operating on a month-to-month basis upon expiration in May 2002. Upon consummation of the Company's IPO, the Company no longer has an ownership interest in this property; as such, the management fees earned subsequent to the IPO are reflected as third-party management services on the accompanying consolidated statements of operations.

Subsequent to the IPO, the Company paid its Predecessor owners approximately $1.7 million and $1.4 million for the years ended December 31, 2005 and 2004, respectively, related to a guarantee fee and the distribution of insurance proceeds from a fire that occurred at an off-campus student housing property.

14. Lease Commitments

The Company is a party to a sublease for corporate office space beginning August 15, 2002, and expiring December 31, 2010. The terms of the sublease provide for a period of free rent and scheduled rental rate increases and common area maintenance charges upon expiration of the free rent period.

The Company entered into a ground lease agreement on October 2, 2003 for the purpose of constructing a student housing facility near the campus of Temple University in Philadelphia, Pennsylvania. The agreement terminates June 30, 2079 and has four six year extensions available. Under the terms of the ground lease, the lessor receives annual minimum rents of $0.1 million and contingent rental payments which are based upon the operating performance of the property. The contingent rental payment was approximately $0.1 million for 2006 and 2005.

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The Company entered into a 95-year ground lease agreement on August 3, 2005 for the purpose of constructing a student housing facility near the campuses of Rutgers University and the New Jersey Institute of Technology in Newark, New Jersey. The agreement terminates May 2102 with no extensions or renewals available. Under the terms of the ground lease, the lessor receives escalating annual rents ranging from $0.1 million to $0.4 million and contingent rental payments based upon the operating performance of the property. Straight-lined rental amounts are capitalized during the construction period and will be expensed once the property commences operations.

The Company entered into a 65-year ground lease agreement on December 22, 2006 for the purpose of constructing a student housing facility on the campus of Arizona State University in Tempe, Arizona. The agreement will terminate on the 65th anniversary date of the opening date (August 2073) and has two ten year extensions available. During the first five years, under the terms of the ground lease, the lessor will receive annual minimum rents of approximately $0.7 million and variable rent payments based upon the operating performance of the property. For the remaining years of the lease, the lessor will receive variable rent payments based upon the operating performance of the property.

The Company also has various operating and capital leases for furniture, office and technology equipment, which expire through 2011. Rental expense under the operating lease agreements approximated $0.6 million, $0.6 million, and $0.5 million for the years ended December 31, 2006, 2005, and 2004, respectively.

Owned off-campus properties, net at December 31, 2006 included approximately $1.8 million related to capital leases of furniture, net of approximately $0.3 million of accumulated amortization. On-campus participating properties, net at December 31, 2006 included approximately $0.4 million related to capital leases of technology equipment, net of approximately $0.2 million of accumulated amortization. Other assets at December 31, 2006 included approximately $0.4 million related to corporate assets under capital leases, net of $0.2 million of accumulated amortization.

Future minimum commitments over the life of all leases subsequent to December 31, 2006, are as follows:

	Operating	Capital
2007	$ 644	$ 907
2008	1,354	713
2009	1,360	552
2010	1,371	329
2011	1,006	192
Thereafter	39,639	—
Total minimum lease payments	45,374	2,693
Amount representing interest	—	(345)
Balance of minimum lease payments	**$ 45,374**	**$ 2,348**

The capital lease obligations are reflected in other liabilities in the accompanying consolidated balance sheets. Amortization of assets recorded under capital leases is included in depreciation expense and was approximately $0.5 million for the years ended December 31, 2006 and 2005 and immaterial for the year ended December 31, 2004.

15. Concentration of Risks

The Company has a significant presence on a single university campus, Prairie View A&M University. These on-campus participating properties represent approximately 10.7%, 15.3%, and 21.0% of the Company's consolidated and combined revenues for 2006, 2005, and 2004, respectively. The percentage of consolidated and combined net income attributable to those facilities is minimal. The unlikely event of significantly diminished enrollment at this university could have a negative impact on the Company's ability to achieve its forecasted profitability.

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

16. Commitments and Contingencies

Commitments

Development-related guarantees: The Company commonly provides alternate housing and project cost guarantees, subject to force majeure. These guarantees are typically limited, on an aggregate basis, to the amount of the projects' related development fees or a contractually agreed-upon maximum exposure amount. Alternate housing guarantees typically expire five days after construction is complete and generally require the Company to provide substitute living quarters and transportation for students to and from the university if the project is not complete by an agreed-upon completion date. Project cost guarantees hold the Company responsible for the cost of a project in excess of an approved budget. The budget consists primarily of costs included in the general contractors' guaranteed maximum price contract ("GMP"). In most cases, the GMP obligates the general contractor, subject to force majeure and approved change orders, to provide completion date guarantees and to cover cost overruns and liquidated damages. In addition, the GMP is typically secured with payment and performance bonds. Project cost guarantees expire upon completion of certain developer obligations, which are normally satisfied within one year after completion of the project.

On one completed project, the Company has guaranteed losses up to $3.0 million in excess of the development fee if the loss is due to any failure of the Company to maintain, or cause its professionals to maintain, required insurance for a period of five years after completion of the project (August 2009).

The Company's estimated maximum exposure amount under the above guarantees is approximately $10.4 million.

At December 31, 2006, management does not anticipate any material deviations from schedule or budget related to third-party development projects currently in progress. The Company has estimated the fair value of guarantees entered into or modified after December 31, 2002, the effective date of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, to be immaterial.

In the normal course of business, the Company enters into various development-related purchase commitments with parties that provide development-related goods and services. In the event that the Company was to terminate development services prior to the completion of projects under construction, the Company could potentially be committed to satisfy outstanding purchase orders with such parties.

Contract to Acquire Development Property: At December 31, 2006, the Company was under contract to acquire a $24.8 million property in Waco, Texas. The closing of this transaction was dependent upon completion of construction and lease-up and the achievement of certain occupancy levels and rental rates, which were not met and the contract was terminated in 2007.

Debt-related guarantees: RAP Student Housing Properties, LLC's ("RAP SHP"), an entity wholly owned by the Operating Partnership, limited guaranty of certain obligations of the borrower in connection with the mortgage loan for The Village at Riverside, a property which was retained by the Predecessor owners in connection with the IPO, continues to be in effect. In December 2004, the property was foreclosed upon by the lender. Pursuant to the guaranty, RAP SHP agreed to indemnify the lender against, among other things, the borrower's fraud or misrepresentation, the borrower's failure to maintain insurance, certain environmental matters, and the borrower's criminal acts. As part of the formation transactions, the Predecessor owners have indemnified the Company and its affiliates from and against all claims, costs, expenses, losses and damages incurred by the Company under or in connection with this guaranty. Even if the Company was required to perform under the guaranty, the Predecessor owners would be obligated to reimburse the Company for the amount of such liability under the indemnity. The Company does not expect to incur material exposure under this guarantee.

Contingencies

Litigation: In the normal course of business, the Company is subject to claims, lawsuits, and legal proceedings. While it is not possible to ascertain the ultimate outcome of such matters, management believes that the aggregate amount of such liabilities, if any, in excess of amounts provided or covered by insurance, will not have a material adverse effect on the consolidated financial position or results of operations of the Company.

Letters of Intent: In the ordinary course of the Company's business, the Company enters into letters of intent indicating a willingness to negotiate for acquisitions, dispositions or joint ventures. Such letters of intent are non-binding, and neither party to the letter of intent is obligated to pursue negotiations unless and until a definitive contract is entered into by the parties. Even if definitive contracts are entered into, the letters of intent relating to the acquisition and disposition of real property and resulting contracts generally contemplate that such contracts will provide the acquirer with time to evaluate the property and conduct due diligence, during which periods the acquiror will have the ability to terminate the contracts without penalty or forfeiture of any deposit or earnest money. There can be no assurance that definitive contracts will be entered into with respect to any matter covered by letters of intent or that the Company will consummate any transaction contemplated by any definitive contract. Furthermore, due diligence periods for real property are frequently extended as needed. An acquisition or disposition of real property becomes probable at the time that the due diligence period expires and the definitive contract has not been terminated. The Company is then at risk under a real property acquisition contract, but only to the extent of any earnest money deposits associated with the contract, and is obligated to sell under a real property sales contract.

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Environmental Matters: The Company is not aware of any environmental liability with respect to the properties that would have a material adverse effect on the Company's business, assets or results of operations. However, there can be no assurance that such a material environmental liability does not exist. The existence of any such material environmental liability could have an adverse effect on the Company's results of operations and cash flows.

17. Segments

The Company defines business segments by their distinct customer base and service provided. The Company has identified four reportable segments: Owned Off-Campus Properties, On-Campus Participating Properties, Development Services, and Property Management Services. Management evaluates each segment's performance based on operating income before depreciation, amortization, minority interests and allocation of corporate overhead. Intercompany fees are reflected at the contractually stipulated amounts.

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR
NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

	Year Ended December 31,		
	2006	**2005**	**2004**
Owned Off-Campus Properties			
Rental revenues	$ 90,683	$ 55,412	$ 30,904
Interest and other income	203	19	20
Total revenues from external customers	90,886	55,431	30,924
Operating expenses before depreciation and amortization	42,341	25,181	13,630
Interest expense	18,744	12,283	9,186
Insurance gain	—	430	654
Operating income before depreciation, amortization, minority interests and allocation of corporate overhead	$ 29,801	$ 18,397	$ 8,762
Depreciation and amortization	$ 20,216	$ 11,352	$ 5,532
Capital expenditures	$ 81,597	$ 51,037	$ 61,120
Total segment assets at December 31,	$ 718,428	$ 400,971	$ 247,637
On-Campus Participating Properties			
Rental revenues	$ 19,960	$ 18,470	$ 17,418
Interest and other income	330	182	61
Total revenues from external customers	20,290	18,652	17,479
Operating expenses before depreciation, amortization, ground/facility lease, and allocation of corporate overhead	8,382	7,594	7,476
Ground/facility lease	857	873	812
Interest expense	6,447	5,717	5,469
Insurance gain	—	—	273
Operating income before depreciation, amortization, minority interests and allocation of corporate overhead	$ 4,604	$ 4,468	$ 3,995
Depreciation and amortization	$ 4,131	$ 3,662	$ 3,532
Capital expenditures	$ 483	$ 15,887	$ 1,881
Total segment assets at December 31,	$ 88,814	$ 92,522	$ 79,686
Development Services			
Development and construction management fees from external customers	$ 5,778	$ 5,854	$ 5,803
Intersegment revenues	—	2,651	234
Total revenues	5,778	8,505	6,037
Operating expenses	4,566	4,626	3,796
Operating income before depreciation, amortization, minority interests and allocation of corporate overhead	$ 1,212	$ 3,879	$ 2,241
Total segment assets at December 31,	$ 2,513	$ 3,438	$ 1,246
Property Management Services			
Property management fees from external customers	$ 2,532	$ 2,786	$ 2,105
Intersegment revenues	3,627	2,650	1,152
Total revenues	6,159	5,436	3,257
Operating expenses	2,501	2,110	1,480
Operating income before depreciation, amortization, minority interests and allocation of corporate overhead	$ 3,658	$ 3,326	$ 1,777
Total segment assets at December 31,	$ 1,639	$ 1,459	$ 1,141
Reconciliations			

Total segment revenues	$	123,113	$	88,024	$	57,697
Unallocated interest income earned on corporate cash		697		624		—
Elimination of intersegment revenues		(3,627)		(5,301)		(1,386)
Total consolidated revenues, including interest income	$	120,183	$	83,347	$	56,311
Segment operating income before depreciation, amortization, minority interests and allocation of corporate overhead	$	39,275	$	30,070	$	16,775
Depreciation and amortization		(26,229)		(16,623)		(10,103)
Net unallocated expenses relating to corporate overhead		(9,318)		(11,346)		(8,850)
Income tax (provision) benefit		(28)		(186)		728
Minority interests		(2,038)		(164)		100
Income (loss) from continuing operations	$	1,662	$	1,751	$	(1,350)
Total segment assets	$	811,394	$	498,390	$	329,710
Unallocated corporate assets and assets held for sale		72,987		52,472		37,918
Total assets	**$**	**884,381**	**$**	**550,862**	**$**	**367,628**

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

18. Quarterly Financial Information (Unaudited)

The information presented below represents the consolidated financial results of the Company for the years ended December 31, 2006 and 2005.

	2006				
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Total revenues	$ 28,089	$ 29,237	$ 31,850	$ 34,469	$ 123,645(1)
Net income (loss)	$ 3,664	$ (2,067)	$ (1,611)	$ 22,611	$ 22,597
Net income (loss) per share-basic	$ 0.21	$ (0.12)	$ (0.09)	$ 0.99	$ 1.20
Net income (loss) per share-diluted	$ 0.21	$ (0.12)	$ (0.09)	$ 0.98	$ 1.17

	2005				
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Total revenues	$ 19,570	$ 20,007	$ 21,877	$ 26,049	$ 87,503(1)
Net income (loss)	$ 8,192	$ (1,792)	$ (596)	$ 3,858	$ 9,662
Net income per share-basic	$ 0.65	$ (0.14)	$ (0.04)	$ 0.22	$ 0.65
Net income per share-diluted	$ 0.65	$ (0.14)	$ (0.03)	$ 0.22	$ 0.65

(1) Includes revenues from discontinued operations of $4.7 million and $5.0 million for the years ended December 31, 2006 and 2005, respectively.

19. Subsequent Events

Acquisitions: In January 2007, the Company acquired a 248-unit, 752-bed property (The Village on Sixth) located near the campus of Marshall University in Huntington, West Virginia, for a purchase price of $25.6 million, which excludes $1.7 million of anticipated transaction costs, initial integration expenses and capital expenditures necessary to bring this property up to the Company's operating standards. As part of the transaction, the Company assumed two fixed-rate mortgage loans, which includes one for $16.2 million with an annual interest rate of 5.5% and remaining term to maturity of 7.5 years and the second loan for $1.4 million with an annual interest rate of 6.6% and remaining term to maturity of 9.9 years.

In February 2007, the Company acquired a three property portfolio (the "Edwards Portfolio") for a purchase price of $102.0 million, which excludes $3.5 million of anticipated transaction costs, initial integration expenses and capital expenditures necessary to bring these properties up to the Company's operating standards. As part of the transaction, the Company assumed $70.7 million in fixed-rate mortgage debt with a weighted average annual interest rate of 5.7% and an average remaining term to maturity of 8.5 years. The transaction also includes the pre-sale of an additional phase containing 84 beds currently under construction for $4.6 million, subject to the satisfaction of certain conditions. The completion of the additional phase is expected in August 2007.

The Edwards Portfolio consists of one property in Lexington, Kentucky located near the campus of the University of Kentucky, one property in Toledo, Ohio located near the campus of the University of Toledo and one property in Ypsilanti, Michigan located near the campus of Eastern Michigan University. These three properties total 764 units and 1,971 beds. Subsequent to these transactions, the Company's total owned and managed portfolio is comprised of

57 properties that represent approximately 35,700 beds in approximately 11,900 units.

Distributions: On January 29, 2007, the Company declared a fourth quarter 2006 distribution per share of $0.3375 which was paid on March 1, 2007 to all common stockholders of record as of February 16, 2007. At the same time, the Operating Partnership was paid an equivalent amount per unit to holders of Common Units, as well as the quarterly cumulative preferential distribution to holders of Series A Preferred Units (see Note 9).

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Cullen Oaks Loans: In February 2007, the Company extended the maturity date of the Cullen Oaks Phase I and Phase II loans to February 2014. The extended loans bear interest at a rate of LIBOR plus 1.35% and require payments of interest only through May 2008 and monthly payments of principal and interest from May 2008 through the maturity date. In connection with these loan extensions, the Company terminated the existing interest rate swap agreement which resulted in the reclassification of a gain from accumulated other comprehensive income to earnings, amounting to $0.2 million in 2007 and $0.2 million in 2008.

In addition, the Company entered into an interest rate swap on February 12, 2007 (effective February 15, 2007 through February 15, 2014) that is designated to hedge its exposure to fluctuations on interest payments attributed to changes in interest rates associated with payments on the Cullen Oaks Phase I and Phase II loans. Under the terms of the interest rate swap agreement, the Company pays a fixed rate of 6.69% and receives a floating rate of LIBOR plus 1.35%.

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR
NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

20. Schedule of Real Estate and Accumulated Depreciation

			Initial Costs		Basis Step-Up			Total Costs					
	Units	Beds	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Costs Capitalized Subsequent to Acquisition	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Total (1)	Accumulated Depreciation (2)	Encumbrances (3)	Year Built
Owned Off-campus Properties													
Villas on Apache	111	288	$ 1,465	$ 8,071	$ —	$ —	$ 2,971	$ 1,465	$ 11,042	$ 12,507	$ 2,804	$ 7,459	1987
The Village at Blacksburg	288	1,056	3,826	22,155	—	—	2,260	3,826	24,415	28,241	4,495	20,843	1990/ 1998
River Club Apartments	266	792	3,478	19,655	—	—	964	3,478	20,619	24,097	4,470	18,137	1996
River Walk Townhomes	100	336	1,442	8,194	—	—	416	1,442	8,610	10,052	1,855	7,498	1998
The Callaway House	173	538	5,080	20,500	—	—	870	5,080	21,370	26,450	4,155	19,227	1999
The Village at Alafaya Club	228	839	3,788	21,851	—	—	980	3,788	22,831	26,619	4,233	20,037	1999
The Village at Science Drive	192	732	4,673	19,021	—	—	409	4,673	19,430	24,103	2,776	—	2000
University Village at Boulder Creek	82	309	939	14,887	96	1,506	640	1,035	17,033	18,068	2,333	16,058	2002
University Village at Fresno	105	406	900	15,070	29	483	54	929	15,607	16,536	1,256	—	2004
University Village at TU	220	749	—	38,739	—	2,380	228	—	41,347	41,347	2,969	—	2004
University Village at Sweet Home	269	828	2,473	34,626	—	—	47	2,473	34,673	37,146	1,592	—	2005
	152	608	4,065	17,368	—	—	1,672	4,065	19,040	23,105	1,607	13,321	2000

University Club Tallahassee (4)													
The Grove at University Club (4)	64	128	600	5,735	—	—	316	600	6,051	6,651	379	4,281	2002
College Club Tallahassee (5)	96	384	1,498	11,156	—	—	340	1,498	11,496	12,994	895	8,701	2001
The Greens at College Club (5)	40	160	601	4,893	—	—	142	601	5,035	5,636	348	—	2004

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR
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			Initial Costs		Basis Step-Up			Total Costs					
	Units	Beds	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Costs Capitalized Subsequent to Acquisition	Land	Buildings and Improvements and Furniture, Fixtures and Equipment	Total (1)	Accumulated Depreciation (2)	Encumbrances (3)	Y Bu
University Club Gainesville	94	376	1,416	11,848	—	—	289	1,416	12,137	13,553	781	8,312	1
The Estates	396	1,044	4,254	43,164	—	—	846	4,254	44,010	48,264	2,273	37,963	2
City Parc at Fry Street	136	418	1,902	17,678	—	—	513	1,902	18,191	20,093	1,048	11,494	2
Callaway Villas	236	704	3,903	32,287	—	—	—	3,903	32,287	36,190	421	—	2
Northgate Lakes	194	710	4,807	27,284	—	—	505	4,807	27,789	32,596	690	11,085	1
Royal Oaks (6)	82	224	1,346	8,153	—	—	67	1,346	8,220	9,566	198	2,969	1
Royal Pavilion (6)	60	204	1,212	7,304	—	—	61	1,212	7,365	8,577	180	2,481	1
Royal Village Tallahassee (6)	75	288	1,764	10,768	—	—	86	1,764	10,854	12,618	255	3,337	1
Royal Village Gainesville	118	448	2,484	15,153	—	—	379	2,484	15,532	18,016	394	6,076	1
Royal Lexington	94	364	2,848	12,783	—	—	304	2,848	13,087	15,935	331	4,761	1
The Woods at Greenland	78	276	1,050	7,286	—	—	141	1,050	7,427	8,477	185	6,138	2
Raider's Crossing	96	276	1,089	8,404	—	—	134	1,089	8,538	9,627	208	6,560	2
Entrada Real	98	363	1,475	15,859	—	—	227	1,475	16,086	17,561	378	9,652	1
The Outpost San Marcos	162	486	1,987	18,973	—	—	148	1,987	19,121	21,108	447	13,607	2
The Outpost San Antonio	276	828	3,262	36,252	—	—	185	3,262	36,437	39,699	847	24,069	2
	264	828	3,877	32,445	—	—	803	3,877	33,248	37,125	791	19,456	2

Raider's Pass													
Aggie Station	156	450	1,634	18,821	—	—	268	1,634	19,089	20,723	447	11,522	2
University Centre (7)	234	838	—	52,996	—	—	—	—	52,996	52,996	—	21,386	2
ASU – SCRC (8)	613	1,866	—	3,962	—	—	—	—	3,962	3,962	—	—	2
Subtotal	5,848	19,144	$ 75,138	$ 643,341	$ 125	$ 4,369	$ 17,265	$ 75,263	$ 664,975	$ 740,238	$ 46,041	$ 336,430	

AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND AMERICAN CAMPUS PREDECESSOR
NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

			Initial Costs		Basis Step-Up			Total Costs					
	Units	**Beds**	**Land**	**Buildings and Improvements and Furniture, Fixtures and Equipment**	**Land**	**Buildings and Improvements and Furniture, Fixtures and Equipment**	**Costs Capitalized Subsequent to Acquisition**	**Land**	**Buildings and Improvements and Furniture, Fixtures and Equipment**	**Total (1)**	**Accumulated Depreciation (2)**	**Encumbrances (3)**	**Ye**
On-Campus Participating Properties													
University Village - PVAMU	612	1,920	$ —	$ 36,506	$ —	$ —	$ 1,771	$ —	$ 38,277	$ 38,277	$ 13,847	$ 29,229	
University College - PVAMU	756	1,470	—	22,650	—	—	1,222	—	23,872	23,872	5,853	22,975	20
University Village - TAMIU	84	250	—	5,844	—	—	165	—	6,009	6,009	2,162	4,471	
Cullen Oaks Phase I and II	411	879	—	33,910	—	—	718	—	34,628	34,628	4,236	33,223	20
Subtotal	1,863	4,519	—	98,910	—	—	3,876	—	102,786	102,786	26,098	89,898	
Total-all properties	**7,711**	**23,663**	**$ 75,138**	**$ 742,251**	**$ 125**	**$ 4,369**	**$ 21,141**	**$ 75,263**	**$ 767,761**	**$ 843,024**	**$ 72,139**	**$ 426,328**	

(1) Total aggregate costs for Federal income tax purposes is $875.7 million.

(2) The depreciable lives for buildings and improvements and furniture, fixtures and equipment range from three to forty years.

(3) Total encumbrances exclude net unamortized debt premiums of $6.4 million and net unamortized debt discounts of $0.4 million as of December 31, 2006.

(4) For lease administration purposes, University Club Tallahassee and The Grove at University Club are reported combined. As a result, costs capitalized subsequent to acquisition and accumulated depreciation are allocated to the respective properties based on relative bed count.

(5) For lease administration purposes, College Club Tallahassee and The Greens at College Club are reported combined. As a result, costs capitalized subsequent to acquisition and accumulated depreciation are allocated to the respective properties based on relative bed count.

(6) For lease administration purposes, Royal Oaks, Royal Pavilion, and Royal Village Tallahassee are reported combined. As a result, costs capitalized subsequent to acquisition and accumulated depreciation are allocated to the respective properties based on relative bed count.

(7) University Centre (formerly Village at Newark) commenced construction in September 2005. Initial costs represent construction costs associated with the development of this property. Year built represents the scheduled completion date.

(8) ASU-SCRC commenced construction in December 2006. Initial costs represent construction costs associated with the development of this property. Year built represents the scheduled completion date.

**AMERICAN CAMPUS COMMUNITIES, INC. AND SUBSIDIARIES AND
AMERICAN CAMPUS PREDECESSOR
NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS**

The changes in the Company's and the Predecessor's investments in real estate and related accumulated depreciation for each of the years ended December 31, 2006, 2005, and 2004 are as follows:

	For the Year Ended December 31,					
	2006		2005		2004	
	Off-Campus(1)	On-Campus(2)	Off-Campus(1)	On-Campus(2)	Off-Campus(1)	On-Campus(2)
Investments in Real Estate:						
Balance, beginning of year	$ 451,033	$ 102,337	$ 295,313	$ 86,370	$ 240,504	$ 92,463
Basis step-up	—	—	—	—	5,589	—
Acquisition of land for development	—	—	3,903	—	2,532	—
Acquisition of properties	248,321	—	126,176	—	—	—
Improvements and development expenditures	79,099	449	48,214	15,967	61,286	1,883
Disposition of properties	(38,216)	—	(22,573)	—	—	(7,976)
Distribution of non-core assets to Predecessor owners	—	—	—	—	(14,598)	—
Balance, end of year	$ 740,237	$ 102,786	$ 451,033	$ 102,337	$ 295,313	$ 86,370
Accumulated Depreciation:						
Balance, beginning of year	$ (33,935)	$ (21,967)	$ (22,863)	$ (18,306)	$ (17,597)	$ (14,774)
Depreciation for the year	(18,462)	(4,131)	(11,241)	(3,661)	(6,520)	(3,532)
Disposition of properties	6,357	—	169	—	—	—
Distribution of non-core assets to Predecessor owners	—	—	—	—	1,254	—
Balance, end of year	$ (46,040)	$ (26,098)	$ (33,935)	$ (21,967)	$ (22,863)	$ (18,306)

(1) Owned off-campus properties

(2) On-campus participating properties