

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

May 12, 2008

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

**Form 10-Q**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarter ended March 31, 2008**
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission File Number 1-14094**

**Meadowbrook Insurance Group, Inc.**

*(Exact name of Registrant as specified in its charter)*

**Michigan**  
*(State of Incorporation)*

**38-2626206**  
*(IRS Employer  
Identification No.)*

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

**(248) 358-1100**  
*(Registrant's telephone number, including area code)*

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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. (Check one):

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

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on May 2, 2008 was 37,021,032.

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	<u>Section 906 Certification by Senior Vice President &amp; Chief Financial Officer</u>	

**Table of Contents****PART 1 FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME****For the Three Months Ended March 31,**

	<b>2008</b>	<b>2007</b>
	<b>(Unaudited)</b>	
	<b>(In thousands, except share data)</b>	
<b>Revenues</b>		
Premiums earned		
Gross	\$ 83,971	\$ 81,551
Ceded	(17,949)	(16,347)
Net earned premiums	66,022	65,204
Net commissions and fees	12,031	11,551
Net investment income	7,148	6,156
Net realized losses	(31)	(6)
Total revenues	85,170	82,905
<b>Expenses</b>		
Losses and loss adjustment expenses	48,739	50,002
Reinsurance recoveries	(11,078)	(13,356)
Net losses and loss adjustment expenses	37,661	36,646
Salaries and employee benefits	12,755	13,532
Policy acquisition and other underwriting expenses	13,147	13,643
Other administrative expenses	8,832	7,393
Amortization expense	1,551	144
Interest expense	1,311	1,488
Total expenses	75,257	72,846
Income before taxes and equity earnings	9,913	10,059
Federal and state income tax expense	2,911	3,149
Equity earnings of affiliates	56	13
Net income	\$ 7,058	\$ 6,923

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Earnings Per Share			
Basic	\$	0.19	\$ 0.23
Diluted	\$	0.19	\$ 0.23
Weighted average number of common shares			
Basic		37,012,104	29,344,293
Diluted		37,103,270	29,465,807
Dividends paid per common share	\$	0.02	\$

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

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**MEADOWBROOK INSURANCE GROUP, INC.**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**For the Three Months Ended March 31,**

	<b>2008</b>	<b>2007</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
Net income	\$ 7,058	\$ 6,923
Other comprehensive income, net of tax:		
Unrealized gains on securities	1,789	380
Net deferred derivative loss   hedging activity	(449)	(76)
Less: reclassification adjustment for losses included in net income	65	18
Other comprehensive income, net of tax	1,405	322
Comprehensive income	\$ 8,463	\$ 7,245

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

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

	<b>March 31, 2008 (Unaudited)</b>	<b>December 31, 2007</b>
	<b>(In thousands, except share data)</b>	
<b>ASSETS</b>		
Debt securities available for sale, at fair value (amortized cost of \$581,250 and \$604,829)	\$ 590,030	\$ 610,756
Cash and cash equivalents	50,012	40,845
Accrued investment income	6,776	6,473
Premiums and agent balances receivable, net	94,611	87,341
Reinsurance recoverable on:		
Paid losses, net of allowances	(239)	1,053
Unpaid losses	198,031	198,461
Prepaid reinsurance premiums	18,883	17,763
Deferred policy acquisition costs	28,420	26,926
Deferred federal income taxes	15,268	14,936
Goodwill	53,030	43,497
Other assets	76,005	65,915
<b>Total assets</b>	<b>\$ 1,130,827</b>	<b>\$ 1,113,966</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Losses and loss adjustment expenses	\$ 545,521	\$ 540,002
Unearned premiums	160,424	153,927
Debentures	55,930	55,930
Accounts payable and accrued expenses	20,761	22,604
Reinsurance funds held and balances payable	15,862	16,416
Payable to insurance companies	5,899	6,231
Other liabilities	16,515	16,962
<b>Total liabilities</b>	<b>820,912</b>	<b>812,072</b>
Common stock, \$0.01 stated value; authorized 75,000,000 shares; 37,021,032 and 36,996,287 shares issued and outstanding	370	370
Additional paid-in capital	194,913	194,621
Retained earnings	110,593	104,274
Note receivable from officer	(865)	(870)
Accumulated other comprehensive income	4,904	3,499
<b>Total shareholders equity</b>	<b>309,915</b>	<b>301,894</b>



Total liabilities and shareholders' equity	\$ 1,130,827	\$ 1,113,966
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The accompanying notes are an integral part of the Consolidated Financial Statements.

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Three Months Ended March 31,**

	<b>2008</b>	<b>2007</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 7,058	\$ 6,923
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of other intangible assets	1,551	144
Amortization of deferred debenture issuance costs	118	59
Depreciation of furniture, equipment, and building	745	738
Net accretion of discount and premiums on bonds	696	690
Loss on sale of investments	100	28
Gain on sale of fixed assets	(22)	(22)
Stock-based employee compensation		2
Incremental tax benefits from stock options exercised	(80)	(131)
Long term incentive plan expense	209	65
Deferred income tax (benefit) expense	(1,089)	443
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(7,270)	(9,541)
Reinsurance recoverable on paid and unpaid losses	1,722	(3,685)
Prepaid reinsurance premiums	(1,120)	(1,186)
Deferred policy acquisition costs	(1,494)	(1,711)
Other assets	(921)	753
Increase (decrease) in:		
Losses and loss adjustment expenses	5,519	13,756
Unearned premiums	6,497	7,953
Payable to insurance companies	(332)	(2,715)
Reinsurance funds held and balances payable	(554)	3,938
Other liabilities	(2,490)	651
Total adjustments	1,785	10,229
Net cash provided by operating activities	8,843	17,152
<b>Cash Flows From Investing Activities</b>		
Purchases of debt securities available for sale	(22,037)	(70,135)
Proceeds from sales and maturities of debt securities available for sale	44,797	50,740
Capital expenditures	(664)	(927)
Purchase of books of business	(229)	(75)
Acquisition of remaining economics of U.S. Specialty Underwriters, Inc.	(20,971)	
Other investing activities	(224)	(241)

Net cash provided by (used in) investing activities	673	(20,638)
<b>Cash Flows From Financing Activities</b>		
Proceeds from lines of credit		5,900
Payment of lines of credit		(2,500)
Book overdraft	326	423
Dividend paid on common stock	(740)	
Stock options exercised	4	85
Cash payment for payroll taxes associated with long-term incentive plan net stock issuance		(1,841)
Incremental tax benefits from stock options exercised	80	131
Other financing activities	(19)	(73)
Net cash (used in) provided by financing activities	(349)	2,125
Net increase (decrease) in cash and cash equivalents	9,167	(1,361)
Cash and cash equivalents, beginning of period	40,845	42,876
Cash and cash equivalents, end of period	\$ 50,012	\$ 41,515

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

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**MEADOWBROOK INSURANCE GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1 Summary of Significant Accounting Policies**

***Basis of Presentation and Management Representation***

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the Company), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which are collectively referred to as the Insurance Company Subsidiaries), and Preferred Insurance Company, Ltd. (PICL). The consolidated financial statements also include Meadowbrook, Inc. (Meadowbrook), Crest Financial Corporation, and their subsidiaries. As of December 31, 2007, PICL was deregulated under Bermuda law and merged into Meadowbrook's subsidiary, Meadowbrook Risk Management, Ltd. On January 31, 2008, PICL was legally dissolved.

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

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months ended March 31, 2008 are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its annual report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2007.

The Company's Note 9 *Segment Information* of the Notes to Consolidated Financial Statements for the three months ended March 31, 2007, previously reported, had a change in allocation. The agency operations of the Company's segment information include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The allocation for Insurance & Benefits Consultants, a division of the Company's insurance agency, was previously included in specialty risk management operations. The effect of this reclassification was a reduction in agency operations pre-tax income and an increase in specialty risk management operations pre-tax income for the three months ended March 31, 2007 of \$67,000. The Company's Note 9 *Segment Information* for the three months ended March 31, 2007 has been restated to reflect this reclassification.

***Revenue Recognition***

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

For the three months ending March 31, 2008, total assumed written premiums were \$1.6 million, of which \$800,000, relates to assumed business the Company manages directly. The remaining \$800,000 of assumed written premiums relates to residual markets and mandatory assumed pool business. For the three months ending March 31, 2007, total assumed written premiums were \$23.4 million, of which \$21.7 million related to assumed business the Company managed directly.

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**MEADOWBROOK INSURANCE GROUP, INC.**

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

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

In addition, certain premiums are subject to retrospective premium adjustments. Premium is recognized over the term of the insurance contract. For the three months ended March 31, 2008, the Company recorded a \$1.8 million adjustment to reduce a premium accrual associated with a discontinued retrospectively rated policy with one of its risk sharing partners.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized during the period the services are provided. Depending on the terms of the contract, claims processing fees are recognized as revenue over the estimated life of the claims, or the estimated life of the contract. For those contracts that provide services beyond the expiration or termination of the contract, fees are deferred in an amount equal to management's estimate of the Company's obligation to continue to provide services.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Any commission adjustments that occur subsequent to the earnings process are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

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

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

***Earnings Per Share***

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

Outstanding options of 68,250 and 99,937 for the periods ended March 31, 2008 and 2007, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 239 and 112,248 for the three months ended March 31, 2008 and 2007, respectively. Shares related to the Company's Long Term Incentive Plan ( LTIP ) included in diluted earnings per share

were 90,927 and 9,266 for the three months ended March 31, 2008 and 2007, respectively.

***Recent Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value and establishes a framework for measuring fair value in accordance with generally accepted accounting principles. SFAS No. 157 also requires expanded disclosures about (1) the extent to which companies measure assets and liabilities at fair value, (2) the methods and assumptions used to measure fair value and (3) the effect of

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**MEADOWBROOK INSURANCE GROUP, INC.**

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

fair value measures on earnings. SFAS No. 157 was effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS 157 in the first quarter of 2008 and appropriate disclosures are provided in Note 5.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 permits entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis as of specified election dates. This election is irrevocable as to specific assets and liabilities. The objective of SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 was effective for fiscal years beginning after November 15, 2007. The Company did not elect the fair valu