

ALLEGHANY CORP /DE
Form 10-Q
August 09, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(MARK ONE)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
FOR QUARTERLY PERIOD ENDED JUNE 30, 2006**

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER 1-9371

ALLEGHANY CORPORATION

EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER

DELAWARE

STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION

51-0283071

I.R.S. EMPLOYER IDENTIFICATION NO.

7 TIMES SQUARE TOWER, 17TH FLOOR, NY, NY 10036

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE

212-752-1356

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE

NOT APPLICABLE

FORMER NAME, FORMER ADDRESS, AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT INDICATE BY CHECK MARK WHETHER THE REGISTRANT (1) HAS FILED ALL REPORTS REQUIRED TO BE FILED BY SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 DURING THE PRECEDING 12 MONTHS (OR FOR SUCH SHORTER PERIOD THAT THE REGISTRANT WAS REQUIRED TO FILE SUCH REPORTS), AND (2) HAS BEEN SUBJECT TO SUCH FILING REQUIREMENTS FOR THE PAST 90 DAYS.

YES

NO

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS A LARGE ACCELERATED FILER, AN ACCELERATED FILER, OR A NON-ACCELERATED FILER. SEE DEFINITION OF ACCELERATED FILER AND LARGE ACCELERATED FILER IN RULE 12b-2 OF THE EXCHANGE ACT. (CHECK ONE):

LARGE ACCELERATED FILER

ACCELERATED FILER

NON-ACCELERATED FILER

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS A SHELL COMPANY (AS DEFINED IN RULE 12B-2 OF THE EXCHANGE ACT). 12b-2 OF THE EXCHANGE ACT).

YES

NO

INDICATE THE NUMBER OF SHARES OUTSTANDING OF EACH OF THE ISSUER'S CLASSES OF COMMON STOCK, AS OF THE LAST PRACTICABLE DATE.

7,952,637 SHARES AS OF JULY 31, 2006

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PART 1. FINANCIAL INFORMATION
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ALLEGHANY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS
AND COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED
JUNE 30, 2006 AND 2005

(dollars in thousands, except share and per share amounts)
(unaudited)

	2006	2005
Revenues		
Net premiums earned	\$ 246,712	\$ 218,654
Net investment income	32,328	19,482
Realized capital gains	10,883	617
Other income	23,703	3,997
 Total revenues	 313,626	 242,750
 Costs and expenses		
Loss and loss adjustment expenses	123,161	114,305
Commissions, brokerage and other underwriting expenses	60,189	55,378
Other operating expenses	11,710	9,078
Corporate administration	9,561	10,508
Interest expense	1,805	1,000
 Total costs and expenses	 206,426	 190,269
 Earnings from continuing operations, before income taxes and minority interest	 107,200	 52,481
Income taxes	32,852	15,554
 Earnings from continuing operations before minority interest	 74,348	 36,927
Minority interest, net of tax	1,148	
 Earnings from continuing operations	 73,200	 36,927
 Discontinued operations		
Operations		(2,178)
Income taxes		3,347

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Loss from discontinued operations, net of tax		(5,525)
Net earnings	\$ 73,200	\$ 31,402
Changes in other comprehensive income		
Change in unrealized gains, net of tax	(21,163)	(17,731)
Less: reclassification for gains realized in net earnings (net of tax)	(7,074)	(401)
Other	(125)	(2,661)
Comprehensive income	\$ 44,838	\$ 10,609
Net earnings	\$ 73,200	\$ 31,402
Preferred dividends	331	
Net earnings available to common stockholders	\$ 72,869	\$ 31,402
Basic earnings (loss) per share of common stock **		
Continuing operations	\$ 9.17	\$ 4.59
Discontinued operations		(0.69)
	\$ 9.17	\$ 3.90
Diluted earnings (loss) per share of common stock **		
Continuing operations	\$ 9.10	\$ 4.57
Discontinued operations		(0.68)
	\$ 9.10	\$ 3.89
Dividends per share of common stock	*	*

* In February 2006 and March 2005, Alleghany declared a stock dividend consisting of one share of Alleghany common stock for every fifty shares

outstanding.

** Adjusted to
reflect the
common stock
dividend
declared in
February 2006.

See accompanying Notes to Unaudited Consolidated Financial Statements.

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ALLEGHANY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS
AND COMPREHENSIVE INCOME
FOR THE SIX MONTHS ENDED
JUNE 30, 2006 AND 2005

(dollars in thousands, except share and per share amounts)
(unaudited)

	2006	2005
Revenues		
Net premiums earned	\$ 477,294	\$ 432,206
Net investment income	61,641	34,684
Realized capital gains	17,866	47,844
Other income	25,640	6,396
Total revenues	582,441	521,130
Costs and expenses		
Loss and loss adjustment expenses	245,691	229,582
Commissions, brokerage and other underwriting expenses	117,574	108,422
Other operating expenses	22,520	17,231
Corporate administration	17,984	19,466
Interest expense	2,906	1,665
Total costs and expenses	406,675	376,366
Earnings from continuing operations, before income taxes and minority interest	175,766	144,764
Income taxes	42,193	46,614
Earnings from continuing operations before minority interest	133,573	98,150
Minority interest, net of tax	1,167	
Earnings from continuing operations	132,406	98,150
Discontinued operations		
Operations		(653)
Income taxes		5,224
Loss from discontinued operations, net of tax		(5,877)

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Net earnings	\$ 132,406	\$ 92,273
Changes in other comprehensive income		
Change in unrealized gains, net of tax	21,395	6,801
Less: reclassification for gains realized in net earnings (net of tax)	(11,613)	(31,099)
Other	319	(4,823)
Comprehensive income	\$ 142,507	\$ 63,152
Net earnings	\$ 132,406	\$ 92,273
Preferred dividends	331	
Net earnings available to common stockholders	\$ 132,075	\$ 92,273
Basic earnings (loss) per share of common stock **		
Continuing operations	\$ 16.52	\$ 12.22
Discontinued operations		(0.73)
	\$ 16.52	\$ 11.49
Diluted earnings (loss) per share of common stock **		
Continuing operations	\$ 16.45	\$ 12.19
Discontinued operations		(0.73)
	\$ 16.45	\$ 11.46
Dividends per share of common stock	*	*

* In February 2006 and March 2005, Alleghany declared a stock dividend consisting of one share of Alleghany common stock for every fifty shares outstanding.

** Adjusted to reflect the

common stock
dividend
declared in
February 2006.

See accompanying Notes to Unaudited Consolidated Financial Statements.

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ALLEGHANY CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(dollars in thousands, except share amounts)

	June 30, 2006 (unaudited)	December 31, 2005
Assets		
Available for sale securities at fair value:		
Equity securities (cost: 2006 \$323,592; 2005 \$384,890)	\$ 777,540	\$ 796,192
Debt securities (amortized cost: 2006 \$1,926,102; 2005 \$1,607,948)	1,879,615	1,589,371
Short-term investments	1,064,054	738,846
	3,721,209	3,124,409
Other invested assets	11,542	10,876
Total investments	3,732,751	3,135,285
Cash	63,931	47,457
Notes receivable	91,601	91,535
Premium balances receivable	275,203	223,378
Reinsurance recoverables	1,374,777	1,642,199
Ceded unearned premium reserves	322,067	314,472
Deferred acquisition costs	76,147	62,161
Property and equipment at cost, net of accumulated depreciation and amortization	18,808	19,708
Goodwill and other intangibles, net of amortization	163,374	167,506
Other assets	73,905	74,196
Current taxes receivable		18,310
	\$ 6,192,564	\$ 5,796,207
Liabilities and Stockholders Equity		
Losses and loss adjustment expenses	\$ 2,432,312	\$ 2,581,041
Unearned premiums	897,993	812,982
Reinsurance payable	147,350	181,693
Net deferred tax liabilities	82,490	95,988
Subsidiaries debt	80,000	80,000
Current taxes payable	18,471	
Minority interest	72,220	
Other liabilities	173,410	176,176
Total liabilities	3,904,246	3,927,880

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Preferred stock (shares authorized: 2006 - 1,132,000; 2005 - none; issued and outstanding 2006 - 1,132,000; 2005 - none)	299,527	
Common stock		
Common stock (shares authorized: 2006 and 2005 - 22,000,000; issued and outstanding 2006 - 7,950,297; 2005 - 8,062,977)	7,950	7,905
Contributed capital	622,297	599,617
Accumulated other comprehensive income (including unearned compensation)	256,045	245,944
Treasury stock, at cost (2006 - none; 2005 - none)		
Retained earnings	1,102,499	1,014,861
Total stockholders' equity	2,288,318	1,868,327
	\$ 6,192,564	\$ 5,796,207
Common Shares Outstanding *	7,950,297	8,062,977

* Adjusted to reflect the common stock dividend declared in February 2006.

See accompanying Notes to Unaudited Consolidated Financial Statements.

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**ALLEGHANY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED**

JUNE 30, 2006 AND 2005

(dollars in thousands)

(unaudited)

	2006	Revised 2005 (see Note 1)
Cash flows from operating activities		
Net earnings	\$ 132,406	\$ 92,273
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	4,643	12,632
Realized capital gains	(17,866)	(47,844)
(Increase) decrease in other assets	(5,895)	10,377
Decrease (increase) in reinsurance receivable, net of reinsurance payables	233,079	(44,697)
Decrease in premium balances receivable	(51,825)	(14,835)
Decrease in ceded unearned premium reserves	(7,595)	(6,501)
Decrease in deferred acquisition costs	(13,986)	(725)
Increase in other liabilities and current taxes	67,954	43,325
Decrease in unearned premiums	85,011	10,276
(Decrease) increase in losses and loss adjustment expenses	(148,729)	130,256
Discontinued operations	0	10,173
Net adjustments	144,791	102,437
Net cash provided by operating activities	277,197	194,710
Cash flows from investing activities		
Purchase of investments	(655,284)	(718,948)
Sales of investments	240,221	260,602
Maturities of investments	163,659	127,719
Purchases of property and equipment	(2,082)	(5,521)
Net change in short-term investments	(317,281)	162,520
Acquisition of insurance companies, net of cash acquired	(214)	(25,574)
Discontinued operations	0	(21,434)
Other, net	(29,144)	(22,815)
Net cash used in investing activities	(600,125)	(243,451)
Cash flows from financing activities		
Proceeds from issuance of convertible preferred stock, net of issuance costs	290,961	0
Proceeds from issuance of subsidiary common stock, net of issuance costs	86,288	0
Treasury stock acquisitions	(39,186)	0
Discontinued operations	0	4,679
Tax benefit on stock options exercised	585	0

Other, net	754	889
Net cash provided by financing activities	339,402	5,568
Cash flows of discontinued operations		
Operating activities	0	(5,054)
Investing activities	0	22,600
Financing activities	0	(4,679)
Net cash provided by discontinued operations	0	12,867
Net increase (decrease) in cash	16,474	(30,306)
Cash at beginning of period	47,457	73,545
Cash at end of period	\$ 63,931	\$ 43,239
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Interest	\$ 2,199	\$ 1,262
Income taxes	\$ 27,665	\$ 30,611
See accompanying Notes to Unaudited Consolidated Financial Statements.		

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Notes to Unaudited Consolidated Financial Statements

1. Principles of Financial Statement Presentation

This report should be read in conjunction with the Annual Report on 10-K for the year ended December 31, 2005 (the 2005 10-K), and the Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, of Alleghany Corporation (the Company).

The information included in this report is unaudited, but reflects all adjustments which, in the opinion of management, are necessary to a fair statement of the results of the interim periods covered thereby. All adjustments are of a normal and recurring nature except as described herein.

The accompanying consolidated financial statements include the results of the Company and its majority-owned subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant inter-company balances and transactions have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those reported results to the extent that those estimates and assumptions prove to be inaccurate.

Certain prior year amounts have been reclassified to conform to the 2006 presentation. Starting with the fourth quarter of 2005, the Company has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations in the consolidated statements of cash flows, which in prior periods were excluded from such statements.

2. Share-Based Compensation Plans

(a) Basis of Accounting In December 2004, FASB Statement 123 (revised), Share-Based Payment (SFAS 123R), was issued. SFAS 123R requires that the cost resulting from all share-based compensation transactions be recognized in the financial statements, establishes fair value as the measurement objective in accounting for share-based compensation arrangements and requires the application of a fair value based measurement method in accounting for share-based compensation transactions with employees. SFAS 123R was adopted by the Company for awards made or modified on or after January 1, 2006.

Prior to SFAS 123R, the Company followed Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). SFAS 123 established accounting and reporting standards for stock-based employee compensation plans, and allowed companies to choose between the fair value based method of accounting as defined in SFAS 123 and the intrinsic value based method of accounting as prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). The Company had elected to continue to follow the intrinsic value based method of accounting for awards

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granted prior to 2003, and accordingly, no expense was recognized for stock option-based awards. Effective January 1, 2003, the Company adopted the fair value based method of accounting of SFAS 123, and used the prospective transition method for stock-based awards granted after January 1, 2003. The fair value based method under SFAS 123 is similar to that employed under SFAS 123R. The adoption of SFAS 123R on the Company's consolidated financial results and financial condition was immaterial.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: no cash dividend yield for all years; expected volatility ranges of 17.9 percent to 19.0 percent; risk-free interest rates ranging from 3.21 percent to 5.15 percent and expected lives of up to eight years. As of June 30, 2006, all outstanding stock-based awards were accounted for under the fair value based method of accounting.

(b) General As of June 30, 2006, the Company had stock-based payment plans for parent-level employees and directors. As described in more detail below, parent-level stock-based payments to current employees consist only of restricted stock awards and performance share awards, and no stock options. Parent-level stock-based payments to non-employee directors consist of annual awards of stock options and restricted stock. In addition, as of June 30, 2006, RSUI Group, Inc. (RSUI) and Darwin Professional Underwriters, Inc. (Darwin) had their own stock-based payment plans, which are described below.

Amounts recognized as compensation expense in the consolidated statement of earnings and comprehensive income with respect to stock-based awards under plans for parent-level employees and directors were \$2.6 million and \$5.0 million for the three months ended June 30, 2006, and 2005, respectively, and \$4.1 million and \$8.9 million for the six months ended June 30, 2006, and 2005, respectively. The amount of related income tax benefit recognized as income in the consolidated statement of earnings and comprehensive income with respect to these plans was \$0.9 million and \$1.8 million for the three months ended June 30, 2006, and 2005, respectively, and \$1.4 million and \$3.1 million for the six months ended June 30, 2006, and 2005, respectively. For the first six months of 2006 and 2005, \$5.4 million and \$6.6 million of common stock, par value \$1.00 per share, of the Company (Common Stock), at fair market value, respectively, and \$3.5 and \$6.8 million of cash, respectively, was paid by the Company under plans for parent-level employees and directors. As noted above, as of June 30, 2006, all outstanding awards were accounted for under the fair value based method of accounting. However, under the prospective transition method, not all outstanding awards were accounted for under the fair value based method of accounting as of June 30, 2005. The table below illustrates the effect for the three and six months ended June 30, 2005 had the fair value method been adopted with respect to all outstanding and unvested awards under all plans for parent-level employees and directors (in millions, except per share data):

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	Three months ended June 30, 2005	Six months ended June 30, 2005
Net earnings, as reported	\$ 31,402	\$ 92,273
Add: stock-based employee compensation expense included in reported net earnings, net of related tax	3,251	5,798
Less: stock-based compensation expense determined exclusively under the fair value method, net of related tax	2,556	4,729
Pro forma net earnings	\$ 32,097	\$ 93,342
Basic earnings per share, as reported	\$ 3.90	\$ 11.49
Pro forma basic earnings per share	\$ 3.99	\$ 11.62
Diluted earnings per share, as reported	\$ 3.89	\$ 11.44
Pro forma basic earnings per share	\$ 3.97	\$ 11.58

The Company does not have an established policy or practice of repurchasing shares of its Common Stock in the open market for the purpose of delivering Common Stock upon the exercise of stock options. The Company issues authorized but not outstanding shares of Common Stock to settle option exercises in those instances where the number of shares it has repurchased are not sufficient to settle an option exercise.

(c) Stock Option Plans The Company provides, through its Amended and Restated Directors' Stock Option Plan (under which options were granted through May 1999) and its 2000 Directors' Stock Option Plan (which terminated on December 31, 2004), for the automatic grant of non-qualified options to purchase 1,000 shares of Common Stock in each year after 1987 to each non-employee director. In addition, the Company's 2005 Directors' Stock Plan (the 2005 Plan) provides for the automatic grant of nonqualified options to purchase 500 shares of Common Stock as well as 250 shares of restricted Common Stock to each non-employee director. In 2006 and 2005, a total of 2,000 restricted shares and 1,785 restricted shares, respectively, were granted which vest over a one-year period.

In addition, the Company has options outstanding under certain subsidiary stock option plans. These plans consist of: (i) the Subsidiary Directors' Stock Option Plan (the Subsidiary Option Plan); and (ii) the Underwriters Re Group, Inc. 1997 Stock Option Plan (the URG 1997 Plan). Under the Subsidiary Option Plan, non-employee directors of the Company's subsidiaries were eligible to receive grants of nonqualified stock options for Common Stock from the Company. The Subsidiary Option Plan expired on July 31, 2003. Under the URG 1997 Plan, options for

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Common Stock were granted to certain members of URG management in exchange for options to purchase shares of URG. No shares of Common Stock remain available for future option grants under the URG 1997 Plan.

The amount of options outstanding and exercisable with respect to all of the above stock option plans as of June 30, 2006 and 2005 was 92,000 and 111,000, respectively. In addition, such options had:

- a weighted average grant price of \$175.00 per share and \$158.00 per share as of June 30, 2006 and 2005, respectively;
- a weighted average remaining term of 4.1 years and 4.1 years, as of June 30, 2006 and 2005 respectively;
- an intrinsic value (i.e., exercise price) of \$16.1 million and \$17.5 million as of June 30, 2006 and 2005, respectively.

The intrinsic value of stock options exercised during the six months ended June 30, 2006 and 2005 were \$0.9 million and \$0.6 million, respectively. The number of non-vested options outstanding as of June 30, 2006 was 13,000, with a total average grant date fair value of \$2.7 million.

(d) Alleghany 2002 Long Term Incentive Plan The Company provides through its 2002 Long-Term Incentive Plan (the 2002 LTIP) incentive compensation to management employees of the type commonly known as restricted stock, stock appreciation rights, performance shares and performance units, as well as other types of incentive compensation. Awards may include, but are not limited to, cash and/or shares of Common Stock, rights to receive cash and/or shares of Common Stock, and options to purchase shares of Common Stock including options intended to qualify as incentive stock options under the Internal Revenue Code and options not intended to so qualify. Under the 2002 LTIP, the following types of awards are outstanding:

(i) Performance Share Awards Participants are entitled, at the end of a four-year award period, to a maximum amount equal to the value of one and one-half shares of Common Stock for each performance share issued to them based on market value on the payment date. In general, performance share payouts will be made in cash to the extent of minimum statutory withholding requirements in respect of an award, with the balance in Common Stock. Payouts are made provided defined levels of performance are achieved. As of June 30, 2006, 86,829 performance shares were outstanding. Expense is recognized over the performance period on a pro rata basis.

(ii) Restricted Share Awards The Company has awarded to certain management employees restricted shares of Common Stock. These awards entitle the participants to a specified maximum amount equal to the value of one share of Common Stock for each restricted share issued to them based on the market value on the payment date. In virtually all instances, payouts are made provided defined levels of performance are achieved. As of June 30, 2006, 65,243 restricted shares were outstanding, of which 2,000 shares were granted in 2006, 30,770 were granted in 2004 and 32,473 were granted in 2003. The expense is recognized ratably over the performance period, which can be extended under certain circumstances. The 2004 and 2003 awards are expected to vest over eight years. In addition, as of June 30, 2006, 21,224 restricted stock units were outstanding.

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(e) RSUI Restricted Share Plan RSUI has a Restricted Stock Unit Plan (the RSUI Plan) for the purpose of providing equity-like incentives to key employees. Under the RSUI Plan, restricted stock units (units) are issued. Additional units, defined as the Deferred Equity Pool, may be created in the future if certain financial performance measures are met. Units may only be settled in cash. The fair value of each unit is calculated as stockholder s equity of RSUI, adjusted for certain capital transactions and accumulated compensation expense recognized under the RSUI Plan, divided by the sum of RSUI common stock outstanding and the original units available under the RSUI Plan. The units vest on the fourth anniversary of the date of grant and contain certain restrictions, relating to, among other things, forfeiture in the event of termination of employment and transferability. For the three months ended June 30, 2006 and 2005, RSUI recorded \$6.9 million and \$5.6 million, respectively, in compensation expense related to the RSUI Plan. For the six months ended June 30, 2006 and 2005, \$15.0 million and \$10.1 million, respectively, of compensation expense was recorded. During the same periods, a deferred tax benefit of \$2.4 million, \$2.0 million, \$5.3 million and \$3.5 million, respectively, related to the compensation expense was recorded.

(f) Darwin Share Plans Darwin has four share-based payment plans for employees and non-employee directors. The 2003 Restricted Stock Plan (as amended November 2005), and the 2006 Stock Incentive Plan apply to key employees. The 2006 Employees Restricted Stock Plan applies to all employees at the time of Darwin s initial public offering. Finally, the Unit Plan for Non-employee Directors applies to non-employee directors. Collectively, the shares issued under these plans had a nominal fair value at the date of grant, and consequently, resulted in immaterial increases in compensation expense.

Under the 2003 Restricted Stock Plan (the most significant of these plans), Darwin reserved 1,650,000 of its authorized common shares (currently approximating 10.0 percent of all shares currently outstanding). These restricted stock awards generally vest at a rate of 50 percent on each of the third and fourth anniversaries of the grant date, contingent on the continued employment at Darwin of the grantee.

3. Discontinued Operations

As more fully described in Note 2 to the Consolidated Financial Statements contained in the 2005 10-K, the Company sold World Minerals, Inc. (World Minerals), its world-wide industrial minerals business, on July 14, 2005. The sale of World Minerals produced an after-tax gain of \$18.6 million in the third quarter of 2005. The Company has classified the operations of World Minerals as a discontinued operation in its financial statements.

4. Earnings Per Share

The following is a reconciliation of the income and share data used in the basic and diluted earnings per share computations for the three and six months ended June 30, 2006 and 2005 (in thousands, except share amounts):

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	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Net earnings	\$ 73,200	\$ 31,402	\$ 132,406	\$ 92,273
Preferred dividends	331		331	
Income available to common stockholders for basic earnings per share	72,869	31,402	132,075	92,273
Preferred dividends	331		331	
Effect of other dilutive securities	79	64	178	116
Income available to common stockholders for diluted earnings per share	\$ 73,279	\$ 31,466	\$ 132,584	\$ 92,389
Weighted average shares outstanding applicable to basic earnings per share	7,947,514	8,045,406	7,996,998	8,032,675
Preferred Stock	87,077		43,779	
Effect of other dilutive securities	20,324	30,500	20,324	30,500
Adjusted weighted average shares outstanding applicable to diluted earnings per share	8,054,915	8,075,906	8,061,101	8,063,175

Contingently issuable shares of 133,750 and 48,907 were potentially available during 2006 and 2005, respectively, but were not included in the computations of diluted earnings per share because the impact was anti-dilutive to the earnings per share calculation.

Quarterly earnings per share amounts may not equal year-to-date amounts due to rounding.

5. Commitments and Contingencies

(a) Leases The Company leases certain facilities, furniture and equipment under long-term lease agreements.

(b) Litigation The Company's subsidiaries are parties to pending litigation and claims in connection with the ordinary course of their businesses. Each such subsidiary makes provisions for estimated losses to be incurred in such litigation and claims, including legal costs. In the opinion of management, such provisions are adequate.

(c) Asbestos and Environmental Exposure Alleghany Insurance Holdings LLC's (AIHL) reserve for unpaid losses and loss adjustment expenses includes \$25.0 million of gross reserves and \$25.0 million of net reserves at June 30, 2006 for various liability coverages related to asbestos and environmental impairment claims that arose from reinsurance assumed by a subsidiary of Capitol Transamerica Corporation (CATA) between 1969 and 1976. This subsidiary exited this business in 1976. Reserves for asbestos and environmental impairment claims cannot be estimated with traditional loss reserving techniques because of uncertainties that are greater than those associated with other types of claims. Factors contributing to those uncertainties include a lack of historical data, the significant periods of time that often elapse between the occurrence of an insured loss and the reporting of that loss to the ceding company and the reinsurer, uncertainty as to the number and identity of insureds with potential exposure to

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such risks, unresolved legal issues regarding policy coverage, and the extent and timing of any such contractual liability. Loss reserve estimates for such environmental and asbestos exposures include case reserves, which also reflect reserves for legal and other loss adjustment expenses and for claims incurred but not reported (IBNR) reserves. IBNR reserves are determined based upon historic general liability exposure base and policy language, previous environmental loss experience and the assessment of current trends of environmental law, environmental cleanup costs, asbestos liability law and judgmental settlements of asbestos liabilities.

For both asbestos and environmental reinsurance claims, CATA establishes case reserves by receiving case reserve amounts from its ceding companies, and verifies these amounts against reinsurance contract terms, analyzing from the first dollar of loss incurred by the primary insurer. In establishing the liability for claims for asbestos related liability and for environmental impairment claims, management considers facts currently known and the current state of the law and coverage litigation. Additionally, ceding companies often report potential losses on a precautionary basis to protect their rights under the reinsurance arrangement, which generally calls for prompt notice to the reinsurer. Ceding companies, at the time they report such potential losses, advise CATA of the ceding companies' current estimate of the extent of such loss. CATA's claims department reviews each of the precautionary claims notices and, based upon current information, assesses the likelihood of loss to CATA. Such assessment is one of the factors used in determining the adequacy of the recorded asbestos and environmental reserves.

(d) Indemnification Obligations On July 14, 2005, the Company completed the sale of its world-wide industrial minerals business, World Minerals, to Imerys USA, Inc. (the Purchaser), a wholly-owned subsidiary of Imerys, S.A., pursuant to a Stock Purchase Agreement, dated as of May 19, 2005 by and among the Purchaser, Imerys, S.A. and the Company (the Stock Purchase Agreement). In connection with the sale of World Minerals, the Company undertook certain indemnification obligations pursuant to the Stock Purchase Agreement, including a general indemnification provision for breaches of representations and warranties set forth in the Stock Purchase Agreement (the Contract Indemnification) and a special indemnification provision (the Products Liability Indemnification) related to products liability claims arising from events that occurred during pre-closing periods, including the period of Company ownership (the Alleghany Period).

The representations and warranties to which the Contract Indemnification applies survive for a two-year period (with the exception of certain representations and warranties such as those related to environmental, real estate and tax matters, which survive for periods longer than two years) and generally, except for tax and certain other matters, apply only to aggregate losses in excess of \$2.5 million, up to a maximum of approximately \$123.0 million. The Stock Purchase Agreement provides that the Company has no responsibility for products liability claims arising in respect of events occurring after the closing, and that any products liability claims involving both pre-closing and post-closing periods will be apportioned on an equitable basis. Further information concerning the Contract Indemnification and Products Liability Indemnification can be found in Note 14 to the Consolidated Financial Statements contained in the 2005 10-K.

Based on the Company's experience to date and other analyses, the Company established a \$600,000 reserve in connection with the Products Liability Indemnification for the Alleghany Period. The reserve was \$538,000 at June 30, 2006.

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(e) Equity Holdings The Company invests a portion of its investment portfolio in equity securities which are subject to fluctuations in market value. As of June 30, 2006, the Company's equity portfolio had an investment concentration in the common stock of Burlington Northern Santa Fe Corporation, a railroad holding company, amounting to \$475.5 million in fair market value as of that date. In addition, as of June 30, 2006, the Company's equity portfolio had an investment concentration in common stocks of companies in the energy sector, amounting to \$220.1 million in fair market value as of that date.

6. Segments of Business

Information related to the Company's reportable business operating segments is shown in the tables below (in thousands). Property and casualty insurance operations, including fidelity and surety operations, are conducted by AIHL and at its subsidiaries RSUI, CATA and Darwin. The primary components of corporate activities are Alleghany Properties, LLC., and corporate investment and other activities at the parent level, including strategic equity investments which are available to support the internal growth of subsidiaries and for acquisitions of, and substantial investments in, operating companies.

The Company's reportable segments are reported in a manner consistent with the way management evaluates the businesses. As such, insurance underwriting activities are evaluated separately from investment activities. Realized investment gains are not considered relevant in evaluating investment performance on an annual basis. Segment accounting policies are the same as the Consolidated Accounting Policies described in Note 1 to the Consolidated Financial Statements contained in the 2005 Form 10-K.

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<i>(dollars in millions)</i>	Three Months Ended,		Six Months Ended,	
	2006	2005	2006	2005
Revenues:				
<i>AIHL insurance group:</i>				
Net premiums earned				
RSUI	\$ 172.4	\$ 158.2	\$ 334.5	\$ 313.7
CATA	42.3	40.5	83.5	79.8
Darwin	32.0	20.0	59.3	38.7
	246.7	218.7	477.3	432.2
Net investment income	28.6	15.4	53.5	28.8
Realized capital gains	10.9	0.6	15.5	25.8
Other income	0.5	1.3	1.3	2.0
Total insurance group	286.7	236.0	547.6	488.8
<i>Corporate activities:</i>				
Net investment income	3.7	4.1	8.1	5.9
Realized capital gains			2.4	22.0
Other income (1)	23.2	2.7	24.3	4.4
Total	\$ 313.6	\$ 242.8	\$ 582.4	\$ 521.1
Earnings from continuing operations, before income taxes and minority interest:				
<i>AIHL insurance group:</i>				
Underwriting profit (2)				
RSUI	\$ 56.2	\$ 43.8	\$ 102.7	\$ 87.0
CATA	6.0	4.8	9.3	6.4
Darwin	1.2	0.4	2.0	0.8
	63.4	49.0	114.0	94.2
Net investment income	28.6	15.4	53.5	28.8
Realized capital gains	10.9	0.6	15.5	25.8
Other income, less other expenses	(9.4)	(7.0)	(18.7)	(13.6)
Total insurance group	93.4	58.0	164.3	135.2
<i>Corporate activities:</i>				
Net investment income	3.7	4.1	8.1	5.9
Realized capital gains			2.4	22.0
Other income (1)	23.2	2.7	24.3	4.4
Corporate administration	11.3	11.3	20.5	21.1
Interest expense	1.8	1.0	2.9	1.7
Total (1)	\$ 107.2	\$ 52.5	\$ 175.7	\$ 144.7

- (1) - On May 26, 2006, Alleghany Properties completed the sale of 59 acres of real property consisting of unimproved land located in Rocklin County, California for \$29.3 million, recorded in other income. The sale resulted in an estimated net pre-tax gain of \$23.1 million for the three and six months ended June 30, 2006.
- (2) - Represents net premiums earned less loss and loss adjustment expenses and underwriting expenses, all as determined in accordance with GAAP, and does not include net investment income and other income or realized capital gains. Underwriting expenses represents commission and brokerage expenses and that portion of salaries, administration and other operating expenses directly attributable to underwriting activities, whereas the remainder constitutes other expenses.

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Table of Contents**7. Taxes**

Net earnings from continuing operations for the six months of 2006 include a tax benefit of \$10.8 million resulting from the release of a valuation allowance the Company held with respect to a portion of its deferred tax assets relating to unused foreign tax credits. As a result of the release, the Company's effective tax rate on earnings from continuing operations before income taxes and minority interest was 24.0 percent for the first six months of 2006, compared with 32.2 percent in the comparable 2005 period. The unused foreign tax credits arose from the Company's ownership of World Minerals prior to its sale in July 2005. These credits were originally estimated at \$19.2 million as of December 31, 2005, but were reduced to \$10.8 million in 2006 based on new information received from World Minerals and its parent, Imerys USA, Inc. In the first quarter of 2006, the Company adopted and began implementation of a formal plan which it believes will allow it to fully use such credits commencing in 2007. During the second quarter of 2006, as a result of the Company's anticipation of re-filing a prior year tax return, additional foreign tax credits were determined. However, these deferred tax benefits were substantially offset by increases in current tax liabilities, principally connected to taxes incurred on the Company's sale of World Minerals as a result of additional information.

On May 26, 2006, Alleghany Properties completed the sale of 59 acres of real property consisting of unimproved land located in Rocklin County, California for \$29.3 million, which such proceeds were recorded in other income. The sale resulted in an estimated net pre-tax gain of \$23.1 million, and tax expense of approximately \$10.2 million. The tax was classified as deferred, as the Company currently intends to use the proceeds of the sale to purchase certain real estate, thereby permitting deferral of tax under the Internal Revenue Code of 1986, as amended, assuming that all conditions are met by the Company during the 2006 fourth quarter.

8. Reinsurance

RSUI's catastrophe reinsurance program, which provided coverage for \$360.0 million of catastrophe losses in excess of a \$40.0 million net retention, with a 5 percent co-participation by RSUI, expired on April 30, 2006. At renewal, RSUI sought coverage for \$625.0 million of losses in excess of a \$75.0 million net retention, with a 5 percent co-participation by RSUI. However, RSUI was successful in placing with third party reinsurers a program covering only \$425.0 million of losses in excess of its \$75.0 million net retention. As of May 1, 2006, this program was placed approximately 51 percent for non-earthquake losses and approximately 72 percent for earthquake losses with third party reinsurers.

In view of the high reinsurance costs and limited capacity, AIHL decided to complete RSUI's reinsurance program primarily through a newly established captive reinsurance subsidiary, AIHL Re LLC (AIHL Re). In this regard, RSUI entered into an agreement, effective July 1, 2006, whereby AIHL Re, in exchange for market-based premiums, took the unplaced portion of the \$425.0 million program and the unplaced portion of the additional \$200.0 million of reinsurance coverage before co-participation by RSUI. As a result, RSUI completed its originally sought catastrophe reinsurance coverage of \$625.0 million of losses in excess of a \$75.0 million net retention, with approximately 36 percent of non-earthquake losses and approximately 51 percent of earthquake losses covered by third party reinsurers. The 64 percent of non-earthquake losses and 49 percent of earthquake losses not covered by third party reinsurers are retained by AIHL.

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Re and include a 5 percent co-participation by RSUI. Because AIHL Re is a wholly-owned subsidiary of AIHL, there is no net reduction of the Company's catastrophe exposure on a consolidated basis as a result of RSUI's arrangement with AIHL Re.

RSUI's property per risk reinsurance program also expired on April 30, 2006. At renewal, RSUI obtained reinsurance coverage for \$90.0 million in excess of a \$10.0 million net retention per risk (compared with coverage for \$95.0 million in excess of a \$5.0 million net retention per risk, with RSUI having a 50 percent co-participation on losses between \$5.0 and \$10.0 million under the expiring program) after the application of the surplus share treaties and facultative reinsurance, providing coverage substantially similar to that of the expired program.

AIHL's largest concentration of reinsurance recoverables at June 30, 2006 was \$265.6 million due from Swiss Reinsurance America Corporation (Swiss Re), which recently acquired Employers Reinsurance Corp., representing 19.3 percent of total reinsurance recoverables. At June 30, 2006, the A.M. Best Company Inc. financial strength rating of Swiss Re was A+ (Superior).

9. Mandatory Convertible Preferred Stock Offering

On June 23, 2006, the Company completed an offering of 1,132,000 shares of 5.75% mandatory convertible preferred stock (the Preferred Stock) at a price to the public of \$264.60 per share, less underwriter discounts and other related expenses, resulting in net proceeds of \$290.4 million. The annual dividend on each share of Preferred Stock is \$15.2144. Dividends on the Preferred Stock accrue and accumulate from the date of issuance, and, to the extent the Company is legally permitted to pay dividends and the Company's board of directors declares a dividend payable, the Company will pay dividends in cash on a quarterly basis.

Each share of Preferred Stock has a liquidation preference of \$264.60, plus any accrued, cumulated and unpaid dividends. Each share of Preferred Stock will automatically convert on June 15, 2009 into between 0.8475 and 1.0000 shares of Common Stock depending on the average market price per share of Common Stock over the 20 trading day period ending on the third trading day prior to such date. The conversion rate will also be subject to anti-dilution adjustments. At any time prior to June 15, 2009, holders may elect to convert each share of Preferred Stock into 0.8475 shares of Common Stock, subject to anti-dilution adjustments.

10. Stockholders' Equity

On May 24, 2006, Darwin closed the initial public offering of its common stock. In the offering, Darwin sold 6.0 million shares of common stock for net proceeds of \$86.3 million, all of which were used to reduce the Company's equity interests in Darwin by redeeming Darwin preferred stock held by the Company. Upon completion of the offering, all remaining unredeemed shares of Darwin preferred stock automatically converted to shares of Darwin common stock. The Company continues to own 54.9 percent of the total outstanding shares of common stock of Darwin (with no preferred stock outstanding). In connection with this transaction, the Company recorded an after-tax gain of \$9.1 million, which has been reflected in Contributed Capital. The third party ownership of Darwin is reflected on the consolidated balance sheet and income statement as a minority interest liability and expense, respectively.

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11. Recent Accounting Standards

In June 2005 FASB Statement 154, *Accounting Changes and Error Corrections*, was issued. This Statement applies to all voluntary changes in accounting principle and changes the requirements for, and reporting of, a change in accounting principle. The new standard requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable. The new standard does not change the transition provisions of any existing accounting pronouncements such as SFAS 123R (refer to Note 2). Statement 154 is effective for accounting changes and corrections of errors made in reporting periods beginning after December 15, 2005. The Company does not believe that this Statement will have a material impact on its results of operations and financial condition.

In March 2006, FASB Statement 155, *Accounting for certain Hybrid Instruments*, an amendment to FASB Statement No. 133 and 140 was issued. This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe that this Statement will have a material impact on its results of operations and financial condition.

In July 2006, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, was issued. This Interpretation clarifies the accounting for income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation 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. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company will adopt the provisions of this Interpretation in the first quarter of 2007, and does not anticipate that it will have any material impact on its results of operations and financial condition.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

References in this Form 10-Q to the Company, Alleghany, we, us, and our refer to Alleghany Corporation and its consolidated subsidiaries unless the context otherwise requires. AIHL refers to our insurance holding company subsidiary Alleghany Insurance Holdings LLC. RSUI refers to our subsidiary RSUI Group, Inc. and its subsidiaries.

CATA refers to our subsidiary Capitol Transamerica Corporation and its subsidiaries. Darwin refers to Darwin Professional Underwriters, Inc. and its subsidiaries. Unless the context otherwise requires, references to AIHL include the operations of RSUI, CATA and Darwin. Alleghany Properties refers to our subsidiary Alleghany Properties LLC.

Cautionary Statement Regarding Forward-Looking Information

Management's Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosures About Market Risk contain disclosures which are forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that do not relate solely to historical or current facts, and can be identified by the use of words such as may, will, expect, project, estimate, anticipate, plan, believe, potential, should, continue or the negative versions of those words or other comparable words. These forward-looking statements are based upon our current plans or expectations and are subject to a number of uncertainties and risks that could significantly affect current plans, anticipated actions and our future financial condition and results. These statements are not guarantees of future performance, and we have no specific intention to update these statements. The uncertainties and risks include, but are not limited to, risks relating to our insurance operating units such as

significant weather-related or other natural or human-made catastrophes and disasters;

the cyclical nature of the property and casualty industry;

the long-tail and potentially volatile nature of certain casualty lines of business written by our insurance operating units;

the cost and availability of reinsurance;

exposure to terrorist acts;

the willingness and ability of our insurance operating units' reinsurers to pay reinsurance recoverables owed to our insurance operating units;

changes in the ratings assigned to our insurance operating units;

claims development and the process of estimating reserves;

legal and regulatory changes;

the uncertain nature of damage theories and loss amounts;

increases in the levels of risk retention by our insurance operating units; and

adverse loss development for events insured by our insurance operating units in either the current year or prior year.

Additional risks and uncertainties include general economic and political conditions, including the effects of a prolonged U.S. or global economic downturn or recession; changes in costs; variations in political, economic or other factors; risks relating to conducting operations in

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a competitive environment; effects of acquisition and disposition activities, inflation rates or recessionary or expansive trends; changes in market prices of our significant equity investments; extended labor disruptions, civil unrest or other external factors over which we have no control; and changes in our plans, strategies, objectives, expectations or intentions, which may happen at any time at our discretion. As a consequence, current plans, anticipated actions and future financial condition and results may differ from those expressed in any forward-looking statements made by us or on our behalf.

Business Overview

We are engaged, through AIHL and its subsidiaries RSUI, CATA (which includes the results of Platte River Insurance Company) and Darwin in the property and casualty insurance business. We also own and manage properties in the Sacramento, California region through our subsidiary Alleghany Properties and conduct corporate investment and other activities at the parent level, including the holding of strategic equity investments which are available to support the internal growth of subsidiaries and for acquisitions of, and substantial investments in, operating companies. We were engaged in the industrial minerals business through World Minerals, Inc. and its subsidiaries, or World Minerals, until July 14, 2005, when we sold that business to Imerys USA, Inc. As a result of our disposition of World Minerals, this business has been classified as a discontinued operation in this Form 10-Q, and we no longer have any foreign operations. We intend to continue to expand our operations through internal growth at our subsidiaries as well as through potential operating company acquisitions and investments.

The following discussion and analysis presents a review of our results for the three and six months ended June 30, 2006 and 2005. You should read this review in conjunction with the consolidated financial statements and other data presented in this Form 10-Q as well as Management's Discussion and Analysis of Financial Condition and Results of Operation and Risk Factors contained in our Report on Form 10-K for the year ended December 31, 2005, or the 2005 10-K, and our Report on Form 10-Q for the quarter ended March 31, 2006. Our 2006 results are not indicative of operating results in future periods.

Critical Accounting Estimates

The preparation of financial statements in accordance with GAAP requires us to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period covered by the financial statements. Critical accounting estimates are defined as those estimates that are important to the presentation of our financial condition and results of operations and require us to exercise significant judgment.

We review our critical accounting estimates and assumptions quarterly. These reviews include evaluating the adequacy of reserves for unpaid losses and loss adjustment expenses and the reinsurance allowance for doubtful accounts, analyzing the recoverability of deferred tax assets, assessing goodwill for impairment and evaluating the investment portfolio for other-than-temporary declines in estimated fair value. Actual results may differ from the estimates used in preparing the consolidated financial statements.

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Readers are encouraged to review our 2005 10-K for a more complete description of our critical accounting estimates.

Consolidated Results of Operations

The following table summarizes our consolidated revenues, costs and expenses and earnings.

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Revenues				
Net premiums earned	\$246,712	\$218,654	\$477,294	\$432,206
Net investment income	32,328	19,482	61,641	34,684
Realized capital gains	10,883	617	17,866	47,844
Other income	23,703	3,997	25,640	6,396
Total revenues	\$313,626	\$242,750	\$582,441	\$521,130
Costs and expenses				
Loss and loss adjustment expenses	\$123,161	\$114,305	\$245,691	\$229,582
Commissions, brokerage and other underwriting expenses	60,189	55,378	117,574	108,422
Other operating expenses	11,710	9,078	22,520	17,231
Corporate administration	9,561	10,508	17,984	19,466
Interest expense	1,805	1,000	2,906	1,665
Total costs and expenses	\$206,426	\$190,269	\$406,675	\$376,366
Earnings from continuing operations, before income taxes and minority interest				
Income taxes	107,200	52,481	175,766	144,764
	32,852	15,554	42,193	46,614
Earnings from continuing operations before minority interest				
Minority interest	74,348	36,927	133,573	98,150
	1,148		1,167	
Earnings from continuing operations				
Loss from discontinued operations, net of tax	73,200	36,927	132,406	98,150
		(5,525)*		(5,877)*
Net earnings	\$ 73,200	\$ 31,402	\$132,406	\$ 92,273
Revenues				
AIHL	\$286,701	\$235,941	\$547,589	\$488,834
Corporate activities**	\$ 26,925	\$ 6,809	\$ 34,852	\$ 32,296

Earnings (loss) from continuing operations,
before income taxes and minority interest

AIHL	\$ 93,417	\$ 57,998	\$164,295	\$135,216
Corporate activities**	\$ 13,783	\$ (5,517)	\$ 11,471	\$ 9,548

* Amount reflects the discontinued operations of World Minerals prior to its sale in July 2005.

** Corporate activities consists of Alleghany Properties and corporate activities at the parent level.

Earnings from continuing operations, before income taxes and minority interest. Our earnings from continuing operations before income taxes for the first six months of 2006 increased from the corresponding 2005 period, primarily reflecting an increase in other income, net investment

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income and net premiums earned, partially offset by lower realized capital gains and higher loss and loss adjustment expenses related to the increase in net premiums earned. Other income reflects a \$23.1 million gain on sale of 59 acres of real estate in May of 2006 by Alleghany Properties. The increase in net investment income was primarily due to higher investment yields in 2006. The increase in net premiums earned at AIHL primarily reflects growth at Darwin and RSUI.

Earnings from continuing operations. Net earnings from continuing operations for the first six months of 2006 include a tax benefit of \$10.8 million resulting from the release of a valuation allowance we held with respect to a portion of our deferred tax assets related to unused foreign tax credits. The unused foreign tax credits arose from our ownership of World Minerals prior to its sale in July 2005. As a result of this release, our effective tax rate on earnings from continuing operations before income taxes and minority interest was 24.0 percent for the first six months of 2006, compared with 32.2 percent for the corresponding 2005 period. In the first quarter of 2006, we adopted and implemented a formal plan which we believe will allow us to fully use such foreign tax credits commencing in 2007.

Table of Contents**AIHL Results of Operations**

The comparative pre-tax contributions to AIHL's results made by its operating units RSUI, CATA and Darwin, and total AIHL results, were as follows (in millions, except ratios):

Three Months Ended June 30.

	RSUI	CATA	Darwin	AIHL
2006				
Gross premiums written	\$ 407.5	\$ 49.6	\$ 58.1	\$ 515.2
Net premiums written	229.2	47.4	36.4	313.0
Net premiums earned (1)	\$ 172.4	\$ 42.3	\$ 32.0	\$ 246.7
Loss and loss adjustment expenses	83.1	18.2	21.8	123.1
Underwriting expenses (2)	33.1	18.1	9.0	60.2
Underwriting profit (3)	\$ 56.2	\$ 6.0	\$ 1.2	63.4
Net investment income (1)				28.6
Realized capital gains (1)				10.9
Other income (1)				0.5
Other expenses (2)				(9.9)
Earnings before income taxes and minority interest				\$ 93.4
Loss ratio (4)	48.2%	43.2%	68.2%	49.9%
Expense ratio (5)	19.2%	42.7%	28.1%	24.4%
Combined ratio (6)	67.4%	85.9%	96.3%	74.3%
2005				
Gross premiums written	\$ 325.3	\$ 45.7	\$ 36.7	\$ 407.7
Net premiums written	168.2	43.7	20.8	232.7
Net premiums earned (1)	\$ 158.2	\$ 40.5	\$ 20.0	\$ 218.7
Loss and loss adjustment expenses	83.0	17.8	13.5	114.3
Underwriting expenses (2)	31.4	17.9	6.1	55.4
Underwriting profit (3)	\$ 43.8	\$ 4.8	\$ 0.4	49.0
Net investment income (1)				15.4
Realized capital gains (1)				0.6
Other income (1)				1.3
Other expenses (2)				(8.3)
Earnings before income taxes and minority interest				\$ 58.0
Loss ratio (4)	52.5%	44.0%	67.6%	52.3%

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Expense ratio (5)	19.8%	44.1%	30.9%	25.3%
Combined ratio (6)	72.3%	88.1%	98.5%	77.6%

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Table of ContentsSix Months Ended June 30.

	RSUI	CATA	Darwin	AIHL
2006				
Gross premiums written	\$ 703.0	\$ 93.9	\$ 117.9	\$ 914.8
Net premiums written	391.9	89.6	73.2	554.7
Net premiums earned (1)	\$ 334.5	\$ 83.5	\$ 59.3	\$ 477.3
Loss and loss adjustment expenses	166.8	37.8	41.1	245.7
Underwriting expenses (2)	65.0	36.4	16.2	117.6
Underwriting profit (3)	\$ 102.7	\$ 9.3	\$ 2.0	114.0
Net investment income (1)				53.5
Realized capital gains (1)				15.5
Other income (1)				1.3
Other expenses (2)				(20.0)
Earnings before income taxes and minority interest				\$ 164.3
Loss ratio (4)	49.9%	45.3%	69.3%	51.5%
Expense ratio (5)	19.4%	43.6%	27.4%	24.6%
Combined ratio (6)	69.3%	88.9%	96.7%	76.1%
2005				
Gross premiums written	\$ 596.3	\$ 88.9	\$ 70.5	\$ 755.7
Net premiums written	309.8	84.8	41.4	436.0
Net premiums earned (1)	\$ 313.7	\$ 79.8	\$ 38.7	\$ 432.2
Loss and loss adjustment expenses	165.4	37.8	26.4	229.6
Underwriting expenses (2)	61.3	35.6	11.5	108.4
Underwriting profit (3)	\$ 87.0	\$ 6.4	\$ 0.8	94.2
Net investment income (1)				28.8
Realized capital gains (1)				25.8
Other income (1)				2.0
Other expenses (2)				(15.6)
Earnings before income taxes and minority interest				\$ 135.2
Loss ratio (4)	52.7%	47.4%	68.2%	53.1%
Expense ratio (5)	19.6%	44.6%	29.7%	25.1%
Combined ratio (6)	72.3%	92.0%	97.9%	78.2%

- (1) Represent components of total revenues.
- (2) Underwriting expenses represent commission and brokerage expenses and that portion of salaries, administration and other operating expenses directly attributable to underwriting activities, whereas the remainder constitutes other expenses.
- (3) Represents net premiums earned less loss and loss adjustment expenses and underwriting expenses, all as determined in accordance with GAAP, and does not include net investment income and other income or realized capital gains. Underwriting profit does not replace net income determined in accordance with GAAP as a measure of profitability;

rather, we
believe that
underwriting
profit, which
does not include
net investment
income and
other income or
realized capital
gains, enhances
the
understanding
of AIHL s
insurance
operating

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units operating results by highlighting net income attributable to their underwriting performance. With the addition of net investment income and other income and realized capital gains, reported pre-tax net income (a GAAP measure) may show a profit despite an underlying underwriting loss. Where underwriting losses persist over extended periods, an insurance company's ability to continue as an ongoing concern may be at risk. Therefore, we view underwriting profit as an important measure in the overall evaluation of performance.

- (4) Loss and loss adjustment expenses divided by net premiums earned, all as

determined in accordance with GAAP.

(5) Underwriting expenses divided by net premiums earned, all as determined in accordance with GAAP.

(6) The sum of the loss ratio and expense ratio, all as determined in accordance with GAAP, representing the percentage of each premium dollar an insurance company has to spend on losses (including loss adjustment expenses) and underwriting expenses.

AIHL Operating Unit Results

RSUI

RSUI's net premiums earned for the second quarter and first six months of 2006 increased from the corresponding 2005 periods, reflecting increases in all casualty lines of business, due primarily to growth in gross premiums written. In addition, net premiums earned increased in property lines of business due to higher prices and increased retention under its property surplus-share reinsurance treaties, partially offset by higher per risk and catastrophe reinsurance costs. RSUI's underwriting profit for the second quarter and first six months of 2006 increased from the corresponding 2005 periods, reflecting lower estimated ultimate casualty loss and loss adjustment expense ratios for the current accident year in the general liability, professional liability and umbrella lines of business, reductions in ceded premiums under RSUI's property surplus-share reinsurance treaties and a decrease in catastrophe losses to \$2.4 million during the 2006 first half from \$14.3 million in the corresponding 2005 period. RSUI's underwriting profit in each of its casualty and property lines of business increased in the 2006 first half from the corresponding 2005 period, despite, with respect to property lines, a substantial increase at May 1, 2006 in the cost of RSUI's per risk and catastrophe reinsurance.

Rates for RSUI's catastrophe-exposed property risks have increased substantially, more than offsetting any reduction in premium resulting from exposure reduction efforts RSUI commenced during the 2005 fourth quarter. RSUI undertook such efforts to reduce its exposed limits and raise attachment points on catastrophe exposed property business. As part of these exposure reduction efforts, RSUI reviewed its catastrophe exposure management approach, resulting in the implementation of new modeling tools and a revision of its underwriting guidelines and procedures.

RSUI believes that its efforts will result in significantly lower accumulations of catastrophe risk on a gross basis. In May 2006, RSUI announced that it was suspending the writing of any new wind coverage for catastrophe-exposed coastal areas generally from North Carolina to Texas, or any new earthquake coverage in certain California counties. Although rates for RSUI's catastrophe-exposed property risks have substantially increased, they may not be sufficient to absorb potential catastrophe losses. In addition, RSUI's exposure mitigation efforts may not be successful in sufficiently mitigating risk exposures and losses resulting from future catastrophes.

With respect to RSUI's casualty lines of business, rates during the second quarter and first half of 2006 were flat or decreased slightly from the corresponding 2005 periods due to

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increased competition. If rates continue to soften in RSUI's casualty lines of business, RSUI may write lower levels of such business going forward, since RSUI is expected to write less business when it considers prices inadequate to support acceptable profit margins.

As discussed in our 2005 10-K, RSUI reinsures its property lines of business through surplus share treaties, facultative placements, per risk and catastrophe excess of loss treaties. RSUI's catastrophe reinsurance program covers risks including, among others, windstorms and earthquakes. RSUI's catastrophe reinsurance program, which provided coverage for \$360.0 million of losses in excess of a \$40.0 million