

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

May 10, 2005

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

- b** Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended March 31, 2005.
- o** Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from _____ to _____

Commission file number 001-13790

HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware

76-0336636

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

13403 Northwest Freeway, Houston, Texas

77040-6094

(Address of principal executive offices)

(Zip Code)

(713) 690-7300

(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 an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

On April 29, 2005, there were approximately 69.8 million shares of common stock, \$1.00 par value issued and outstanding.

HCC INSURANCE HOLDINGS, INC.
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This report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions we are making forward-looking statements.

Many risks and uncertainties may impact the matters addressed in these forward-looking statements, which could affect our future financial results and performance, including, among other things:

the occurrence of additional terrorist activities;

changing legal and social trends and inherent uncertainties (including but not limited to those uncertainties associated with our reserves) in the loss estimation process can adversely impact the adequacy of loss reserves and the allowance for reinsurance recoverables;

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industry and economic conditions can affect the ability and/or willingness of reinsurers to pay balances due and our ability to obtain adequate reinsurance;

catastrophic losses, including hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather, fires and man-made events;

state, federal and foreign regulations can impede our ability to charge adequate rates and efficiently allocate capital;

economic conditions, interest rates, and foreign exchange rate volatility can have a significant impact on the market value of fixed maturity investments as well as the carrying value of other assets and liabilities;

assessments by states for high risk or otherwise uninsured individuals;

changes in our assigned financial strength ratings;

our ability to receive dividends from our insurance company subsidiaries to meet our cash flow, debt, dividend and other corporate expense obligations;

our ability to effectively integrate acquired operations and to continue to expand our business through the acquisition of insurance industry related companies;

our ability to maintain adequate internal controls and procedures; and

the effects of state and other regulatory investigations into the practices and procedures of the insurance industry.

These events or factors could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and therefore also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

Our forward-looking statements speak only at the date made and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this report may not occur.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(unaudited, in thousands, except per share data)

	March 31, 2005	December 31, 2004
ASSETS		
Investments:		
Fixed income securities, at market (cost: 2005 - \$1,904,630; 2004 - \$1,682,421)	\$ 1,905,297	\$ 1,703,171
Short-term investments, at cost, which approximates market	587,151	729,985
Other investments, at market (cost: 2005 - \$58,646; 2004 - \$34,137)	61,795	35,335
Total investments	2,554,243	2,468,491
Cash	70,077	69,933
Restricted cash and cash investments	192,083	188,510
Premium, claims and other receivables	1,028,903	923,638
Reinsurance recoverables	1,099,439	1,098,999
Ceded unearned premium	264,755	317,055
Ceded life and annuity benefits	75,136	74,627
Deferred policy acquisition costs	135,514	139,199
Goodwill	455,999	444,031
Other assets	222,987	208,954
Total assets	\$ 6,099,136	\$ 5,933,437
LIABILITIES		
Loss and loss adjustment expense payable	\$ 2,142,284	\$ 2,089,199
Life and annuity policy benefits	75,136	74,627
Reinsurance balances payable	199,933	228,998
Unearned premium	727,866	741,706
Deferred ceding commissions	81,323	94,896
Premium and claims payable	888,074	795,576
Notes payable	311,142	311,277
Accounts payable and accrued liabilities	270,495	273,493
Total liabilities	4,696,253	4,609,772
SHAREHOLDERS EQUITY		
Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2005 69,797; 2004 68,038)	69,797	68,038

Additional paid-in capital	610,463	566,776
Retained earnings	702,601	651,216
Accumulated other comprehensive income	20,022	37,635
Total shareholders equity	1,402,883	1,323,665
Total liabilities and shareholders equity	\$ 6,099,136	\$ 5,933,437

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Earnings

(unaudited, in thousands, except per share data)

	Three months ended March 31,	
	2005	2004
REVENUE		
Net earned premium	\$ 320,117	\$ 217,063
Fee and commission income	33,076	43,843
Net investment income	22,341	14,435
Net realized investment gain (loss)	(3)	518
Other operating income	4,147	2,159
Total revenue	379,678	278,018
EXPENSE		
Loss and loss adjustment expense, net	186,063	125,864
Operating expense:		
Policy acquisition costs, net	59,357	44,764
Compensation expense	27,006	21,561
Other operating expense	18,943	15,086
Total operating expense	105,306	81,411
Interest expense	1,808	2,212
Total expense	293,177	209,487
Earnings from continuing operations before income tax expense	86,501	68,531
Income tax expense from continuing operations	29,183	23,729
Earnings from continuing operations	57,318	44,802
Loss from discontinued operations, net of income tax benefit of \$146		(234)
Net earnings	\$ 57,318	\$ 44,568
Basic earnings per share data:		
Earnings from continuing operations	\$ 0.83	\$ 0.70
Loss from discontinued operations		(0.01)
Net earnings	\$ 0.83	\$ 0.69
Weighted average shares outstanding	68,827	64,249

Diluted earnings per share data:

Earnings from continuing operations	\$	0.81	\$	0.68
Earnings from discontinued operations				

Net earnings

	\$	0.81	\$	0.68
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Weighted average shares outstanding		70,489		65,417
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Cash dividends declared, per share	\$	0.085	\$	0.075
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See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statement of Changes in Shareholders' Equity

Three months ended March 31, 2005

(unaudited, in thousands, except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders equity
Balance at December 31, 2004	\$ 68,038	\$ 566,776	\$ 651,216	\$ 37,635	\$ 1,323,665
Net earnings			57,318		57,318
Other comprehensive income (loss)				(17,613)	(17,613)
Comprehensive income					39,705
Issuance of 965 shares for exercise of options, including tax benefit of \$4,908	965	25,030			25,995
Issuance of 794 shares for purchased company	794	18,657			19,451
Cash dividends declared, \$0.085 per share			(5,933)		(5,933)
Balance at March 31, 2005	\$ 69,797	\$ 610,463	\$ 702,601	\$ 20,022	\$ 1,402,883

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(unaudited, in thousands, except per share data)

	Three months ended March	
	31,	
	2005	2004
Cash flows from operating activities:		
Net earnings	\$ 57,318	\$ 44,568
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	(123,893)	(108,556)
Change in reinsurance recoverables	251	(43,618)
Change in ceded unearned premium	52,300	(8,366)
Change in loss and loss adjustment expense payable	49,939	93,623
Change in reinsurance balances payable	(29,842)	37
Change in unearned premium	(16,842)	27,632
Change in premium and claims payable, net of restricted cash	88,925	103,013
Change in trading portfolio	(41,328)	(7,762)
Depreciation and amortization expense	3,710	3,390
Other, net	(6,629)	(3,096)
Cash provided by operating activities	33,909	100,865
Cash flows from investing activities:		
Sales of fixed income securities	55,681	103,092
Maturity or call of fixed income securities	32,250	33,116
Cost of securities acquired	(277,000)	(213,354)
Change in short-term investments	145,025	(59,045)
Payment for purchase of subsidiary, net of cash received		(43,307)
Other, net	(1,118)	2,566
Cash used by investing activities	(45,162)	(176,932)
Cash flows from financing activities:		
Sale of common stock	21,087	9,924
Payments on notes payable	(93)	(91)
Dividends paid	(5,783)	(4,800)
Other	(3,814)	
Cash provided by financing activities	11,397	5,033
Net increase (decrease) in cash	144	(71,034)
Cash at beginning of period	69,933	96,416

Cash at end of period	\$	70,077	\$	25,382
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See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, tables in thousands, except per share data)

(1) GENERAL INFORMATION

HCC Insurance Holdings, Inc. and its subsidiaries (we, us and our) include domestic and foreign property and casualty and life insurance companies, underwriting agencies and reinsurance brokers. We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency and reinsurance brokerage services to commercial customers and individuals. We market our products both directly to customers and through a network of independent and affiliated agents and brokers. Our lines of business include diversified financial products (which includes directors and officers liability, errors and omissions, employment practices liability and surety); group life, accident and health; aviation; our London market account (which includes energy, marine, property, and accident and health); and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain and Bermuda, although some of our operations have a broader international scope.

Basis of Presentation

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments which, in our opinion, are necessary for a fair presentation of the results of the interim periods. All adjustments made to the interim periods are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements for periods reported herein should be read in conjunction with the annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet as of December 31, 2004 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Management must make estimates and assumptions that affect amounts reported in our financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. Certain amounts in our 2004 condensed consolidated financial statements have been reclassified to conform to the 2005 presentation. Such reclassifications had no effect on our consolidated net earnings, shareholders equity or cash flows.

See Note (2) for discussion of our 2005 acquisition. During 2004, we completed several acquisitions. The results of operations of these entities are included in our condensed consolidated financial statements beginning on the effective date of each acquisition. Thus, our condensed consolidated statements of earnings and cash flows for the three months ended March 31, 2004 do not contain any operations of the entity acquired in 2005 or of the entities acquired in 2004 prior to their acquisition dates.

Income Tax

For the three months ended March 31, 2005 and 2004, the income tax provision was calculated based on an estimated effective tax rate for each of the fiscal years. The difference between our effective tax rate and the United States federal statutory rate is primarily the result of tax exempt municipal bond interest and state income

taxes.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, tables in thousands, except per share data, continued)

Stock Options

We account for stock options granted to employees using the intrinsic value method, in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. All options have been granted at fixed exercise prices at the market price of our common stock on the grant date. Thus, no stock-based employee compensation expense is reflected in our reported net earnings. Options vest over a period of up to seven years and expire four to ten years after grant date. The following table illustrates the effects on net earnings and earnings per share if we had used the fair value method of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*.

	Three months ended March 31,	
	2005	2004
Reported net earnings	\$ 57,318	\$ 44,568
Stock-based compensation using the fair value method, net of income taxes	(1,277)	(1,220)
Pro forma net earnings	\$ 56,041	\$ 43,348
Reported basic earnings per share	\$ 0.83	\$ 0.69
Fair value stock-based compensation	(0.02)	(0.02)
Pro forma basic earnings per share	\$ 0.81	\$ 0.67
Reported diluted earnings per share	\$ 0.81	\$ 0.68
Fair value stock-based compensation	(0.02)	(0.02)
Pro forma diluted earnings per share	\$ 0.79	\$ 0.66

The Financial Accounting Standards Board (FASB) has issued SFAS No. 123(R), *Share-Based Payment*, which requires stock-based employee compensation to be deducted from net income beginning January 1, 2006. We are currently reviewing the requirements of SFAS No. 123(R), including the valuation methods permitted. Using the Black-Scholes single option pricing model that we utilized for the SFAS No. 123 calculations above, compensation costs related to nonvested awards approximated \$18.5 million at March 31, 2005. If we ultimately utilize the Black-Scholes model for purposes of SFAS No. 123(R), this cost will be recognized through the last vesting period in 2010, although approximately 78% will be recognized through 2007.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, tables in thousands, except per share data, continued)

Recent Accounting Pronouncements

In March 2004, the Emerging Issues Task Force (EITF) reached a consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. EITF 03-1 provides guidance with respect to the meaning of other-than-temporary impairment and its application to investments classified as either available for sale or held to maturity under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and investments accounted for under the cost method or the equity method. In September 2004, the FASB issued a Staff Position, FSP EITF Issue 03-1-1, delaying the effective date for the measurement and recognition guidance included in EITF 03-1, and also issued an exposure draft, FSP EITF Issue 03-1a, which proposes guidance relating to debt securities that are impaired because of interest rate and/or sector spread increases. The delay in the effective date for the measurement and recognition guidance of EITF 03-1 did not suspend existing requirements for assessing whether investment impairments are other-than-temporary. It is expected that the proposed guidance under FSP EITF Issue 03-1a will be finalized in 2005. We are monitoring the outcome of the EITF's consideration of these issues.

(2) ACQUISITION

On February 25, 2005, we issued 0.8 million shares of our common stock to acquire all of the shares of USSC Holdings, Inc., the parent company of United States Surety Company, a Maryland-domiciled company specializing in contract bonding for small and medium sized contractors. United States Surety Company's results are reported in our insurance company segment. This business combination was recorded using the purchase method of accounting. The results of operations of United States Surety Company were included in our condensed consolidated financial statements beginning on the effective date of the transaction. The consideration paid and the inclusion of United States Surety Company's financial information in our condensed consolidated financial statements are not material to our consolidated financial position, results of operations or cash flows. The approximate fair values of assets acquired and liabilities assumed were \$29.8 million and \$10.3 million, respectively. Goodwill resulting from this acquisition approximated \$12.8 million at March 31, 2005 and will not be deductible for United States federal income tax purposes. We are still in the process of valuing certain agreements to complete the purchase price allocation.

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, tables in thousands, except per share data, continued)

(3) REINSURANCE

In the normal course of business, our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although ceding for reinsurance purposes does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

	Written premium	Earned premium	Loss and loss adjustment expense
<u>Three months ended March 31, 2005</u>			
Direct business	\$ 398,281	\$ 412,095	\$ 221,534
Reinsurance assumed	76,838	72,580	48,506
Reinsurance ceded	(117,767)	(164,558)	(83,977)
Net amounts	\$ 357,352	\$ 320,117	\$ 186,063
<u>Three months ended March 31, 2004</u>			
Direct business	\$ 371,961	\$ 358,079	\$ 211,108
Reinsurance assumed	87,620	74,226	57,989
Reinsurance ceded	(223,626)	(215,242)	(143,233)
Net amounts	\$ 235,955	\$ 217,063	\$ 125,864

The table below shows the components of reinsurance recoverables in our condensed consolidated balance sheets.

	March 31, 2005	December 31, 2004
Reinsurance recoverable on paid losses	\$ 104,424	\$ 89,508
Reinsurance recoverable on outstanding losses	486,094	509,512
Reinsurance recoverable on incurred but not reported losses	529,606	520,404
Reserve for uncollectible reinsurance	(20,685)	(20,425)
Total reinsurance recoverables	\$ 1,099,439	\$ 1,098,999

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HCC Insurance Holdings, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(unaudited, tables in thousands, except per share data, continued)

Our U.S. domiciled insurance companies require their reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset.

	March 31, 2005	December 31, 2004
Payables to reinsurers	\$ 352,098	\$ 350,514
Letters of credit	223,244	265,152
Cash deposits	69,277	68,307
Total credits	\$ 644,619	\$ 683,973

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs.

	March 31, 2005	December 31, 2004
Loss and loss adjustment expense payable	\$ 2,142,284	\$ 2,089,199
Reinsurance recoverable on outstanding losses	(486,094)	(509,512)
Reinsurance recoverable on incurred but not reported losses	(529,606)	