

ENSTAR GROUP INC  
Form 10-Q  
November 09, 2006

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**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 the quarterly period ended September 30, 2006**

**OR**

- 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 0-07477**

**The Enstar Group, Inc.**

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

**Georgia**

*(State or other jurisdiction of  
incorporation or organization)*

**63-0590560**

*(I.R.S. Employer  
Identification No.)*

**401 Madison Avenue**

**Montgomery, Alabama 36104**

**(Address of principal executive offices)**

**(334) 834-5483**

*(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

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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). Yes  No

The number of shares of Registrant's Common Stock, \$.01 par value per share, outstanding at November 9, 2006 was 5,739,384.

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**THIS FORM 10-Q AND OTHER STATEMENTS ISSUED OR MADE FROM TIME TO TIME BY THE ENSTAR GROUP, INC. OR MEMBERS OF ITS MANAGEMENT TEAM CONTAIN STATEMENTS WHICH MAY CONSTITUTE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE SECURITIES ACT OF 1933, AND THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED BY THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, 15 U.S.C.A. SECTIONS 77Z-2 AND 78U-5 (SUPP. 1996). THOSE STATEMENTS INCLUDE STATEMENTS REGARDING THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF THE ENSTAR GROUP, INC. AND MEMBERS OF ITS MANAGEMENT TEAM, AS WELL AS THE ASSUMPTIONS ON WHICH SUCH STATEMENTS ARE BASED. PROSPECTIVE INVESTORS ARE CAUTIONED THAT ANY SUCH FORWARD-LOOKING STATEMENTS ARE NOT GUARANTEES OF FUTURE PERFORMANCE AND INVOLVE RISKS AND UNCERTAINTIES, AND THAT ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTEMPLATED BY SUCH FORWARD-LOOKING STATEMENTS. THERE ARE A NUMBER OF IMPORTANT FACTORS THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE INDICATED BY SUCH FORWARD-LOOKING STATEMENTS. THESE FACTORS INCLUDE, WITHOUT LIMITATION, THOSE SET FORTH IN ITEM 1A. RISK FACTORS TO THE ENSTAR GROUP, INC. ANNUAL REPORT ON FORM 10-K/A FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005. THE ENSTAR GROUP, INC. UNDERTAKES NO OBLIGATION TO UPDATE OR REVISE FORWARD-LOOKING STATEMENTS TO REFLECT CHANGED ASSUMPTIONS, THE OCCURRENCE OF UNANTICIPATED EVENTS OR CHANGES TO FUTURE OPERATING RESULTS OVER TIME.**

**Table of Contents****PART I****FINANCIAL INFORMATION****Item 1. Financial Statements****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(Dollars in thousands) (Unaudited)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 74,285	\$ 54,032
Certificates of deposit	20,390	19,686
Other current assets	30	129
Total current assets	94,705	73,847
Partially owned equity affiliates	99,678	107,329
Other investments	5,382	3,542
Other assets	514	502
Total assets	\$ 200,279	\$ 185,220
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 2,673	\$ 595
Income taxes payable	4,246	5,467
Total current liabilities	6,919	6,062
Deferred income tax liabilities	10,099	10,401
Accrued taxes	2,325	2,325
Deferred compensation	1,002	853
Other liabilities	466	456
Total liabilities	20,811	20,097
Commitments and contingencies (Note 5)		
Shareholders' equity:		
Common stock (\$.01 par value; 55,000,000 shares authorized, 6,185,260 and 5,960,260 shares issued at September 30, 2006 and December 31, 2005, respectively)	62	60

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Additional paid-in capital	198,248	189,968
Accumulated other comprehensive income of partially owned equity affiliates, net	465	210
Accumulated deficit	(13,227)	(19,305)
Treasury stock, at cost (445,876 and 442,351 shares at September 30, 2006 and December 31, 2005, respectively)	(6,080)	(5,810)
Total shareholders' equity	179,468	165,123
Total liabilities and shareholders' equity	\$ 200,279	\$ 185,220

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

**Table of Contents****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(Dollars in thousands, except per share data)</b>			
	<b>(Unaudited)</b>			
Interest income	\$ 1,237	\$ 608	\$ 3,086	\$ 1,651
Other investment income		487	199	1,091
Earnings of partially owned equity affiliates	3,890	1,186	10,645	2,497
Other income (includes related party income of \$100, \$100, \$300 and \$300, respectively)	121	100	330	301
General and administrative expenses	(745)	(617)	(4,245)	(2,258)
Income before income taxes and extraordinary gain	4,503	1,764	10,015	3,282
Income taxes	(2,260)	(794)	(4,812)	(1,477)
Income before extraordinary gain	2,243	970	5,203	1,805
Extraordinary gain, net of income taxes of \$543			875	
Net income	\$ 2,243	\$ 970	\$ 6,078	\$ 1,805
Weighted average shares outstanding basic	5,739,384	5,517,909	5,621,279	5,517,909
Weighted average shares outstanding assuming dilution	6,002,448	5,862,172	5,939,750	5,852,596
Income per common share before extraordinary gain basic	\$ 0.39	\$ 0.18	\$ 0.92	\$ 0.33
Extraordinary gain, net of income taxes basic			0.16	
Net income per common share basic	\$ 0.39	\$ 0.18	\$ 1.08	\$ 0.33
Income per common share before extraordinary gain assuming dilution	\$ 0.37	\$ 0.17	\$ 0.87	\$ 0.31
Extraordinary gain, net of income taxes assuming dilution			0.15	
Net income per common share assuming dilution	\$ 0.37	\$ 0.17	\$ 1.02	\$ 0.31

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





Table of Contents**THE ENSTAR GROUP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(Dollars in thousands) (Unaudited)</b>			
Net income	\$ 2,243	\$ 970	\$ 6,078	\$ 1,805
Other comprehensive income (loss):				
Unrealized holding gains (losses) on investments, net of income tax expense (benefit) of \$(103), \$(21), \$67 and \$408	(165)	(34)	110	657
Reclassification adjustment for losses (gains) included in net income, net of income tax (benefit) expense of \$2, \$57, \$(8) and \$74	(3)	(91)	12	(119)
Currency translation adjustment, net of income tax expense (benefit) of \$12, \$(10), \$84 and \$(85)	19	(17)	133	(138)
Other comprehensive income (loss)	(149)	(142)	255	400
Comprehensive income	\$ 2,094	\$ 828	\$ 6,333	\$ 2,205

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

Table of Contents**THE ENSTAR GROUP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in thousands)</b>	
	<b>(Unaudited)</b>	
Cash flows from operating activities:		
Net income	\$ 6,078	\$ 1,805
Adjustments to reconcile net income to net cash used in operating activities:		
Earnings of partially owned equity affiliates	(10,645)	(2,497)
Dividends and distributions received from partially owned equity affiliates	20,169	
Extraordinary gain, net of income taxes	(875)	
Noncash compensation expense	163	
Gain on sale of marketable securities		(1,060)
Deferred income taxes	(1,004)	484
Tax benefit from exercise of stock options	(5,694)	
Changes in assets and liabilities:		
Accounts payable and accrued expenses	2,078	(315)
Income taxes payable	4,473	(82)
Other, net	335	162
Net cash provided by (used in) operating activities	15,078	(1,503)
Cash flows from investing activities:		
Investment in J.C. Flowers II LP	(1,896)	
Purchase of marketable securities		(9,460)
Proceeds from sale of marketable securities		7,060
Return of capital from NIB Partners	56	
Capital contributions to Affirmative Investment		(8,406)
Purchases of certificates of deposit	(86,525)	(14,084)
Maturities of certificates of deposit	85,730	4,048
Net cash used in investing activities	(2,635)	(20,842)
Cash flows from financing activities:		
Tax benefit from exercise of stock options	5,694	
Proceeds from exercise of stock options	2,116	
Net cash provided by financing activities	7,810	
Increase (decrease) in cash and cash equivalents	20,253	(22,345)
Cash and cash equivalents at the beginning of the period	54,032	81,675
Cash and cash equivalents at the end of the period	\$ 74,285	\$ 59,330

Supplemental disclosures of cash flow information:

Income taxes paid	\$	842	\$	1,079
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Supplemental disclosures of noncash financing activities:

Receipt of treasury stock from exercise of stock options	\$	270	\$	
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The accompanying notes are an integral part of the consolidated financial statements.

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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

**Note 1: General**

The Enstar Group, Inc. and Subsidiaries, (the Company or Enstar ), is a publicly traded company engaged in the operation of several equity affiliates in the financial services industry.

The Company, through the operations of its partially owned equity affiliates, Castlewood Holdings Limited ( Castlewood Holdings ) and B.H. Acquisition Limited ( B.H. Acquisition ), and their subsidiaries, acquires and manages insurance and reinsurance companies in run-off. The management of these businesses includes claims administration, adjustment and settlement together with the collection of reinsurance recoveries. Castlewood Holdings, a Bermuda-based company, also provides management, consulting and other services to the insurance and reinsurance industry for both fixed and success-based fee arrangements. In general, reinsurance is an arrangement in which the reinsurer agrees to indemnify an insurance or reinsurance company against all or a portion of the risks underwritten by such insurance or reinsurance company under one or more insurance or reinsurance contracts.

The Company consolidates JCF CFN LLC and related entities (collectively, the JCF CFN Entities ). The JCF CFN Entities were formed to serve as members of Green Tree Investment Holdings LLC (formerly known as CFN Investment Holdings LLC) and related entities (collectively, Green Tree ), which, in turn, were formed to effect the acquisition of a portfolio of home equity and manufactured housing loan securities and the associated servicing businesses from Conseco Finance Corp. In July 2004, the JCF CFN Entities completed the sale of their entire interest in Green Tree and have been inactive since then.

The condensed consolidated financial statements of the Company are unaudited and, in the opinion of management, include all adjustments consisting solely of normal recurring adjustments necessary to fairly state the Company's financial condition, results of operations and cash flows for the interim period. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2005 included in the Company's Form 10-K/A as filed with the Securities and Exchange Commission (the SEC ) on September 20, 2006 under the Securities Exchange Act of 1934, as amended.

**Note 2: Significant Accounting Policies**

(a) *Principles of Consolidation* The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Enstar Financial Services, Inc. and Enstar Group Operations, Inc., both of which are currently inactive. In addition, the Company consolidates the JCF CFN Entities, recording a minority interest in its financial statements for Castlewood Holdings' 40% interest. All significant intercompany balances and transactions have been eliminated in consolidation.

(b) *Use of Estimates* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The estimates susceptible to significant change are those related to the valuation allowance for deferred tax assets and loss and loss adjustment expenses included in earnings of partially owned equity affiliates.

(c) *Cash Equivalents* Cash equivalents consist of short term, highly liquid investments with original purchased maturities of three months or less.

(d) *Partially Owned Equity Affiliates* Partially owned equity affiliates are accounted for under the equity method of accounting. Equity method investments are recorded at cost and are adjusted periodically to recognize the Company's proportionate share of the investee's income or loss, additional contributions made and dividends and capital distributions received. In the event any of the partially owned equity affiliates were to incur a loss and the

Table of Contents**THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company's cumulative proportionate share of the loss exceeded the carrying amount of the equity method investment, application of the equity method would be suspended and the Company's proportionate share of further losses would not be recognized until the Company committed to provide further financial support to the investee. The Company would resume application of the equity method once the investee becomes profitable and the Company's proportionate share of the investee's earnings equals its cumulative proportionate share of losses that were not recognized during the period the application of the equity method was suspended.

(e) *Comprehensive Income* The Company reports comprehensive income in accordance with Statement of Financial Accounting Standards (SFAS) 130, Reporting Comprehensive Income which defines comprehensive income as certain changes in equity from non-owner sources. The Company recorded other comprehensive income from its partially owned equity affiliates. This other comprehensive income arose from unrealized holding gains and losses from debt and equity securities that are classified as available for sale and are carried at fair value, and currency translation adjustments resulting from the translations of financial information of subsidiaries into U.S. dollars.

The components of accumulated other comprehensive income are as follows:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
Currency translation adjustment, net of income tax expense of \$213 and \$130	\$ 344	\$ 210
Unrealized holding gains, net of income tax expense of \$75	121	
Total accumulated other comprehensive income	\$ 465	\$ 210

(f) *Revenue Recognition* Revenue includes interest income earned from cash, cash equivalents and certificates of deposit, the Company's proportionate share of earnings from partially owned equity affiliates, investment income and other income. Interest income is recorded when earned. The Company's proportionate share of earnings from partially owned equity affiliates is recorded as such earnings are recognized by the partially owned equity affiliate.

(g) *Stock-Based Compensation* The Company utilizes various stock-based compensation plans for the benefit of non-employee directors and certain officers. In 1997, the Company adopted the Deferred Compensation and Stock Plan for Non-Employee Directors and a long-term incentive program made up of three stock option/incentive plans. Additionally, in 2001, the Company adopted the 2001 Outside Directors' Stock Option Plan.

The options granted under the plans are exercisable during the period commencing from the date they vest until expiring according to the terms of the grant. Options generally expire no later than ten years from the grant date. Options under the various plans had original vesting schedules that ranged from one to four years. Any shares issued from the exercise of options would be from newly issued shares. There are a total of 817,500 shares authorized under the Company's various stock option plans, 52,500 of which are available to be granted at September 30, 2006. Prior to 2006, no compensation expense was recognized in net earnings for grants under stock option/incentive plans that had an exercise price equal to the market value of the Company's underlying common stock on the date of grant. In connection with options granted in November 2001, the market value of the Company's common stock on the date of

grant exceeded the exercise price, resulting in a charge to earnings for that year. In addition, compensation expense was recognized over the vesting life of these options through June 2004.

As of January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ). This Statement requires companies to recognize an expense in their financial statements for stock options based on the fair value method. The fair value method requires that a fair value be assigned to a stock option on its grant date and that this value be amortized over the grantees service period. Prior to January 1, 2006, the Company accounted for stock options in accordance with SFAS No. 123, Accounting for Stock-Based Compensation as amended by SFAS 148, Accounting for Stock-Based Compensation Transition. These Statements permitted companies to choose between two methods of recording the expense for stock options in their financial statements; either the fair value method, or the intrinsic value method, in accordance with Accounting



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Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) and related interpretations. Under the intrinsic value method, compensation expense for the Company's option grants was only recognized if the exercise price of the employee stock option was less than the market price of the underlying stock on the date of grant. If a company elected to use the intrinsic value method, pro forma disclosures of earnings and earnings per share were required as if the fair value method of accounting had been applied. The Company previously elected to account for its stock options under the intrinsic value method and therefore computed and disclosed the required pro forma disclosures.

SFAS 123R provides for two alternative methods of adoption: the modified retrospective method and the modified prospective method. While the modified retrospective method permits restatement of prior periods for comparability, the Company has elected to apply the modified prospective method. The modified prospective method calls for unvested options as of January 1, 2006 and options granted after January 1, 2006 to be expensed in accordance with SFAS 123R after that date. Compensation expense under the fair value method for prior periods is not reflected in the financial statements of those periods but was disclosed on a pro forma basis. The table below presents the Company's pro forma earnings information as if stock options issued prior to January 1, 2006, were expensed in prior periods.

	<b>Three Months Ended</b>	<b>Nine Months Ended</b>
	<b>September 30, 2005</b>	
	<b>(Dollars in thousands, except per share data)</b>	
	<b>(Unaudited)</b>	
Net income, as reported	\$ 970	\$ 1,805
Add: Stock-based employee compensation expense included in reported net income, net of income taxes	29	87
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of income taxes	(92)	(270)
Pro forma net income	\$ 907	\$ 1,622
Income per common share:		
Basic as reported	\$ 0.18	\$ 0.33
Basic pro forma	\$ 0.16	\$ 0.29
Assuming dilution as reported	\$ 0.17	\$ 0.31
Assuming dilution pro forma	\$ 0.15	\$ 0.28

The fair values for options granted under the Company's stock option plans were calculated at the date of grant using the Black-Scholes option pricing model. The estimated weighted average fair value at the date of grant for options vesting during the three and nine months ended September 30, 2006 and 2005 was \$0, \$9.48, \$0 and \$9.50, respectively.

The adoption of SFAS 123R has not altered the Company's methodology of computing option expense from that used to prepare the pro forma disclosures in previous years. Furthermore, at the present time, the Company does not plan to change its policies of stock option compensation with respect to the number of grants, terms, or alternative instruments as a result of the adoption of SFAS 123R. Stock-based employee compensation is based on the application of Emerging Issues Task Force No. 00-23, Issues Related to the Accounting for Stock Compensation under APB 25 and FASB Interpretation No. 44, which requires straight-line vesting of such awards over the full vesting period. At this time, the Company anticipates that 2006 after-tax stock option expense will be approximately \$111,000 or \$.02 per diluted share.

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as previously required. This requirement reduced net operating cash flows by approximately \$5.7 million and increased net financing cash flows by

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approximately \$5.7 million in the Company's Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2006.

The effect of the adoption of SFAS 123R on selected line items is as follows for the three and nine months ended September 30, 2006:

	<b>Three Months Ended September 30, 2006 Increase (Decrease)</b>	<b>Nine Months Ended September 30, 2006 Increase (Decrease)</b>
General and administrative expenses	\$ 50	\$ 163
Income before income taxes and extraordinary gain	(50)	(163)
Income taxes	(26)	(78)
Net income	(24)	(85)
Net income per common share - basic	(.00)	(.02)
Net income per common share - assuming dilution	(.00)	(.01)

No stock option expense was capitalized during the three and nine months ended September 30, 2006.

A summary of option activity for the nine-month period ended September 30, 2006 is presented below:

<b>Options</b>	<b>Shares</b>	<b>Weighted- Average Exercise Price</b>	<b>Weighted- Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value (in thousands)</b>
Outstanding at December 31, 2005	725,000	\$ 20.47		
Vested during the nine month period ended September 30, 2006	5,000	57.81	8.52	
Exercised during the nine months ended September 30, 2006	225,000	10.60		\$ 14,795
Outstanding at September 30, 2006	500,000	24.91	5.24	35,314
Exercisable at September 30, 2006	420,000	22.04	4.93	30,871
Vested or expected to vest at September 30, 2006	500,000	24.91	5.24	35,314

The total fair value of shares vesting during the three and nine months ended September 30, 2006 was \$0 and \$427,000, respectively.

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There were no shares exercised during the three months ended September 30, 2006. There were no options granted, forfeited or expired during the three or nine months ended September 30, 2006.

Information about the Company's unrecognized stock-based compensation at September 30, 2006 is as follows:

Unrecognized compensation	\$ 138,000
Weighted average period of expected recognition (in years)	.65

(h) *Recent Accounting Pronouncements* In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that a company has taken or expects to take on a tax return. The accounting provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is in the process of determining the effect the adoption of FIN 48 will have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies whenever other accounting standards require or permit assets or liabilities to be measured at fair

**Table of Contents****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

value; accordingly, it does not expand the use of fair value in any new circumstances. Fair value under SFAS 157 is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, a reporting entity's own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the provisions of SFAS 157.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108)*, which provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. Two approaches are commonly used to evaluate the materiality of misstatements or errors in financial statements: the rollover, also known as the current-period or income-statement approach, and the iron curtain, also known as the cumulative or balance-sheet approach. The rollover approach quantifies a misstatement based on the amount of the error originating in the current-period income statement. This approach could allow balance sheet items to grow each year by immaterial amounts, until the cumulative error becomes material. The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current period. This approach does not consider the income statement effects of correcting prior year misstatements in the current year to be errors. The reliance on only one of these approaches, to the exclusion of the other, does not appropriately quantify all misstatements that could be material to financial-statement users. Accordingly, SAB 108 will require quantification of financial statement errors based on the effects of the error on each of a company's financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it essentially requires quantification of errors under both the iron-curtain and the roll-over approaches. From a transition perspective, SAB 108 permits companies to record the cumulative effect of initially applying the dual approach in the first year ending after November 15, 2006 by recording any necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The Company does not expect the adoption of SAB 108 to have a material affect on its results of operations, financial position or liquidity.

**Note 3: Partially Owned Equity Affiliates*****B.H. Acquisition***

In July 2000, the Company, through B.H. Acquisition, a joint venture with Castlewood Limited (Castlewood) and an entity controlled by Trident II, L.P. (Trident), acquired as an operating business two reinsurance companies, Brittany Insurance Company Ltd. (Brittany) and Compagnie Europeenne d'Assurances Industrielles S.A. (CEAI). Brittany and CEAI are principally engaged in the active management of books of reinsurance business from international markets. The Company owns 50% of the voting stock and a 33% economic interest in B.H. Acquisition. As part of the transaction, Castlewood owns 33% of the voting stock and a 45% economic interest in B.H. Acquisition. The Company's ownership in B.H. Acquisition is accounted for using the equity method of accounting.

***Castlewood Holdings Limited***

In November 2001, the Company, together with Trident and the shareholders and senior management of Castlewood (the Castlewood Principals ), completed the formation of a new venture, Castlewood Holdings, to acquire and manage insurance and reinsurance companies, including companies in run-off (insurance and reinsurance companies that have ceased the underwriting of new policies), and to provide management, consulting and other services to the insurance and reinsurance industry (the Castlewood Holdings Transaction ). The

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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

Company owns 50% of the voting stock of Castlewood Holdings and the Castlewood Principals and Trident each own 25% of Castlewood Holdings' voting stock. The Company owns a 32.03% economic interest in Castlewood Holdings. Castlewood is a private Bermuda-based firm, experienced in managing and acquiring reinsurance operations. The Company's ownership in Castlewood Holdings is accounted for using the equity method of accounting.

As a result of this transaction, the Company's 33% direct economic interest in B.H. Acquisition increased by an additional indirect economic interest through Castlewood Holdings. At September 30, 2006, the Company's beneficial ownership in B.H. Acquisition was 47.41%. The Company's combined voting interest in B.H. Acquisition is limited to 50%.

In conjunction with the closing of the Castlewood Holdings Transaction, a wholly owned subsidiary of Castlewood Holdings completed the acquisition of two reinsurance companies in run-off, River Thames Insurance Company Limited ( River Thames ), based in London, England, and Overseas Reinsurance Corporation Limited ( Overseas Reinsurance ), based in Bermuda. The total purchase price of River Thames and Overseas Reinsurance was approximately \$15.2 million.

In August 2002, Castlewood Holdings purchased Hudson Reinsurance Company Limited ( Hudson ), a Bermuda-based company, for approximately \$4.1 million. Hudson reinsured risks relating to property, casualty and workers compensation, on a worldwide basis, and is now administering the run-off of its claims.

Also in 2002, Castlewood Holdings capitalized Fitzwilliam (SAC) Insurance Limited ( Fitzwilliam ), a wholly owned subsidiary. Fitzwilliam, based in Bermuda, offers specialized reinsurance protections to related companies, clients of Castlewood Holdings and other third-party companies.

In March 2003, Castlewood Holdings and Shinsei Bank, Limited ( Shinsei ) completed the acquisition of all of the outstanding capital stock of The Toa-Re Insurance Company (UK) Limited ( Toa-UK ), a London-based subsidiary of The Toa Reinsurance Company, Limited, for approximately \$46 million. Toa-UK underwrote reinsurance business throughout the world between 1980 and 1994, when it stopped writing new business and is currently operating in run-off. The acquisition was effected through Hillcot Holdings Ltd. ( Hillcot ), a newly formed Bermuda company, in which Castlewood Holdings has a 50.1% economic interest and a 50% voting interest. Upon completion of the transaction, Toa-UK's name was changed to Hillcot Re Limited. Hillcot is included in Castlewood Holdings' consolidated financial statements, with the remaining 49.9% economic interest reflected as minority interest. J. Christopher Flowers ( Mr. Flowers ), a member of the Company's board of directors and the Company's largest shareholder, is a director and the largest shareholder of Shinsei.

In August 2004, Castlewood Holdings implemented an employee stock-based compensation plan. The plan allows for the award of Castlewood Holdings' Class D non-voting shares to certain senior employees up to a maximum of 7.5% of the total issued share capital of Castlewood Holdings. As a result of awards made in 2005 and 2004, the Company's economic interest in Castlewood Holdings of 33 1/3% has been diluted by 1.30% to 32.03% as of September 30, 2006. As awarded shares vest and as additional shares are awarded in the future, the Company's economic interest could decrease to a minimum of 30.83%. The Company's voting interest will remain at 50%.

During 2004, Castlewood Holdings, through one of its subsidiaries, invested a total of approximately \$9.1 million in Cassandra Equity LLC and Cassandra Equity (Cayman) LP, (collectively, Cassandra ), for a 27% interest in each. Cassandra was formed to invest in equity shares of a publicly traded international reinsurance company. J.C. Flowers I

LP also owned a 27% interest in Cassandra. J.C. Flowers I LP is a private investment fund, the general partner of which is JCF Associates I LLC. Mr. Flowers is the managing member of JCF Associates I LLC. In March 2005, Cassandra sold all of its holdings for total proceeds of approximately \$40.0 million. Castlewood Holdings proportionate share of the proceeds was approximately \$10.8 million.

Also during 2004, Castlewood Holdings, through one of its subsidiaries, completed the acquisition of Mercantile Indemnity Company Ltd., Harper Insurance Limited (formerly Turegum Insurance Company) and Longmynd Insurance Company Ltd. (formerly Security Insurance (UK) Ltd.) for a total purchase price of



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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

approximately \$4.5 million. Castlewood Holdings recorded an extraordinary gain of approximately \$21.8 million relating to the excess of the fair value of the net assets acquired over the cost of these acquisitions.

In May 2005, Castlewood Holdings, through one of its subsidiaries, purchased Fieldmill Insurance Company Limited (formerly known as Harleysville Insurance Company (UK) Limited) for approximately \$1.4 million.

In December 2005, Castlewood Holdings, through two of its wholly-owned subsidiaries, invested approximately \$24.5 million in New NIB Partners LP ( NIB Partners ), a newly formed Province of Alberta limited partnership, in exchange for an approximately 1.4% interest. NIB Partners was formed for the purpose of purchasing, together with certain affiliated entities, 100% of the outstanding share capital of NIBC N.V. (formerly, NIB Capital N.V.) and its affiliates ( NIBC ). NIBC is a merchant bank focusing on the mid-market segment in northwest Europe with a global distribution network. NIB Partners and certain related entities are indirectly controlled by New NIB Limited, an Irish corporation. Mr. Flowers is a director of New NIB Limited and is on the supervisory board of NIBC. Certain affiliates of J.C. Flowers I LP also participated in the acquisition of NIBC.

In March 2006, Castlewood Holdings and Shinsei completed the acquisition of Aioi Insurance Company of Europe Limited ( Aioi Europe ), a London-based subsidiary of Aioi Insurance Company, Limited, for £62 million (approximately \$108 million), with £50 million in cash upon the closing of the transaction and £12 million in the form of a promissory note, payable twelve months from the date of the closing. Aioi Europe underwrote general insurance and reinsurance business in Europe for its own account until 2002 when it generally ceased underwriting, and placed into run-off, its general insurance and reinsurance business. The acquisition was effected through Hillcot. The acquisition has been accounted for using the purchase method of accounting. Castlewood Holdings recorded an extraordinary gain of approximately \$4.3 million (net of minority interest of \$4.3 million) relating to the excess of the fair value of the assets acquired over their cost. Upon completion of the transaction, Aioi Europe's name was changed to Brampton Insurance Company Limited ( Brampton ). In April 2006, Hillcot entered into a facility loan agreement with an international bank (the Facility ) and drew down approximately \$44.4 million from the Facility to repay shareholder funds advanced for the acquisition of Brampton. The Facility has an interest rate of LIBOR plus 2%, is repayable within four years, and is secured by a first charge over Hillcot's shares in Brampton together with a floating charge over Hillcot's assets. In May 2006, Brampton completed the repurchase of £40 million of its shares (\$73.8 million). The proceeds of the share repurchase were used to repay the £12.1 million promissory note and accumulated interest, reduce the Facility by approximately \$25.2 million, and return approximately \$23.2 million to Hillcot's shareholders.

Also in March 2006, Castlewood Holdings approved a commitment of up to \$75.0 million in J.C. Flowers II LP (the J.C. Flowers Fund ), a private investment fund formed by J.C. Flowers & Co. LLC. In June 2006, the commitment was accepted by the J.C. Flowers Fund. Castlewood Holdings' commitments may be drawn down by the J.C. Flowers Fund over approximately the next five years. Castlewood Holdings intends to use cash on hand to fund its commitment. As of September 30, 2006, approximately \$5.7 million of the commitment had been funded. J.C. Flowers & Co. LLC is controlled by Mr. Flowers. No fees will be payable by Castlewood Holdings to the J.C. Flowers Fund, J.C. Flowers & Co. LLC, or Mr. Flowers in connection with Castlewood Holdings' investment in the J.C. Flowers Fund.

In April 2006, Castlewood Holdings paid a dividend of approximately \$27.9 million to its shareholders and redeemed approximately \$22.1 of Class E non-voting redeemable shares. Enstar's portion of this dividend was approximately \$20.1 million.

In June 2006, Castlewood Holdings entered into a definitive agreement for the purchase of Cavell Holdings Limited ( Cavell ), a U.K. company, from Dukes Place Holdings, L.P. ( Dukes Place ), a portfolio company of GSC Partners, for a purchase price of approximately £32 million (approximately \$59 million). Cavell owns a U.K. reinsurance company and a Norwegian reinsurer, both of which are currently in run-off. Cavell had total consolidated assets of approximately £101 million (approximately \$176 million) at March 31, 2006, as reported in its U.K. regulatory statements. (Note 11)

Also in June 2006, a subsidiary of Castlewood Holdings, in an unrelated transaction, entered into a definitive agreement with Dukes Place for the purchase of a minority interest in a U.S. holding company that owns two

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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

property and casualty insurers based in the U.S., both of which are in run-off. Completion of the transaction is conditioned on, among other things, governmental and regulatory approvals and satisfaction of various other closing conditions. The transaction is expected to close in the first quarter of 2007.

In September 2006, a subsidiary of Castlewood Holdings signed a definitive agreement to acquire 100% of the issued share capital of Unione Italiano (UK) Reinsurance Ltd for a purchase price of approximately \$17 million. Completion of the acquisition, which is subject to approval by the UK insurance regulator, the Financial Services Authority, is expected during the fourth quarter of 2006.

***Affirmative Investment LLC***

In June 2005, the Company committed to contribute up to \$10 million for a 14%, non-voting interest in Affirmative Investment LLC ( Affirmative Investment ), a newly formed Delaware limited liability company. J.C. Flowers I LP committed the capital necessary for the remaining 86% interest in Affirmative Investment. Both J.C. Flowers I LP and Affirmative Associates LLC, the managing member of Affirmative Investment, are controlled by Mr. Flowers, a member of the Company's board of directors and the Company's largest shareholder. In July 2005, the Company funded its initial capital contribution of approximately \$2.6 million. Since that time, the Company has funded additional capital contributions of approximately \$5.7 million. At September 30, 2006, the Company's total investment in Affirmative Investment was approximately \$8.8 million, including equity in earnings from July 1, 2005 to September 30, 2006. The Company's ownership in Affirmative Investment is accounted for using the equity method of accounting.

Also in June 2005, Affirmative Investment acquired 1,183,000 shares of common stock of Affirmative Insurance Holdings, Inc. ( Affirmative Insurance ), through open market purchases. In August, Affirmative Investment acquired 50% of the membership interests of New Affirmative LLC ( NAL ), a newly formed Delaware limited liability company, for approximately \$40.7 million in cash and the 1,183,000 shares of Affirmative Insurance. The remaining 50% of the membership interests of NAL were acquired by Delaware Street Capital Master Fund, LP or its affiliates ( DSC ) for approximately \$37.5 million in cash and 1,459,699 shares of Affirmative Insurance common stock. In turn, NAL, pursuant to a Stock Purchase Agreement with Vesta Insurance Group, Inc. ( VIG ) and Vesta Fire Insurance Corporation, a subsidiary of VIG (together with VIG, Vesta ), acquired from Vesta an aggregate of 5,218,228 shares of Affirmative Insurance common stock for a purchase price of \$15.00 per share. Upon the closing of the transaction with Vesta and the transfer of the shares of Affirmative Insurance from Affirmative Investment and DSC, NAL's ownership percentage in Affirmative Insurance was approximately 52.9%. Due to the issuance of new shares by Affirmative Insurance, NAL's ownership percentage was reduced to approximately 52% at September 30, 2006. Affirmative Investment's ownership in NAL is accounted for using the equity method of accounting. Affirmative Investment accounts for its investment in NAL three months in arrears.

In August 2006, Affirmative Investment purchased all of DSC's membership interests in NAL for approximately \$62.9 million. Upon consummation of the transaction, Affirmative Investment's interest in NAL increased from 50% to 100%. Enstar did not fund additional capital contributions to Affirmative Investment, effectively reducing its ownership percentage to 7%.



Table of Contents**THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Summarized Financial Information*

In accordance with APB No. 18, "The Equity Method of Accounting for Investments in Common Stock", the Company prepared summarized financial information for B.H. Acquisition and Castlewood Holdings as of September 30, 2006 and December 31, 2005 and for the three and nine months ended September 30, 2006 and 2005, respectively. The summarized financial information presented below for B.H. Acquisition and Castlewood Holdings is derived from their respective audited financial statements for December 31, 2005 and their unaudited quarterly financial statements.

	<b>September 30, 2006</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Total assets	\$ 104,332	\$ 1,466,646
Total liabilities	64,386	1,149,082
Minority interest		50,116
Total equity	39,946	267,448

	<b>December 31, 2005</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Total assets	\$ 105,578	\$ 1,199,963
Total liabilities	66,733	898,513
Minority interest		40,544
Total equity	38,845	260,906

	<b>Three Months Ended September 30, 2006</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Revenue		\$ 9,350
Operating income	\$ 516	14,417
Net income	516	10,996

	<b>Nine Months Ended September 30, 2006</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Revenue		\$ 20,950
Operating income	\$ 1,100	38,385
Net income	1,100	35,183

	<b>Three Months Ended September 30, 2005</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Revenue		\$ 5,180
Operating income	\$ 139	4,494
Net income (loss)	139	3,833

**Table of Contents****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Nine Months Ended September 30, 2005</b>	
	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>
	<b>(Dollars in thousands)</b>	
Revenue		\$ 13,525
Operating income	\$ 68	10,814
Net income (loss)	68	7,914

The Company's consolidated accumulated deficit includes undistributed earnings of its partially owned equity affiliates of approximately \$44.5 million and approximately \$52.6 million at September 30, 2006 and December 31, 2005, respectively.

**Note 4: Other Investments**

In December 2005, the Company invested approximately \$3.5 million in NIB Partners, a newly formed Province of Alberta limited partnership, in exchange for an approximately .2% limited partnership interest. NIB Partners was formed for the purpose of purchasing, together with certain affiliated entities, 100% of the outstanding share capital of NIBC. NIBC is a merchant bank focusing on the mid-market segment in northwest Europe with a global distribution network. In April 2006, the Company received a distribution of \$255,000 from its investment in NIB Partners consisting of \$199,000 in dividend income and a return of capital of \$56,000.

NIB Partners and certain related entities are indirectly controlled by New NIB Limited, an Irish corporation. Mr. Flowers is a director of New NIB Limited and is on the supervisory board of NIBC. Certain affiliates of J.C. Flowers I LP also participated in the acquisition of NIBC. The Company's investment in NIB Partners is accounted for at cost.

In August 2006, the Company funded approximately \$1.9 million of its original commitment of up to \$25.0 million in the J.C. Flowers Fund, a private investment fund formed by J.C. Flowers & Co. The Company's investment in the J.C. Flowers Fund is accounted for at cost.

**Note 5: Commitments and Contingencies**

In December 2004, the Company signed a one year lease beginning January 1, 2005 on an office building at 401 Madison Avenue, Montgomery, Alabama which serves as the corporate headquarters. The lease also provides renewal options for three periods of one year each. In December 2005, the Company signed a one year renewal option beginning January 1, 2006. Additionally, pursuant to an oral agreement, the Company leases space in a warehouse at 703 Howe Street, Montgomery, Alabama on a month-to-month basis. The Company leases the office building and warehouse space from unaffiliated third parties for \$3,000 and \$350 per month, respectively. The Company believes the rental amounts are competitive with market rates and that the cancellation or termination of either of these leases would not have a material adverse effect on the Company's results of operations. In September 2005, the Company entered into an agreement with J.C. Flowers & Co. LLC continuing through October 2014 for the use of certain office space and administrative services from J.C. Flowers & Co. LLC for monthly payments of \$4,146. Either party may, at

its option with or without cause, terminate this agreement upon thirty (30) days prior written notice to the other party. J.C. Flowers & Co. LLC is managed by Mr. Flowers, a member of the Company's board of directors and the Company's largest shareholder. The Company does not own any real property. Including payments made to J.C. Flowers & Co. LLC, the Company incurred rent expense in the amount of \$16,488, \$49,464, \$19,268 and \$60,584 for the three and nine months ended September 30, 2006 and 2005, respectively.

In February 2006, the Company approved a commitment of up to \$25.0 million in the J.C. Flowers Fund, a private investment fund formed by J.C. Flowers & Co. LLC. In June 2006, the commitment was accepted by the J.C. Flowers Fund. The Company's commitments may be drawn down by the J.C. Flowers Fund over approximately the next five years. The Company intends to use cash on hand to fund its commitment. As of September 30, 2006, approximately \$1.9 million of the commitment has been funded. No fees will be payable by the Company to J.C.



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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

Flowers II LP, J.C. Flowers & Co. LLC, or Mr. Flowers in connection with the Company's investment in the J.C. Flowers Fund.

**Note 6: Stock Compensation**

In May 2006, Nimrod T. Frazer, the Company's Chairman and Chief Executive Officer, exercised 150,000 stock options in connection with the 1997 Amended CEO Stock Option Plan. In addition, three of the Company's non-employee directors exercised a total of 75,000 stock options in connection with the 1997 Amended Outside Directors' Stock Option Plan. Upon exercise of the options, the Company received approximately \$2.1 million and 3,525 shares of the Company's common stock in payment of the options.

**Note 7: Income Taxes**

Income tax expense was approximately \$2.3 million and approximately \$4.8 million for the three and nine months ended September 30, 2006, respectively, compared to \$794,000 and approximately \$1.5 million for the same periods in 2005. The Company's effective tax rates for 2006 and 2005 differ from the statutory rate primarily due to changes in the valuation allowance related to deferred tax assets, tax contingencies and state income taxes.

The Company provides U.S. taxes for the anticipated repatriation of certain earnings of foreign subsidiaries. A valuation allowance is recorded when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability to generate sufficient taxable income in the future in the appropriate jurisdictions. The Company has provided a valuation allowance for operating losses of partially owned foreign subsidiaries at September 30, 2006 and December 31, 2005.

The Company has established reserves for tax-related uncertainties based on its best estimates of whether, and the extent to which, additional taxes and interest will be due. These reserves are adjusted in light of changing facts and circumstances. Accruals of \$2.3 million for tax contingencies are reflected in accrued taxes in the consolidated balance sheets at September 30, 2006 and December 31, 2005.

In the second quarter of 2006, additional paid-in capital increased by approximately \$5.7 million as a result of an income tax benefit. This income tax benefit resulted from tax deductions triggered by the exercise of stock options by Nimrod T. Frazer, the Company's Chairman and Chief Executive Officer, and three of the Company's non-employee directors.

**Note 8: Segment Information**

The Company separately evaluates the performance of B.H. Acquisition and Castlewood Holdings based on the different services provided by each of the entities, and such evaluation is based on 100% of the entities' results of operations. Because the Company separately evaluates the financial results of B.H. Acquisition and Castlewood Holdings on a gross basis, the amounts presented herein represent the gross results of each entity. The amounts in excess of the Company's ownership percentage are eliminated as part of the reconciliation from the gross amounts presented to the measure of profit or loss included in the consolidated financial statements. The Company also reviews separate financial results for Affirmative Investment and Enstar's corporate activity.

B.H. Acquisition, through its wholly owned subsidiaries, Brittany and CEAI, is principally engaged in the active management of books of reinsurance business from international markets. Castlewood Holdings acquires and manages insurance and reinsurance companies, including companies in run-off, and provides management, consulting and other services to the insurance and reinsurance industry. Affirmative Investment was formed to facilitate the participation of its members in the purchase, sale and ownership of membership interests of NAL and common stock of Affirmative Insurance.

Table of Contents**THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A reconciliation of the consolidated financial information by segment to the Company's consolidated financial statements as of September 30, 2006 and December 31, 2005 and for the three and nine months ended September 30, 2006 and 2005, respectively, is as follows:

	<b>September 30, 2006</b>				
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Total reportable segment assets:					
Partially owned equity affiliates		\$ 13,269	\$ 77,569	\$ 8,840	\$ 99,678
Corporate assets	\$ 100,601				100,601
Total	\$ 100,601	\$ 13,269	\$ 77,569	\$ 8,840	\$ 200,279

	<b>December 31, 2005</b>				
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Total reportable segment assets:					
Partially owned equity affiliates		\$ 12,906	\$ 85,908	\$ 8,515	\$ 107,329
Corporate assets	\$ 77,891				77,891
Total	\$ 77,891	\$ 12,906	\$ 85,908	\$ 8,515	\$ 185,220

	<b>Three Months Ended September 30, 2006</b>				
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Revenue			\$ 9,350		
Net investment income		\$ 1,262	12,712		
Interest income	\$ 1,237				
Net (increase) reduction in loss and loss adjustment expense liabilities		(337)	3,920		
General and administrative expenses	(745)	(658)	(12,150)		
Amortization of run-off provision		250			

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Interest expense			(362)		
Other income	121				
Foreign exchange gain (loss)		(1)	947		
Share of net income of partly-owned companies			232		
Income before income taxes	613	516	14,649		
Income tax expense	(2,260)		(1,034)		
Minority interest			(2,619)		
Net income (loss)	\$ (1,647)	\$ 516	\$ 10,996		
Company's economic ownership %		33%	32.03%		
Earnings of partially owned equity affiliates		\$ 170	\$ 3,522	\$ 198	\$ 3,890

**Table of Contents****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Nine Months Ended September 30, 2006</b>				
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Revenue			\$ 20,950		
Net investment income	\$ 199	\$ 3,091	33,438		
Interest income	3,086				
Net (increase) reduction in loss and loss adjustment expense liabilities		(1,010)	10,700		
General and administrative expenses	(4,245)	(1,811)	(34,723)		
Amortization of run-off provision		750			
Interest expense			(894)		
Other income	330				
Foreign exchange gain		80	8,914		
Share of net income of partly-owned companies			495		
Income (loss) before income taxes	(630)	1,100	38,880		
Income tax expense	(5,355)		(239)		
Minority interest			(7,805)		
Income (loss) before extraordinary gain	(5,985)	1,100	30,836		
Extraordinary gain, net of minority interest			4,347		
Net income (loss)	\$ (5,985)	\$ 1,100	\$ 35,183		
Company's economic ownership %		33%	32.24%		
			11,342		
Company's portion of pre-tax extraordinary gain			(1,418)		
Earnings of partially owned equity affiliates		\$ 363	\$ 9,924	\$ 358	\$ 10,645

The income tax amount of approximately \$5.4 million included in the corporate segment includes \$543,000 which is netted against the Company's proportionate share of an extraordinary gain in the Company's consolidated statement of income. The Company's economic ownership percentage in Castlewood Holdings decreased from 32.63% to 32.03% during the second quarter of 2006. The Company's economic ownership percentage in Castlewood Holdings used in the table above for the nine months ended September 30, 2006 represents a weighted average for the period. (Note 3)



**Table of Contents****THE ENSTAR GROUP, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Three Months Ended September 30, 2005</b>				<b>Total</b>
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	
	<b>(Dollars in thousands)</b>				
Revenue			\$ 5,180		
Net investment income (loss)	\$ 487	\$ 680	7,866		
Interest income	608				
Net (increase) reduction in loss and loss adjustment expense liabilities		(290)	1,043		
General and administrative expenses	(617)	(601)	(9,372)		
Amortization of run-off provision		334			
Other income	100				
Foreign exchange gain (loss)		16	(223)		
Share of net income of partly-owned companies			63		
Income (loss) before income taxes	578	139	4,557		
Income tax expense	(794)		(285)		
Minority interest			(439)		
Net income (loss)	\$ (216)	\$ 139	\$ 3,833		
Company's economic ownership %		33%	32.63%		
Earnings (loss) of partially owned equity affiliates		\$ 46	\$ 1,250	\$ (110)	\$ 1,186

	<b>Nine Months Ended September 30, 2005</b>				<b>Total</b>
	<b>Corporate</b>	<b>B.H. Acquisition</b>	<b>Castlewood Holdings</b>	<b>Affirmative Investment</b>	
	<b>(Dollars in thousands)</b>				
Revenue			\$ 13,525		
Net investment income (loss)	\$ 1,091	\$ 1,578	21,149		
Interest income	1,651				
Net (increase) reduction in loss and loss adjustment expense liabilities		(870)	6,466		
General and administrative expenses	(2,258)	(1,600)	(27,908)		
Amortization of run-off provision		1,000			
Other income	301				
Foreign exchange loss		(40)	(2,418)		

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Share of net income of partly-owned companies				142		
Income (loss) before income taxes	785	68	10,956			
Income tax expense	(1,477)		(1,612)			
Minority interest			(1,430)			
Net income (loss)	\$ (692)	\$ 68	\$ 7,914			
Company's economic ownership %		33%	32.65%			
Earnings (loss) of partially owned equity affiliates		\$ 23	\$ 2,584	\$ (110)	\$ 2,497	

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The Company's economic ownership percentage in Castlewood Holdings decreased from 32.89% to 32.63% during the second quarter of 2005. The Company's economic ownership percentage used in the table above for the nine months ended September 30, 2005 represents a weighted average for the period.

**Note 9: Income per Share**

The table below illustrates the reconciliation between net income per common share—basic and net income per common share—assuming dilution for the three and nine months ended September 30, 2006 and 2005. Net income per common share—basic is computed by dividing net income by the weighted average shares outstanding. Net income per common share—assuming dilution is computed by dividing net income by the sum of the weighted average shares outstanding and common share equivalents. Common share equivalents consist of stock units deferred under the Deferred Compensation and Stock Plan for Non-Employee Directors and stock options granted under the Company's stock option/incentive plans.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(Dollars in thousands, except per share data)</b>			
	<b>(Unaudited)</b>			
Income before extraordinary gain	\$ 2,243	\$ 970	\$ 5,203	\$ 1,805
Extraordinary gain, net of income taxes			875	
Net income	\$ 2,243	\$ 970	\$ 6,078	\$ 1,805
Income per common share before extraordinary gain—basic	\$ 0.39	\$ 0.18	\$ 0.92	\$ 0.33
Extraordinary gain, net of income taxes—basic			0.16	
Net income per common share—basic	\$ 0.39	\$ 0.18	\$ 1.08	\$ 0.33
Income per common share before extraordinary gain—assuming dilution	\$ 0.37	\$ 0.17	\$ 0.87	\$ 0.31
Extraordinary gain, net of income taxes—assuming dilution			0.15	
Net income per common share—assuming dilution	\$ 0.37	\$ 0.17	\$ 1.02	\$ 0.31
Weighted average shares outstanding—basic	5,739,384	5,517,909	5,621,279	5,517,909
Common share equivalents	263,064	344,263	318,471	334,687
	6,002,448	5,862,172	5,939,750	5,852,596

Weighted average shares outstanding assuming  
dilution

There were no antidilutive common stock equivalents for the three and nine months ended September 30, 2006 and 2005.

**Note 10: Plan of Merger**

On May 23, 2006, the Company entered into a definitive Agreement and Plan of Merger (the Merger Agreement ) with Castlewood Holdings and CWMS Subsidiary Corp., a Georgia corporation and a direct wholly-owned subsidiary of Castlewood Holdings, pursuant to which CWMS Subsidiary Corp. will be merged (the Merger ) with and into Enstar, and Enstar, which will be renamed Enstar USA, Inc., will become a direct wholly-owned subsidiary of Castlewood Holdings. Holders of shares of Enstar common stock will be entitled to receive one ordinary share of Castlewood Holdings in the Merger for each share of Enstar common stock they own.

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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

Immediately following the Merger, shareholders of Enstar will hold approximately 48.7% of the outstanding ordinary shares of the combined entity, which will be based in Bermuda and is expected to list its shares on Nasdaq. Enstar also expects to pay, in connection with but prior to the Merger, a special dividend of \$3.00 per share, or approximately \$17.3 million in the aggregate. The record date for such dividend will be set at a later date and announced prior to the consummation of the Merger.

The Board of Directors of each of Enstar and Castlewood Holdings unanimously approved the terms and conditions of the Merger Agreement. The transaction is expected to close during the fourth quarter of 2006, subject to the satisfaction of various closing conditions, including the approval by the shareholders of Enstar and Castlewood Holdings and the obtaining of certain governmental and regulatory approvals and decisions. The Merger is intended to qualify as a reorganization for federal income tax purposes.

On May 23, 2006, J. Christopher Flowers, John J. Oros and Nimrod T. Frazer, who collectively beneficially own approximately 36% of the shares and approximately 30% of the voting power of Enstar, entered into a Support Agreement (the Support Agreement) with Castlewood Holdings pursuant to which such shareholders agreed, among other things, to vote their shares of common stock of Enstar in favor of the adoption and approval of the Merger Agreement and the Merger.

In addition, on May 23, 2006, Castlewood Holdings, Enstar, Trident and certain other shareholders of Castlewood Holdings entered into a Recapitalization Agreement (the Recapitalization Agreement), which provides, among other things, for: a recapitalization of Castlewood Holdings in which all outstanding shares will be exchanged for newly created ordinary shares; the designation of the initial Board of Directors of Castlewood Holdings immediately following the Merger; repurchases of certain shares of Castlewood Holdings from Trident and its affiliates; payments in respect of certain other shares of Castlewood Holdings; the purchase by Castlewood Holdings or its designee of the shares of B.H. Acquisition Ltd., a Bermuda company, held by an affiliate of Trident; and the adoption of new bye-laws that will include, among other things, certain restrictions on transfers and voting of the ordinary shares. Castlewood Holdings shareholders holding the number of shares required to approve the Recapitalization Agreement and the transactions contemplated thereby have agreed to vote in favor of such agreements and transactions.

The Recapitalization Agreement also restricts the transfer by the shareholders party thereto of Castlewood Holdings shares received in the recapitalization for one year, subject to certain exceptions, and provides that at the time of the recapitalization certain shareholders of Castlewood Holdings will enter into a registration rights agreement entitling them to require Castlewood Holdings to register their ordinary shares of Castlewood Holdings for resale under the United States Securities Act of 1933, as amended, beginning one year after the consummation of the merger, although Trident and certain of its affiliates have the right to register up to 750,000 shares of their Castlewood Holdings stock 90 days after the consummation of the merger. The directors of Enstar have agreed to similar transfer restrictions on their shares of Castlewood Holdings, and will receive registration rights pursuant to the same registration rights agreement.

Also on May 23, 2006, Castlewood Holdings entered into a tax indemnification agreement with Mr. Flowers pursuant to which Castlewood Holdings will reimburse and indemnify Mr. Flowers for, and hold him harmless on an after-tax basis against, any increase in Mr. Flower's U.S. federal, state or local income tax liability (including any interests or penalties relating thereto), and reasonable attorneys' fees, incurred by Mr. Flowers as a result of certain dispositions of shares of Enstar or dispositions of all or substantially all of the Enstar assets by Castlewood Holdings within the period beginning immediately after the effective time of the Merger and ending five years after the last day of the

taxable year that includes the effective time.

Castlewood Holdings also has agreed, subject to consummation of the Merger Agreement, to repurchase from two directors of Enstar, T. Whit Armstrong and T. Wayne Davis, upon their request, during a 30-day window period commencing January 15, 2007, at then prevailing market prices, such number of shares as provides an amount sufficient for T. Whit Armstrong and T. Wayne Davis to pay taxes on compensation income resulting from the exercise of options in respect of a combined aggregate number not to exceed 50,000 shares repurchased.

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**THE ENSTAR GROUP, INC. AND SUBSIDIARIES**

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

Enstar currently owns 50% of the voting stock of Castlewood Holdings. Trident and certain members of management of Castlewood Holdings each own 25% of Castlewood Holdings voting stock. Enstar owns an approximately 32% economic interest in Castlewood Holdings.

**Note 11: Subsequent Event**

In October 2006, the Company funded approximately \$3.8 million of additional capital contributions in the J.C. Flowers Fund and received a \$348,000 refund of excess contributions originally paid in August 2006. In October 2006, Castlewood Holdings funded approximately \$10.4 million of additional capital contributions in the J.C. Flowers Fund and received an approximately \$1.0 million refund of excess contributions originally paid in August 2006.

In October 2006, The Company announced that a subsidiary of its partially owned equity affiliate, Castlewood Holdings, completed the acquisition of Cavell, a U.K. company, from Dukes Place for approximately £32 million (approximately \$60 million). Approximately 40% of the purchase price was funded with a loan from an international bank and the remainder was paid from cash on hand. As announced on June 20, 2006, Cavell owns a U.K. and a Norwegian reinsurance company, both of which are currently in run-off.

In connection with the Merger Agreement discussed in Note 10, Castlewood Holdings filed Amendment No. 2 to its Form S-4 with the SEC on November 6, 2006.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders of  
The Enstar Group, Inc.  
Montgomery, Alabama

We have reviewed the accompanying condensed consolidated balance sheet of The Enstar Group, Inc. and Subsidiaries ( Enstar ) as of September 30, 2006, and the related condensed consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2006 and 2005, and of cash flows for the nine-month periods ended September 30, 2006 and 2005. These interim financial statements are the responsibility of Enstar s management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Enstar as of December 31, 2005, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for the year then ended (not presented herein); and in our report dated March 16, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Birmingham, Alabama  
November 9, 2006

**Table of Contents****Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations*****Overview**

Through the operations of The Enstar Group, Inc. and Subsidiaries (the Company or Enstar) partially owned equity affiliates, Castlewood Holdings Limited (Castlewood Holdings) and B.H. Acquisition Limited (B.H. Acquisition), and their subsidiaries, the Company acquires and manages insurance and reinsurance companies in run-off. The management of these businesses includes claims administration, adjustment and settlement together with the collection of reinsurance recoveries. Castlewood Holdings, a Bermuda-based company, also provides management, consulting and other services to the insurance and reinsurance industry for both fixed and success-based fee arrangements. In general, reinsurance is an arrangement in which the reinsurer agrees to indemnify an insurance or reinsurance company against all or a portion of the risks underwritten by such insurance or reinsurance company under one or more insurance or reinsurance contracts. For a discussion of certain risks and uncertainties relating to the Company's participation in the reinsurance industry see Item 1A. Risk Factors to The Enstar Group, Inc.'s Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005, which is hereby incorporated by reference.

**Recent Accounting Pronouncements**

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that a company has taken or expects to take on a tax return. The accounting provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is in the process of determining the effect the adoption of FIN 48 will have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 applies whenever other accounting standards require or permit assets or liabilities to be measured at fair value; accordingly, it does not expand the use of fair value in any new circumstances. Fair value under SFAS 157 is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, a reporting entity's own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the provisions of SFAS 157.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108), which provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. Two approaches are commonly used to evaluate the materiality of misstatements or errors in financial statements: the rollover, also known as the current-period or income-statement approach, and the iron curtain, also known as the cumulative or balance-sheet approach. The rollover approach quantifies a misstatement based on the amount of the error originating in the current-period income statement. This approach could allow balance sheet items to grow each year by immaterial amounts, until the cumulative error becomes material. The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current period. This approach does not consider the income

statement effects of correcting prior year misstatements in the current year to be errors. The reliance on only one of these approaches, to the exclusion of the other, does not appropriately quantify all misstatements that could be material to financial-statement users. Accordingly, SAB 108 will require quantification of financial statement errors based on the effects of the error on each of a company's financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it essentially requires quantification of errors under both the iron-curtain and the roll-over approaches. From a transition perspective, SAB 108 permits companies to record the cumulative effect of initially applying the dual approach in the first year ending after November 15, 2006 by recording any necessary correcting adjustments to the carrying



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values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The Company does not expect the adoption of SAB 108 to have a material affect on its results of operations, financial position or liquidity.

## **Critical Accounting Policies**

### ***Enstar***

In the ordinary course of business, the Company has made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. The most significant accounting estimates inherent in the preparation of the Company's consolidated financial statements include estimates associated with its evaluation of the income tax valuation allowance.

***Income Tax Valuation Reserve*** The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. The effect of temporary differences on the financial statements includes certain operating losses of partially owned foreign subsidiaries and tax credit carryforwards. The Company has established a valuation allowance for the uncertainty of the realization of these and any other net deferred tax assets. However, utilization of the remaining deferred tax assets at September 30, 2006, is based on management's assessment of the Company's earnings history, expectations of future taxable income, and other relevant considerations.

### ***Castlewood Holdings and B.H. Acquisition***

Certain amounts in Castlewood Holdings' and B.H. Acquisition's consolidated financial statements are the result of transactions that require the use of best estimates and assumptions to determine reported values. These amounts could ultimately be materially different than what has been provided for in their consolidated financial statements. The assessment of loss reserves and reinsurance recoverable are considered to be the values requiring the most inherently subjective and complex estimates. In addition, the assessment of the possible impairment of goodwill involves certain estimates and assumptions. As such, the accounting policies for these amounts are of critical importance to their consolidated financial statements.

***Loss and Loss Adjustment Expenses*** Because a significant amount of time can lapse between the assumption of risk, the occurrence of a loss event, the reporting of the event to an insurance or reinsurance company and the ultimate payment of the claim on the loss event, Castlewood Holdings' and B.H. Acquisition's liability for unpaid losses and loss expenses is based largely upon estimates. Castlewood Holdings' and B.H. Acquisition's management must use considerable judgment in the process of developing these estimates. The liability for unpaid losses and loss expenses for property and casualty business includes amounts determined from loss reports on individual cases and amounts for losses incurred but not reported. Such reserves are reviewed and estimated by management based upon reports received from ceding companies, supplemented by Castlewood Holdings' and B.H. Acquisition's own estimates of reserves for which ceding company reports have not been received, and independent actuarial estimates of ultimate unpaid losses. Castlewood Holdings' and B.H. Acquisition's reserves are largely comprised of casualty exposures including asbestos and environmental exposures and therefore these claims are subject to a higher degree of estimation volatility as a result of changes in the legal environment, jury awards, medical cost trends and general inflation. Castlewood Holdings and B.H. Acquisition regularly review and update these estimates using the most current information available and employing various actuarial methods. The ultimate liability for a loss is likely to differ from the original estimate due to the factors discussed above. Adjustments resulting from changes in our

estimates are recorded in the period such adjustments are determined. The establishment of reserves, or the adjustment of reserves for reported losses, could result in significant upward or downward changes to our financial condition or results of our operations in the period such amounts are reported.

*Reinsurance Balances Receivable* One of the ways loss exposure is managed is through the use of reinsurance. While reinsurance arrangements are designed to limit losses and to permit recovery of a portion of direct unpaid losses, reinsurance does not relieve Castlewood Holdings or B.H. Acquisition of their liabilities to their insureds or reinsureds. Accordingly, loss reserves represent total gross losses, and reinsurance receivable represents anticipated recoveries of a portion of those unpaid losses as well as amounts receivable from reinsurers

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with respect to claims that have already been paid. Therefore, Castlewood Holdings and B.H. Acquisition evaluate and monitor concentration of credit risk among their reinsurers, including companies that are insolvent, in run-off or facing financial difficulties. Provisions are made for amounts considered potentially uncollectible.

*Goodwill* SFAS 142, Goodwill and Other Intangible Assets, requires that goodwill be assessed for impairment on at least an annual basis. In determining goodwill, Castlewood Holdings must determine the fair values of the assets of an acquired company. The determination of fair value necessarily involves many assumptions. Fair values of reinsurance assets and liabilities acquired are derived from probability weighted ranges of the associated projected cash flows, based on actuarially prepared information and management run-off strategy. Fair value adjustments are based on the estimated timing of loss and loss adjustment expense payments and an assumed interest rate, and are amortized over the estimated payout period, as adjusted for accelerations on commutation settlements, using the constant yield method options. Interest rates used to determine the fair value of gross loss reserves are based upon risk free rates applicable to the average duration of the loss reserves. Interest rates used to determine the fair value of reinsurance receivables are increased to reflect the credit risk associated with the reinsurers from who the receivables are, or will become, due. If the assumptions made in initially valuing the assets change significantly in the future, Castlewood Holdings may be required to record impairment charges which could have a material impact on the financial statements.

Castlewood Holdings assessed its recorded goodwill in 2005 in accordance with SFAS 142 and determined that there had been no impairment in its carrying value.

During the nine months ended September 30, 2006, Castlewood Holdings took negative goodwill into earnings upon the acquisition of Aioi Insurance Company of Europe Limited ( Aioi Europe ), and presented it as an extraordinary gain, in accordance with SFAS 141, Business Combinations. Upon completion of the transaction, Aioi Europe's name was changed to Brampton Insurance Company Limited ( Brampton ).

## **Plan of Merger**

On May 23, 2006, the Company entered into a definitive Agreement and Plan of Merger (the Merger Agreement ) with Castlewood Holdings and CWMS Subsidiary Corp., a Georgia corporation and a direct wholly-owned subsidiary of Castlewood Holdings, pursuant to which CWMS Subsidiary Corp. will be merged (the Merger ) with and into Enstar, and Enstar, which will be renamed Enstar USA, Inc., will become a direct wholly-owned subsidiary of Castlewood Holdings. Holders of shares of Enstar common stock will be entitled to receive one ordinary share of Castlewood Holdings in the Merger for each share of Enstar common stock they own.

Immediately following the Merger, shareholders of Enstar will hold approximately 48.7% of the outstanding ordinary shares of the combined entity, which will be based in Bermuda and is expected to list its shares on Nasdaq. Enstar also expects to pay, in connection with but prior to the Merger, a special dividend of \$3.00 per share, or approximately \$17.3 million in the aggregate. The record date for such dividend will be set at a later date and announced prior to the consummation of the Merger.

The Board of Directors of each of Enstar and Castlewood Holdings unanimously approved the terms and conditions of the Merger Agreement. The transaction is expected to close during the fourth quarter of 2006, subject to the satisfaction of various closing conditions, including the approval by the shareholders of Enstar and Castlewood Holdings and the obtaining of certain governmental and regulatory approvals and decisions. The Merger is intended to qualify as a reorganization for federal income tax purposes.

On May 23, 2006, J. Christopher Flowers, John J. Oros and Nimrod T. Frazer, who collectively beneficially own approximately 36% of the shares and approximately 30% of the voting power of Enstar, entered into a Support

Agreement (the Support Agreement ) with Castlewood Holdings pursuant to which such shareholders agreed, among other things, to vote their shares of common stock of Enstar in favor of the adoption and approval of the Merger Agreement and the Merger.

In addition, on May 23, 2006, Castlewood Holdings, Enstar, Trident II, L.P. ( Trident ) and certain other shareholders of Castlewood Holdings entered into a Recapitalization Agreement (the Recapitalization Agreement ), which provides, among other things, for: a recapitalization of Castlewood Holdings in which all outstanding shares will be exchanged for newly created ordinary shares; the designation of the initial Board of Directors of Castlewood Holdings immediately following the Merger; repurchases of certain shares of Castlewood Holdings from Trident and its affiliates; payments in respect of certain other shares of Castlewood Holdings; the purchase by

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Castlewood Holdings or its designee of the shares of B.H. Acquisition Ltd., a Bermuda company, held by an affiliate of Trident; and the adoption of new bye-laws that will include, among other things, certain restrictions on transfers and voting of the ordinary shares. Castlewood Holdings shareholders holding the number of shares required to approve the Recapitalization Agreement and the transactions contemplated thereby have agreed to vote in favor of such agreements and transactions.

The Recapitalization Agreement also restricts the transfer by the shareholders party thereto of Castlewood Holdings shares received in the recapitalization for one year, subject to certain exceptions, and provides that at the time of the recapitalization certain shareholders of Castlewood Holdings will enter into a registration rights agreement entitling them to require Castlewood Holdings to register their ordinary shares of Castlewood Holdings for resale under the United States Securities Act of 1933, as amended, beginning one year after the consummation of the merger, although Trident and certain of its affiliates have the right to register up to 750,000 shares of their Castlewood Holdings stock 90 days after the consummation of the merger. The directors of Enstar have agreed to similar transfer restrictions on their shares of Castlewood Holdings, and will receive registration rights pursuant to the same registration rights agreement.

Also on May 23, 2006, Castlewood Holdings entered into a tax indemnification agreement with Mr. Flowers pursuant to which Castlewood Holdings will reimburse and indemnify Mr. Flowers for, and hold him harmless on an after-tax basis against, any increase in Mr. Flower's U.S. federal, state or local income tax liability (including any interests or penalties relating thereto), and reasonable attorneys' fees, incurred by Mr. Flowers as a result of certain dispositions of shares of Enstar or dispositions of all or substantially all of the Enstar assets by Castlewood Holdings within the period beginning immediately after the effective time of the Merger and ending five years after the last day of the taxable year that includes the effective time.

Castlewood Holdings also has agreed, subject to consummation of the Merger Agreement, to repurchase from two directors of Enstar, T. Whit Armstrong and T. Wayne Davis, upon their request, during a 30-day window period commencing January 15, 2007, at then prevailing market prices, such number of shares as provides an amount sufficient for T. Whit Armstrong and T. Wayne Davis to pay taxes on compensation income resulting from the exercise of options in respect of a combined aggregate number not to exceed 50,000 shares repurchased.

Enstar currently owns 50% of the voting stock of Castlewood Holdings. Trident and certain members of management of Castlewood Holdings each own 25% of Castlewood Holdings' voting stock. Enstar owns an approximately 32% economic interest in Castlewood Holdings.

## **Liquidity and Capital Resources**

The Company's primary uses of liquidity include, but are not limited to, funding normal operating expenses as well as various expenses incurred in connection with the Company's search for one or more suitable acquisitions. In addition, the Company uses cash on hand to fund commitments made in connection with the purchase of its partially owned equity affiliates and other investments. The primary sources of the Company's liquidity include the receipt of dividends and distributions from partially owned equity affiliates.

Net cash provided by operating activities was approximately \$15.1 million for the nine months ended September 30, 2006 compared to net cash used in operating activities of \$1.5 million for the same period in 2005. The Company received a dividend of approximately \$20.1 million from Castlewood Holdings in April 2006 and distributions of \$33,000 from Affirmative Investment during the nine month period ending September 30, 2006.

Net cash used in investing activities was approximately \$2.6 million and approximately \$20.8 million for the nine months ended September 30, 2006 and 2005, respectively. During the nine months ended September 30, 2006, the

Company funded capital commitments of approximately \$1.9 million for its investment in J.C. Flowers II LP (the J.C. Flowers Fund ), a private investment fund formed by J.C. Flowers & Co. LLC, and received a \$56,000 return of capital from NIB Partners. During the nine month period ending September 30, 2005, the Company made capital contributions to Affirmative Investment of approximately \$8.4 million. Also in 2005, the Company purchased approximately \$9.5 million in marketable securities, a portion of which was sold for proceeds totaling approximately \$7.1 million. Net cash used in investing activities of \$795,000 and \$10.0 million for the nine months ended September 30, 2006 and 2005, respectively, represents the purchases of new certificates of deposit in excess of certificates of deposit maturing during the periods.

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Net cash provided by financing activities was approximately \$7.8 million for the nine months ended September 30, 2006. This amount represents proceeds received from the exercise of stock options in May 2006 and the tax benefit associated with the exercise of these options. There were no financing activities for the nine months ended September 30, 2005.

The Company's assets, aggregating approximately \$200.3 million at September 30, 2006, include approximately \$74.3 million in cash and cash equivalents and approximately \$20.4 million in short-term certificates of deposit. The Company believes its current liquidity is adequate to fund any foreseeable cash requirements.

## **Contractual Obligations and Commitments**

In December 2004, the Company signed a one year lease beginning January 1, 2005 on an office building at 401 Madison Avenue, Montgomery, Alabama which serves as the corporate headquarters. The lease also provides renewal options for three periods of one year each. In December 2005, the Company signed a one year renewal option beginning January 1, 2006. Additionally, pursuant to an oral agreement, the Company leases space in a warehouse at 703 Howe Street, Montgomery, Alabama on a month-to-month basis. The Company leases the office building and warehouse space from unaffiliated third parties for \$3,000 and \$350 per month, respectively. The Company believes the rental amounts are competitive with market rates and that the cancellation or termination of either of these leases would not have a material adverse effect on the Company's results of operations. In September 2005, the Company entered into an agreement with J.C. Flowers & Co. LLC continuing through October 2014 for the use of certain office space and administrative services from J.C. Flowers & Co. LLC for monthly payments of \$4,146. Either party may, at its option with or without cause, terminate this agreement upon thirty (30) days prior written notice to the other party. J.C. Flowers & Co. LLC is managed by Mr. Flowers, a member of the Company's board of directors and the Company's largest shareholder. The Company does not own any real property.

In February 2006, the Company approved a commitment of up to \$25.0 million in the J.C. Flowers Fund, a private investment fund formed by J.C. Flowers & Co. LLC. In June 2006, the commitment was accepted by the J.C. Flowers Fund. The Company's commitments may be drawn down by the J.C. Flowers Fund over approximately the next five years. The Company intends to use cash on hand to fund its commitment. In March 2006, one of the Company's partially owned equity affiliates, Castlewood Holdings, approved a commitment of up to \$75.0 million in the J.C. Flowers Fund. This commitment was also accepted by the J.C. Flowers Fund in June 2006. Castlewood Holdings intends to use cash on hand to fund its commitment. As of September 30, 2006, approximately \$1.9 million and approximately \$5.7 million of the commitments have been funded by Enstar and Castlewood Holdings, respectively.

No fees will be payable by the Company or Castlewood Holdings to the J.C. Flowers Fund, J.C. Flowers & Co. LLC, or Mr. Flowers in connection with the Company's or Castlewood Holdings' investment in the J.C. Flowers Fund.

## **Recent Developments**

In October 2006, the Company funded approximately \$3.8 million of additional capital contributions in the J.C. Flowers Fund and received a \$348,000 refund of excess contributions originally paid in August 2006. In October 2006, Castlewood Holdings funded approximately \$10.4 million of additional capital contributions in the J.C. Flowers Fund and received an approximately \$1.0 million refund of excess contributions originally paid in August 2006.

In October 2006, The Company announced that a subsidiary of its partially owned equity affiliate, Castlewood Holdings, completed the acquisition of Cavell Holdings Limited ( "Cavell" ), a U.K. company, from Dukes Place Holdings, L.P. for approximately £32 million (approximately \$60 million) . Approximately 40% of the purchase price was funded with a loan from an international bank and the remainder was paid from cash on hand. As announced on June 20, 2006, Cavell owns a U.K. and a Norwegian reinsurance company, both of which are currently in run-off.

In connection with the Merger Agreement discussed above, Castlewood Holdings filed Amendment No. 2 to its Form S-4 with the SEC on November 6, 2006.



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**Results of Operations**

The Company reported net income of approximately \$2.2 million and approximately \$6.1 million for the three and nine months ended September 30, 2006, compared to net income of \$970,000 and approximately \$1.8 million for the same periods in the prior year. The changes in net income for the three and nine month periods ended September 30, 2006 compared to the same periods in the prior year were primarily attributable to an increase in interest income and an increase in earnings from the Company's partially owned equity affiliates, offset by an increase in general and administrative expenses and income tax expense.

Interest income was approximately \$1.2 million and approximately \$3.1 million for the three and nine months periods ended September 30, 2006, respectively, compared to \$608,000 and approximately \$1.7 million for the same periods in the prior year. Interest income was earned from cash, cash equivalents and certificates of deposit. Interest income increased primarily as a result of an increase in cash resulting from the dividend received from Castlewood Holdings and an increase in interest rates earned on the Company's cash, cash equivalents and certificates of deposit.

Other investment income of \$199,000 for the nine months ended September 30, 2006 resulted from dividends received from the Company's investment in New NIB Partners LP. Other investment income of \$487,000 and approximately \$1.1 million for the three and nine months ended September 30, 2005 resulted from the gain on the sale of certain marketable securities.

Earnings of partially owned equity affiliates were approximately \$3.9 million and approximately \$10.6 million for the three and nine month periods ended September 30, 2006, respectively, compared to approximately \$1.2 million and approximately \$2.5 million for the same periods in the prior year. The Company recorded equity in earnings of \$170,000 and \$363,000 from B.H. Acquisition for the three and nine month periods ended September 30, 2006, respectively, compared to equity in earnings of \$46,000 and \$23,000 from B.H. Acquisition for the three and nine month periods ended September 30, 2005, respectively. The Company recorded equity in earnings of approximately \$3.5 million and approximately \$9.9 million from Castlewood Holdings for the three and nine months ended September 30, 2006, respectively, compared to approximately \$1.3 million and approximately \$2.6 million for the same periods in 2005. The Company recorded equity in earnings of \$198,000 and \$358,000 from Affirmative Investment for the three and nine months ended September 30, 2006. The Company reported equity in losses of \$110,000 from Affirmative Investment for the three months ended September 30, 2005, the first quarter in which Affirmative Investment reported any results from operations. In addition, the Company reported income of \$875,000, net of income taxes, as its proportionate share of the excess of the net assets acquired over the cost in the acquisition of Aioi Europe in the nine months ended September 30, 2006. For further discussion of the reasons underlying the changes in earnings (losses) from B.H. Acquisition and Castlewood Holdings, see Results of Operations Partially Owned Equity Affiliates .

Other income consists primarily of investment management fees charged to Castlewood Holdings, one of the Company's partially owned equity affiliates.

General and administrative expenses were \$745,000 and approximately \$4.2 million for the three and nine month periods ended September 30, 2006, respectively, compared to \$617,000 and approximately \$2.3 million for the same periods in 2005. Of these amounts, \$337,000 and approximately \$1.2 million related to employee expenses for the three and nine month periods ended September 30, 2006, respectively, compared to \$290,000 and \$922,000 for the same periods in 2005. Included in these amounts for the three and nine months ended September 30, 2006 are \$50,000 and \$163,000 in non-cash compensation relating to the implementation of SFAS 123R which became effective on January 1, 2006. General and administrative expenses also include legal and professional fees as well as travel expenses incurred in connection with the Company's search for one or more additional operating companies. Additionally, the Company incurs legal and professional fees in connection with reporting requirements associated

with being a publicly traded company, and in connection with handling various other accounting and tax matters. Legal and professional fees and travel expenses were \$250,000 and approximately \$3.0 million for the three and nine months ended September 30, 2006, respectively, compared to \$160,000 and \$850,000 for the same periods in 2005. The significant increase in legal and professional fees and travel expenses from 2005 to 2006 was directly attributable to expenses incurred with the plan of merger, see Plan of Merger .

Income tax expense was approximately \$2.3 million and approximately \$4.8 million for the three and nine months ended September 30, 2006, respectively, compared to \$794,000 and approximately \$1.5 million for the

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same periods in 2005. The Company's effective tax rates for 2006 and 2005 differ from the statutory rate primarily due to changes in the valuation allowance related to deferred tax assets, tax contingencies and state income taxes.

**Results of Operations Partially Owned Equity Affiliates**

Since a substantial portion of the Company's results of operations are comprised of the results of operations of Castlewood Holdings and B.H. Acquisition, the following additional summary information is provided with respect to those companies' results of operations:

***Castlewood Holdings***

Castlewood Holdings reported consolidated net earnings of \$11.0 million and \$35.2 million for the three and nine months ended September 30, 2006, respectively, compared to net earnings of \$3.8 million and \$7.9 million for the same periods in 2005. The increase in earnings of \$27.3 million for the nine months ended September 30, 2006 was due to a combination of increased investment income, foreign exchange gains and negative goodwill offset by increased salary costs, general and administrative expenses and minority interest.

Castlewood Holdings earned consulting fees of \$9.4 million and \$21.0 million for the three and nine months ended September 30, 2006, respectively, compared to \$5.2 million and \$13.5 million for the same periods in 2005. Castlewood Holdings generates its consulting fees based on a combination of fixed and success based fee arrangements. Consulting income will vary dependent on the success and timing of completion of success based fee arrangements. Included in these amounts were \$313,000 and \$938,000 in consulting fees charged to B.H. Acquisition, a related party, for each of the three and nine months ended September 30, 2006 and 2005, respectively. The increase for the three and nine months ended September 30, 2006 as compared to the same periods for 2005 was due primarily to an increase in success based fees earned.

Net investment income, including realized gains and losses, was \$12.7 million and \$33.4 million for the three and nine months ended September 30, 2006, respectively, compared to net investment income of \$7.9 million and \$21.1 million for the same periods in 2005. Investment income is primarily comprised of interest income earned from cash and cash equivalents and debt securities. The increase in income for the nine months ended 2006 as compared to the same period in 2005 is attributable to an increase in interest rates during the period. In addition, total cash and investments held by Castlewood Holdings increased from \$911.2 million at September 30, 2005 to \$1,084.7 million at September 30, 2006.

Net reduction in loss and loss adjustment expense liabilities were \$3.9 million and \$10.7 million for the three and nine months ended September 30, 2006, respectively, compared to \$1.0 million and \$6.5 million for the same periods in 2005. The increase for the three and nine months ended September 30, 2006 over the same periods in 2005 is due primarily to the inclusion of Brampton which was acquired in March 2006.

Salaries and benefits were \$8.0 million and \$22.4 million for the three and nine months ended September 30, 2006, respectively, compared to \$6.1 million and \$18.5 million for the same periods in 2005. Castlewood Holdings is a service based company and as such employee salaries and benefits are its largest cost. The increased cost for the three and nine months ended September 30, 2006 as compared to the same periods for 2005 is mainly attributable to the growth in staff of Castlewood Holdings. Additionally, Castlewood Holdings has an annual incentive compensation plan included as part of its employee compensation.

General and administrative expenses were \$4.2 million and \$12.3 million for the three and nine months ended September 30, 2006, respectively, compared to \$3.2 million and \$9.4 million for the three and nine months ended September 30, 2005. General and administrative expenses include rent and rent related costs, professional fees (legal,

investment, audit and actuarial) and travel expenses. Castlewood Holdings operates in the United States, United Kingdom and Bermuda and staff travel frequently in connection with Castlewood Holdings search for acquisition opportunities and in the general management of the business.

Castlewood Holdings has recorded a foreign exchange gain of \$947,000 and \$8.9 million for the three and nine months ended September 30, 2006, respectively, compared to foreign exchange losses of \$223,000 and \$2.4 million for the same periods in 2005. Through its subsidiaries, Castlewood Holdings conducts business in a variety of non-U.S. currencies, the principal exposures being Euros and British pounds. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of Castlewood Holdings are adjusted to reflect the current exchange rate. Revenue and expense items are translated into U.S. dollars at average rates of

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exchange for the periods. The resulting exchange gains or losses are included in net earnings. During the quarter ended June 30, 2006, Castlewood Holdings had a large unmatched position in British pounds relating to its acquisition of Brampton which was completed on March 30, 2006. This unmatched position was addressed on May 5, 2006 by converting surplus British pounds into U.S. dollars resulting in a realized foreign exchange gain of approximately \$6.7 million.

Castlewood Holdings share of earnings from its partly-owned companies was \$232,000 and \$495,000 for the three and nine months ended September 30, 2006, respectively, and \$63,000 and \$142,000 for the same periods in 2005. In 2006 this amount represented Castlewood Holdings' proportionate share of equity in the earnings of B.H. Acquisition. For 2005 it represented Castlewood Holdings' proportionate share of equity in the earnings of B.H. Acquisition and Cassandra Equity LLC.

Interest expense was \$362,000 and \$894,000 for the three and nine months ended September 30, 2006. The interest expense relates to the interest expense on the credit facility entered into by Hillcot Holdings Ltd. and the interest expense on the vendor loan note payable of £12 million (\$20.9 million) that formed part of the consideration paid in connection with the purchase of Brampton. The vendor loan note was repaid on May 5, 2006.

Income taxes of \$1.0 million and \$239,000 for the three and nine months ended September 30, 2006, respectively, compared to \$285,000 and \$1.6 million for the three and nine months ended September 30, 2005. Under current Bermuda law, Castlewood Holdings and its Bermuda subsidiaries are not required to pay taxes in Bermuda on either income or capital gains. Castlewood Holdings and its Bermuda subsidiaries have received an undertaking from the Bermuda government that, in the event of income or capital gains taxes being imposed, Castlewood Holdings and its Bermuda subsidiaries will be exempted from such taxes until the year 2016. United Kingdom and United States subsidiaries record income taxes based on their graduated statutory rates, net of any tax loss carryforwards that may be available.

Minority interest of \$2.6 million and \$7.8 million for the three and nine months ended September 30, 2006, respectively, compared to \$439,000 and \$1.4 million for the same periods in 2005. For the nine months ended September 30, 2006, the minority interest recorded represents the minority shareholders' 49.9% share of the net earnings of Hillcot Re Limited (Hillcot Re) and Brampton. For the nine months ended September 30, 2005 it represents the share of net earnings for Hillcot Re only.

Negative goodwill was \$4.3 million (net of minority interest of \$4.3 million) for the nine months ended September 30, 2006. On March 30, 2006 the Company acquired Brampton's fair valued net assets of \$117.9 million for total consideration of \$109.2 million (£62 million). The excess has, in accordance with SFAS 141, been recognized as an extraordinary gain. The fair values of the reinsurance assets and liabilities acquired are derived from probability weighted ranges of the associated projected cash flows, based on actuarially prepared information and management run-off strategy. If the assumptions made in initially valuing the assets change significantly in the future, Castlewood Holdings may be required to record impairment charges which could have a material impact on the financial statements.

***B.H. Acquisition***

B.H. Acquisition reported net income of \$516,000 and \$1.1 million for the three months and nine months ended September 30, 2006, respectively, compared to \$139,000 and \$68,000 for the same periods in 2005.

Net investment income was \$1.3 million and \$3.1 million for the three and nine months ended September 30, 2006, respectively, compared to \$680,000 and \$1.6 million for the same periods in 2005. The principal source of net investment income was interest income earned from cash, cash equivalents and mutual funds. The increase in income

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for the nine months ended September 30, 2006 as compared to the same period in 2005 is due to an increase in the average cash balances for the 2006 period as compared to the 2005 period along with an increase in interest rates.

B.H. Acquisition had a net increase in loss and loss adjustment expense liabilities of \$337,000 and \$1.0 million for the three and nine months ended September 30, 2006, respectively, compared to \$290,000 and \$870,000 for the same periods in 2005.

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General and administrative expenses were \$658,000 and \$1.8 million for the three and nine months ended September 30, 2006, respectively, compared to \$601,000 and \$1.6 million for the same periods in 2005. General and administrative expenses include legal, audit, management and actuarial expenses.

B.H. Acquisition recorded a foreign exchange loss of \$1,000 and a foreign exchange gain of \$80,000 for the three and nine months ended September 30, 2006, respectively, compared to a foreign exchange gain \$16,000 and a foreign exchange loss of \$40,000 for the same periods in 2005. Through its subsidiaries B.H. Acquisition conducts business in a variety of foreign (non-U.S.) currencies, the principal exposures being Euros and British pounds. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of B.H. Acquisition are adjusted to reflect the current exchange rate. Revenue and expense items are translated into U.S. dollars at average rates of exchange for the years. The resulting exchange gains or losses are included in net income.

Amortization of the run-off provision was \$250,000 and \$750,000 for the three and nine months ended September 30, 2006, respectively, compared to \$334,000 and \$1.0 million for the same periods in 2005. The Company established a provision at the date of acquisition equal to the anticipated expenses to be incurred over the expected life of the run-off. This provision is amortized on a straight-line basis over this period. In 2005 an additional provision of \$667,000 was established and the expected life of the run-off was extended one year.

**Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

The Company is exposed to market risk from changes in interest rates. At September 30, 2006, the Company had cash and cash equivalents of approximately \$74.3 million in interest bearing accounts (interest at floating rates) and approximately \$20.4 million of short-term certificates of deposit (interest at fixed rates). Accordingly, each one percent change in market interest rates would change interest income by approximately \$947,000 per year. However, any future transactions affecting the Company's cash and cash equivalents and certificates of deposit will change this estimate. Additionally, although interest rate changes would affect the fair value of the Company's certificates of deposits, the weighted average original term of certificates held by the Company at September 30, 2006 is approximately two months. The short-term nature of these certificates limits the Company's risk of changes in the fair value of these certificates.

The Company is also exposed to three types of market risk through its holdings in partially owned equity affiliates and their subsidiaries: interest rate risk, foreign currency risk and credit risk.

Castlewood Holdings and B.H. Acquisition's investments in mutual funds are exposed to interest rate risk. A 100 basis point shift in interest rates was estimated to affect the market value of the mutual funds by approximately .6% at December 31, 2005.

Castlewood Holdings is exposed to credit risk on its holdings of fixed income securities and mutual funds. To minimize this risk, its investment guidelines have been defined to ensure that the fixed income held-to-maturity portfolio is invested in high quality securities. Castlewood Holdings and B.H. Acquisition are also exposed to credit risk on their reinsurance balances receivable. In the event that all or any of the reinsuring companies are unable to meet their obligations under existing reinsurance agreements, Castlewood Holdings and B.H. Acquisition will be liable for such defaulted amounts.

Foreign currency risk is the risk that the Company will incur economic losses due to adverse changes in foreign currency exchange rates. Castlewood Holdings and B.H. Acquisition conduct business in a variety of foreign (non-U.S.) currencies, the principal exposures being in Euros and British pounds. Assets and liabilities denominated in foreign currencies are exposed to risk stemming from changes in currency exchange rates. These entities attempt to

manage their exposure to foreign currency exchange risk by broadly matching assets against liabilities. Exchange rate fluctuations impact the Company's and its partially owned equity affiliates' reported consolidated financial condition, results of operations and cash flows from year to year.

**Item 4. *Controls and Procedures***

As required by Securities and Exchange Commission (SEC) rules, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this quarterly report. This evaluation was carried out under the supervision and with the participation of the Company's management, including its principal executive officer and principal financial officer. Based on this



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evaluation, these officers have concluded that the design and operation of the Company's disclosure controls and procedures are effective. There were no changes to the Company's internal controls over financial reporting during the period covered by this report that materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting subsequent to the date of their evaluation.

Disclosure controls and procedures are the Company's controls and other procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported, within the time periods specified in SEC rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act are accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

**Table of Contents****PART II****OTHER INFORMATION****Item 6. Exhibits**

<b>Reference Number</b>	<b>Description of Exhibits</b>
2.1	Agreement and Plan of Merger, dated as of May 23, 2006, among the Company, Castlewood Holdings Limited and CWMS Subsidiary Corp. (incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K dated May 23, 2006).
3.1	Articles of Incorporation of the Company, as amended on June 10, 1998 (incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q, dated August 4, 1998).
3.2	Bylaws of the Company, as amended on May 20, 1999 (incorporated by reference to Exhibit 3.2 to the Quarterly Report on Form 10-Q, dated August 6, 1999).
4.1	Rights Agreement between the Company and American Stock Transfer & Trust Company, as Rights Agent, dated as of January 20, 1997 (incorporated by reference to Exhibit 4.1 to Amendment No. 2 to the Registration Statement on Form 10, dated March 27, 1997).
4.2	Amendment Agreement, dated as of October 20, 1998, to the Rights Agreement, dated as of January 20, 1997, between the Company and American Stock Transfer & Trust Company (incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K dated October 20, 1998).
10.1	Recapitalization Agreement, dated as of May 23, 2006, among the Company, Castlewood Holdings Limited and other parties thereto. (incorporated by reference to Exhibit 2.2 to the Current Report on Form 8-K dated May 23, 2006).
10.2	Support Agreement, dated as of May 23, 2006, among Castlewood Holdings Limited, J. Christopher Flowers, Nimrod T. Frazer and John J. Oros. (incorporated by reference to Exhibit 2.3 to the Current Report on Form 8-K dated May 23, 2006).
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted under Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

The Enstar Group, Inc.

By: /s/ Cheryl D. Davis

Cheryl D. Davis

*Chief Financial Officer, Vice President*

*of Corporate Taxes, Secretary*

*(Authorized Officer)*

*(Principal Financial Officer)*

Date: November 9, 2006